TrendMacro

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TRENDMACRO LIVE!

On the June FOMC

Wednesday, June 20, 2012

Donald Luskin

The Fed did all it could without growing its balance sheet -- that's for the August meeting.

As we have expected since March (see "On the March FOMC" March 13, 2012), today the FOMC announced new easing action -- in the form of a $267 billion continuation of its maturity extension program "Operation Twist," taking it to year-end rather than letting it expire at this month-end (please see the chart below).

Great… add yet another element to the year-end "fiscal cliff" (see "What Could Possibly Go Worng?" March 8, 2012). That irony aside, we are surprised -- no, *mystified* -- that the easing action announced today was not bigger, in light of deteriorating macro conditions (see "On the May Jobs Report" June 1, 2012) and the politics, philosophies and public statements of the most influential FOMC members (see "On FedSpeak" June 7, 2012).

- It's all the more surprising considering the darkening view taken qualitatively in today's FOMC statement, and quantitatively in the FOMC members' economic forecasts.

Update to strategic view

US FED: "Operation Twist" was continued through year-end with $267 billion. This is less easing than we expected, and small given the FOMC's darkening outlook. The Fed was unwilling to outright expand its balance sheet at this time. We expect the stagnant economy and the upcoming election to force the Fed to do so at the August or September meeting.

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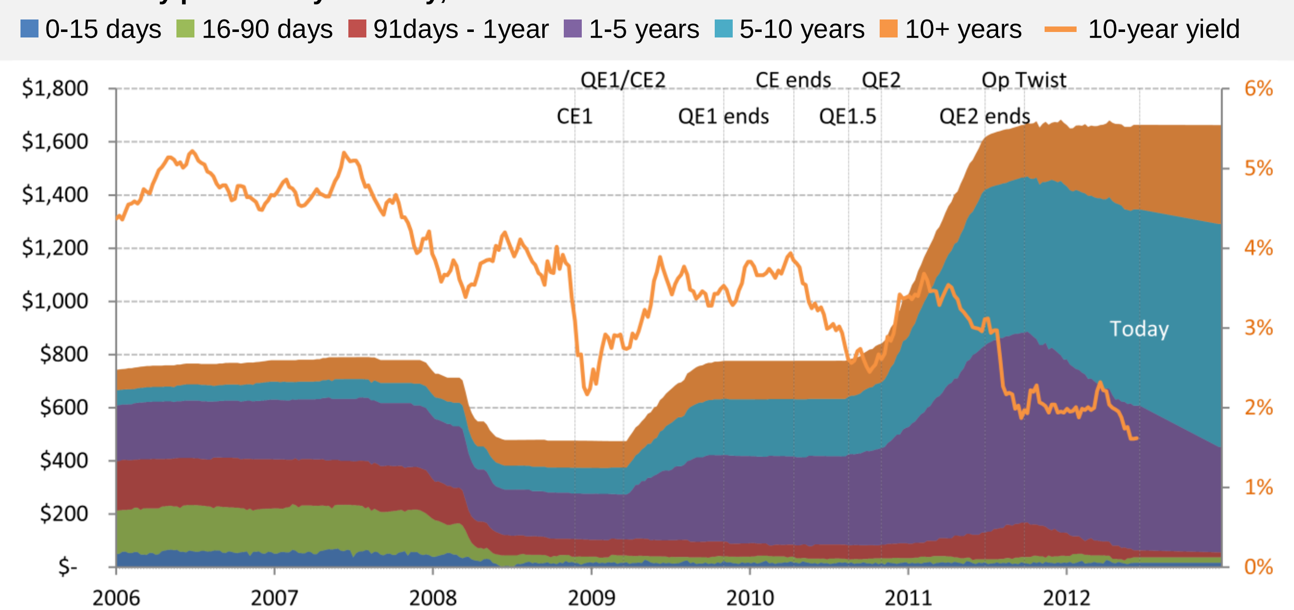
Fed treasury portfolio by maturity, USD billions

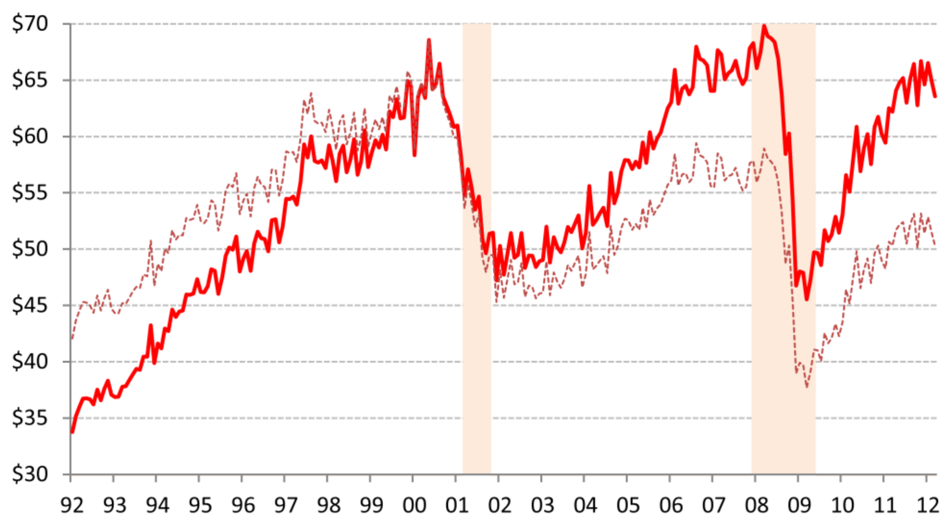


Source: Federal Reserve, TrendMacro calculations

- Versus the statement from the April meeting (see "On the April FOMC" April 25, 2012), the FOMC's characterization of the labor market has gone from "improved in recent months" to "slowed in recent months."
- Household spending has gone from "continued to advance" to "rising at a somewhat slower pace."
- The FOMC claims, as last meeting, that business spending has "continued to advance." That's a strange one to leave unmodified, considering that it wasn't true in April and it's less true now (please see the chart below).

New orders, non-defense cap goods ex-aircraft, USD bil

Nominal ··· Real Recession



Source: Census Bureau, BLS, NBER, TrendMacro calculations

- Once again, as in every FOMC statement since last September's, financial strains emanating from Europe pose "significant downside risks to the economic outlook."
- In the FOMC members' forecasts, 2013 real GDP growth was sharply downgraded to a range of 2.2% to 2.8%, from April's 2.7% to 3.1%.
- Unemployment forecasts moved higher, to a range of 7.5% to 7.8%, from April's 7.3% to 7.7%.
- The FOMC now believes "inflation over the medium term will run at or below" its target rate. In April it was forced to argue that energy prices would "affect inflation only temporarily," and that a return to the target would only happen "subsequently."

So with macro conditions deteriorating -- and inflation not acting as a binding constraint -- we must conclude that the Fed did as much as it felt it could today, *staying within the established framework of the existing maturity extension program*. It *was* willing to act, but *not in a way that would outright expand its balance sheet*. This was crystal clear from Ben Bernanke's responses to repeated questions in today's post-FOMC press conference, asking why the Fed didn't do more in light of its pessimistic outlook.

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Recommended Reading

The Long Shadow of Ordoliberalism: Germany's Approach to Euro Crisis
Sebastien Dullien and Ulrike Guérot
European Council on Foreign Relations Policy Brief
July 2012

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- That will come at the next FOMC meeting, unless conditions improve between now and then. Today's statement is unambiguous on that, completely dropping the prior statement's familiar warning that it will "review the size and composition of its securities holdings" -- this time saying only that "it is prepared to take further action as appropriate."

Bottom line

"Operation Twist" was continued through year-end with $267 billion. This is less easing than we expected, and small given the FOMC's darkening outlook. The Fed was unwilling to outright expand its balance sheet at this time. We expect the stagnant economy and the upcoming election to force the Fed to do so at the August or September meeting.