DAILY GLOBAL COMMENTARY

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Fed's Exit Strategy – A Deft and Fortunate Fed?

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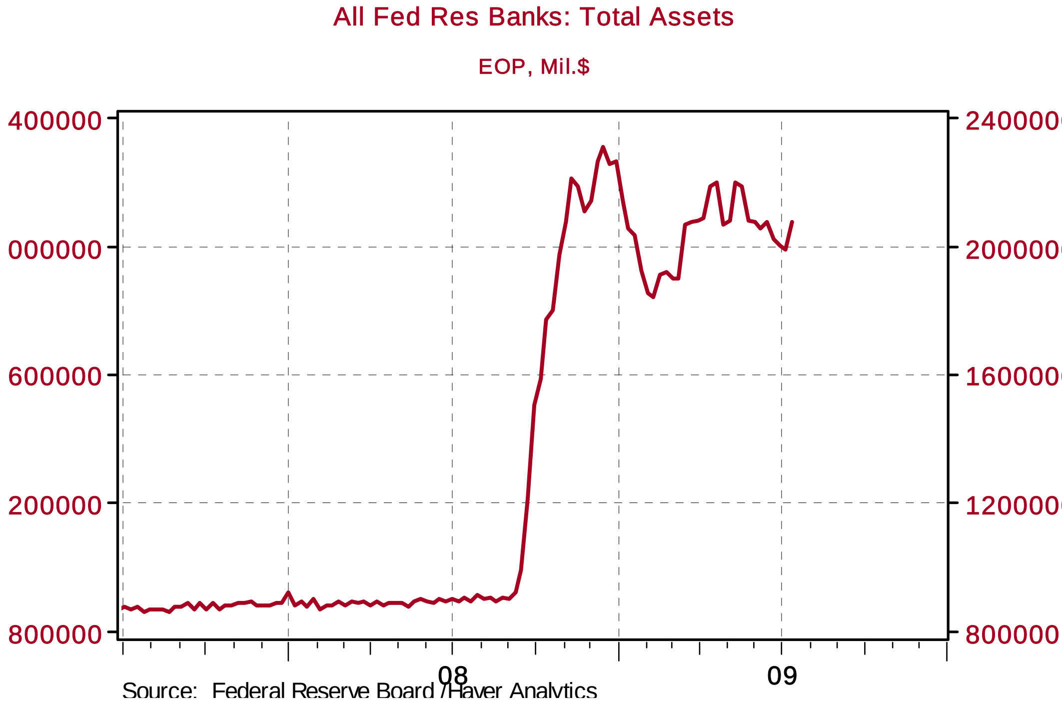
Chairman Bernanke's testimony and Wall Street Journal article outlined the Fed's exit plan and addresses his critics with regard to a lack of transparency about the exit strategy. There is no doubt the Fed will be able and has the tools to unwind the massive monetary stimulus in place at the present time.

Chart 1



More importantly, the question is if the Fed can identify the appropriate "time" and "magnitude" of monetary policy tightening. There is no precise checklist to guide a central bank about when and by how much to tighten monetary policy. The Fed's steps will entail judgments as the economy stabilizes and moves along a new growth path.

Going back in time, there are two cases that come to mind. First, is the case of 1937 when unsuitable and hasty monetary and fiscal policy changes halted the recovery of the economy and reversed course such that the economy recorded the second leg of the downturn during 1937-38 (see chart 2). The main lesson from this experience is to avoid the mistakes of this period. The Fed raised the reserve requirements in July 1936 to reduce excess reserves banks were holding which it viewed as a threat to price stability. During this time period, banks were overwhelmed with fear about financial panics and wanted to hold excess reserves. When the Fed raised reserve requirements and excess reserves of banks were reduced, they stopped lending. This, in turn, led to another period of economic decline.

Chart 2

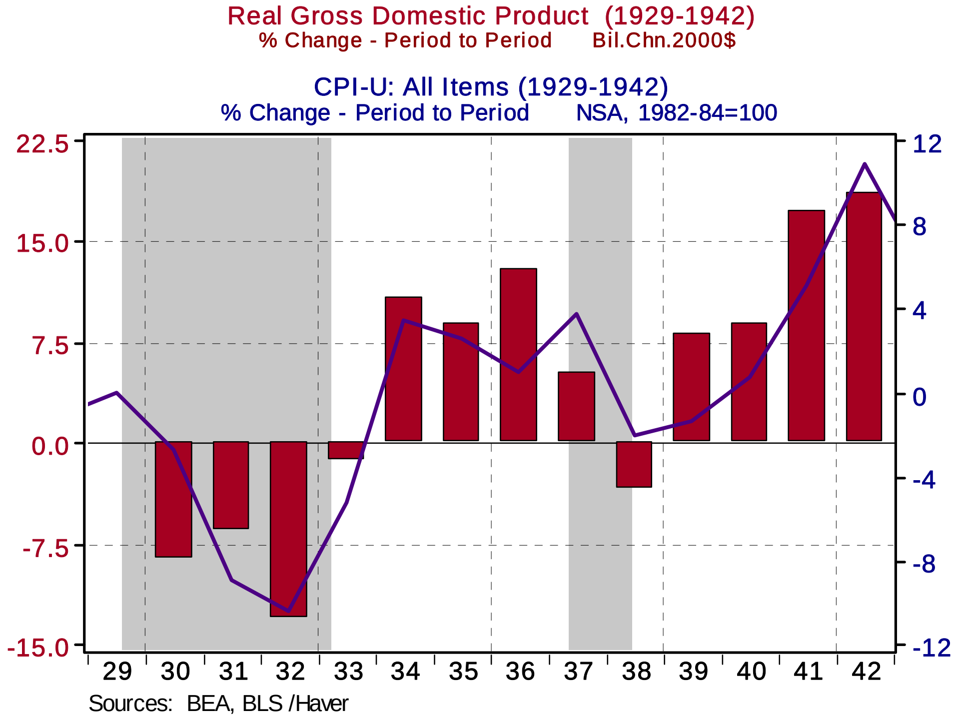
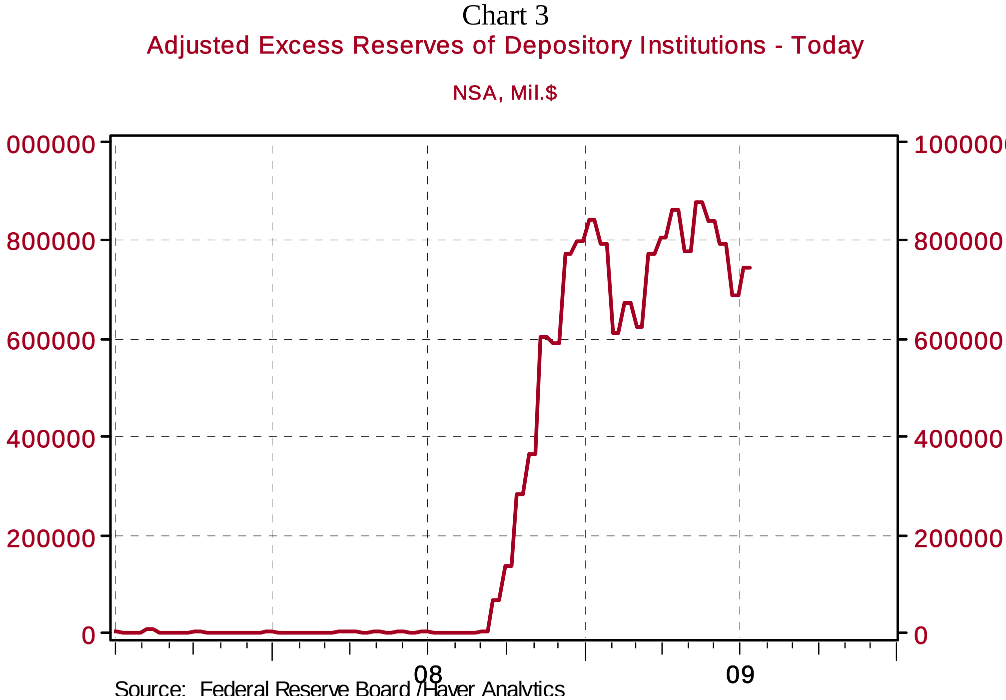


Chart 3



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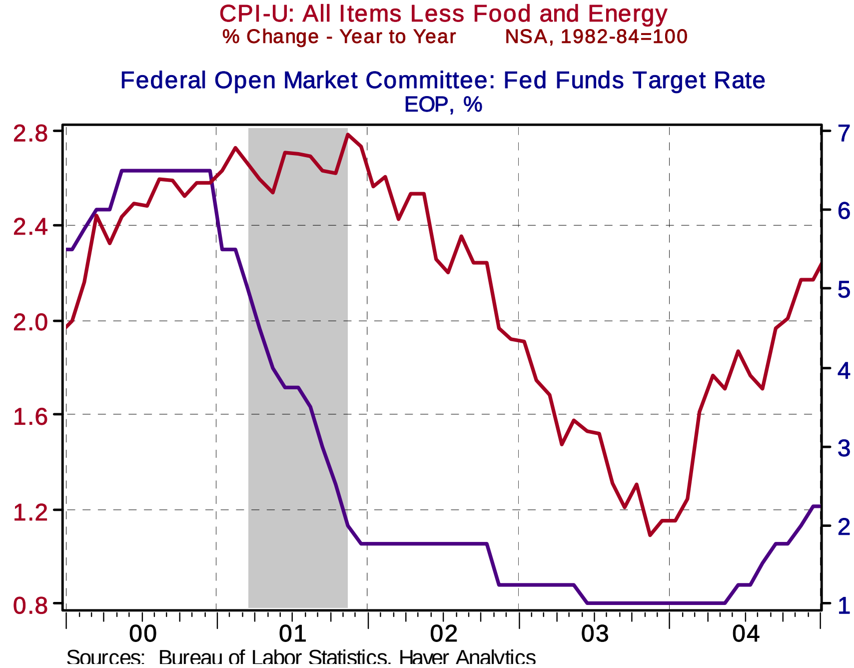
The second case is the more recent episode when the Fed held the federal funds rate at 1.00% from June 2003 to June 2004 in order to prevent a deflationary situation from taking hold. This stance of the Fed has come under severe scrutiny and has been identified as an incorrect policy posture in terms of the duration of an easy policy which eventually led to the housing market boom.

Chart 4



Based on the 1936/37 experience, the Fed will err on the side of delaying tightening, while the 2003/2004 episode suggests that the Fed will have to weigh the risks of maintaining easy monetary policy for an extended period. Both these historical episodes indicate the Fed is not infallible and suggests that the timing and magnitude of monetary policy changes is a tight rope walk. Therefore, it appears that the Fed will have to be not only deft but also lucky to be successful in the management of monetary policy in the months ahead. It is well-known, that the Fed has not been preemptive and has applied monetary policy brakes too late and too strong in the post-war period, with the exception of the 1995 soft-landing event.

Noteworthy excerpt's from Bernanke's testimony:

The Economy: ***"****The U.S. economy contracted sharply in the fourth quarter of last year and the first quarter of this year. More recently, the pace of decline appears to have slowed significantly, and final demand and production have shown tentative signs of stabilization. The labor market, however, has continued to weaken. Consumer price inflation, which fell to low levels late last year, remained subdued in the first six months of 2009."*

Risk –*"Job insecurity, together with declines in home values and tight credit, is likely to limit gains in consumer spending. The possibility that the recent stabilization in household spending will prove transient is an important downside risk to the outlook."*

Inflation*: "All participants expect that inflation will be somewhat lower this year than in recent years, and most expect it to remain subdued over the next two years."*

Monetary Policy*: "The FOMC anticipates that economic conditions are likely to warrant maintaining the federal funds rate at exceptionally low levels for an extended period.*

In light of the substantial economic slack and limited inflation pressures, monetary policy remains focused on fostering economic recovery. Accordingly, as I mentioned earlier, the FOMC believes that a highly accommodative stance of monetary policy will be appropriate for an extended period."

The options the Fed has in its arsenal to tighten monetary policy are discussed in Bernanke's article in the Wall Street Journal (Bernanke Op-ed in WSJ: The Fed's Exit Strategy - WSJ.com). To be sure, the Fed is not limited to these alternatives only.