Washington Policy Flash Note

Bernanke's Friday Night Speech Caps Off His Dovish Week, QE3 Through 2013

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Isaac Boltansky
202.534.1396
iboltansky@compasspointllc.com

On the evening of March 1, just shortly before the budget sequester was officially in effect, Ben Bernanke delivered a speech titled: "Long-Term Interest Rates." The speech had all the makings of an event that would fly under the radar: it was scheduled for late on Friday evening and Bernanke had testified twice earlier in the week, thereby satisfying the markets appetite for Fed Speak. A review of the speech, however, reinforces our view that the Federal Reserve will not take its foot off the QE pedal in the near-term.

The speech itself delivers a detailed inspection of the components and drivers of long-term interest rates as well as commentary regarding how interest rate policy may evolve. Following Bernanke's third – and perhaps most substantive – appearance of the week, we remain confident that the FOMC will remain committed to QE throughout 2013.

We have included below a number of excerpts we view as noteworthy or representative of Bernanke's current policy stance.

- "Let's recap. Long-term interest rates are the sum of expected inflation, expected real short-term interest rates, and a term premium. Expected inflation has been low and stable, reflecting central bank mandates and credibility as well as considerable resource slack in the major industrial economies. Real interest rates are expected to remain low, reflecting the weakness of the recovery in advanced economies (and possibly some downgrading of longer-term growth prospects as well). **This weakness, all else being equal, dictates that monetary policy must remain accommodative if it is to support the recovery and reduce disinflationary risks.** Put another way, at the present time the major industrial economies apparently cannot sustain significantly higher real rates of return; in that respect, central banks--so long as they are meeting their price stability mandates--have little choice but to take actions that keep nominal long-term rates relatively low…"

- "Premature rate increases would carry a high risk of short-circuiting the recovery, possibly leading--ironically enough--to an even longer period of low long-term rates. **Only a strong economy can deliver persistently high real returns to savers and investors, and the economies of the major industrial countries are still in the recovery phase.**"

- "Let me finish with some thoughts on balancing the risks we face in the current challenging economic environment, at a time when our main policy tool, the federal funds rate, is near its effective lower bound… The balance here is not an easy one to strike. While the recent crisis is vivid testament to the costs of ill-judged risk-taking, we must also be aware of constraints posed by the present state of the economy. **In light of the moderate pace of the recovery and the continued high level of economic slack, dialing back accommodation with the goal of deterring excessive risk-taking in some areas poses its own risks to growth, price stability, and, ultimately, financial stability.** Indeed, as I noted, a premature removal of accommodation could, by slowing the economy, perversely serve to extend the period of low long-term rates."

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