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Bernanke May Face ’Self-Induced Paralysis’

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As a Princeton University professor, Ben Bernanke castigated the Bank of Japan in 2000 for a “case of self-induced paralysis” that led to a decade of stagnation. Now, the Federal Reserve chairman may be allowing the U.S. central bank to fall into the same trap after its second round of quantitative easing ends this month.

By all but ruling out another cycle of bond purchases, Fed officials have left themselves with little in the way of policy options to respond to slowing growth and rising unemployment. This raises the risk that the U.S. will remain saddled with what Bernanke himself has called a “frustratingly” sluggish recovery that leaves millions of Americans out of work.

“I worry that QE3 will be hostage to QE2,” said Vincent Reinhart, a former director of the Fed’s monetary-affairs division who is now a scholar at the American Enterprise Institute in Washington. “That may lead to that self-induced paralysis” in further easing policy to aid the economy.

Fed officials, who begin a two-day meeting tomorrow to plot monetary strategy, are betting the slowdown will prove short- lived and growth will pick up from July through December as shocks from Japan’s earthquake and an oil-price surge fade.

GDP Outlook

Private economists agree. After growing at a 2.3 percent annual pace this quarter, the world’s largest economy will expand at a 3.2 percent rate in the second half of the year, according to the median forecast of 67 economists surveyed by Bloomberg News from June 1 to June 8.

Economist Allen Sinai, who sees growth strengthening to between 2.5 percent and 3 percent in the second half and 3 percent in 2012, called the recent stock-market swoon a “consolidation” and forecast that the Standard and Poor’s 500 Index of stocks will rise as high as 1,450 by the end of the year. It was at 1,271.50 on June 17.

The president of Decision Economics in New York also said the "new trading range" for the yield on the 10-year Treasury note is 2.75 percent to 3.375 percent as the Fed responds to the recent economic slowdown by putting off any move to tighten credit until next year. The yield was 2.91 percent as of 9:54 a.m. in London, according to Bloomberg Bond Trader prices.

The danger is that, once again, forecasts for an improved economy prove too optimistic. Economists polled by Bloomberg began 2011 looking for 3.1 percent expansion this year; they now predict a 2.5 percent rate. Fed policy makers are likely to follow suit this week.

"The last batch of data is disappointing, and it is causing us to rethink our outlook for growth for the remainder of the year," Jeffrey Lacker, president of the Federal Reserve Bank of Richmond, told reporters on June 13.

Shaved Forecast

The central bankers may cut their estimate for this year to 2.75 percent from the 3.1 percent to 3.3 percent they foresaw in April, said Laurence Meyer, a former Fed governor who is now vice chairman of St. Louis-based Macroeconomic Advisers.

They probably also will shave their forecast for 2012, by a couple of tenths of a percentage point, he added. In April, the bulk of policy makers saw growth of 3.5 percent to 4.2 percent next year.

The odds have doubled in the last few months to 10 percent that the U.S. will suffer a growth recession -- with gross domestic product rising at an annual pace of about 1 percent for two or more quarters while other economic indicators remain soft, Sinai said.

"If I were at the Fed, I'd be looking at ways to do something like QE3," he added.

Fed officials don't seem so inclined.

"We've done enough," Federal Reserve Bank of Dallas President Richard Fisher said in a June 13 speech.

Dangers of Deflation

The successes and failures of QE2 have diminished chances of QE3. When Bernanke first raised the possibility of a second round of stimulus last August, he stressed the central bank's determination to avoid deflation: an across-the-board fall in consumer prices and wages that would drive the economy down.

Such concerns have since dissipated as surging oil and food prices have driven up inflation and inflation expectations, said Roberto Perli, a former Fed economist who is now a managing director at International Strategy & Investment Group in Washington.

Consumer prices rose at a rate of 3.6 percent in May from a year earlier, compared with a 1.1 percent advance in November, when the central bank began its purchases of $600 billion worth of Treasury securities.

Further Action

The bond buys have had less of a discernible impact on GDP, raising questions inside the Fed about the efficacy of further action, Sinai said. While the purchases did lift stock prices and household wealth, consumer spending has lagged behind, dragging the growth of the overall economy down to 1.8 percent in the first quarter from 3.1 percent in the final three months of 2010.

The political opposition to QE2 -- Congressional Republicans have attacked it as an inflationary policy -- also weighs against the launch of QE3, especially at a time when fiscal policy makers are squabbling over the budget and debt ceiling.

“There are some political constraints that inhibit their willingness to do more,” said Michael Feroli, chief U.S. economist for JPMorgan Chase & Co. in New York and a former member of the Fed's economic forecasting team.

While voicing frustration with the slow pace of the recovery, Bernanke gave no hint he's ready to do anything about it in a June 7 speech in Atlanta. Instead, he spoke of the limits on the Fed, declaring that “monetary policy cannot be a panacea” for all the economy's ills.

Real-Estate Bubble

In a paper Bernanke wrote while at Princeton in 2000, he took Bank of Japan officials to task for saying they had done all they could to help an economy that had grown about 1 percent a year in the previous decade after the country's real-estate bubble burst.

While agreeing Japan faced structural problems that monetary policy couldn't solve, including a broken banking system, Bernanke argued the central bank could do more to pump up demand beyond cutting short-term interest rates to zero.

Among the steps he discussed were "nonstandard open-market operations," including the purchase of Japanese government bonds -- just the sort of strategy the U.S. pursued under QE2.

"The Fed has been a lot more proactive than the Bank of Japan was back then," said Alan Blinder, a former central bank vice chairman who is now a professor at Princeton University in New Jersey.

'Too Passive'

Still, the Fed "is a little too passive" now for Blinder's tastes. He wants it to cut to zero from 0.25 percentage point the interest rate it pays banks on the excess reserves it holds for them. To encourage the banks to deploy that money elsewhere, the Fed could go even further and effectively charge them for holding the reserves through a negative interest rate, said Blinder, a former colleague of Bernanke's at Princeton, who acknowledged such a radical step isn't likely.

"I don't think that the Fed has any options left that it's at all likely to use," Blinder said.

Bernanke instead may suggest at his June 22 press conference that he will keep short-term interest rates low for longer, according to Perli.

"It is becoming increasingly likely that the Fed will be on hold until 2013," he said.

The Fed cut its target for the federal funds rate -- which banks charge each other for overnight money -- to between zero and 0.25 percent in December 2008 and then followed in March 2009 with a declaration that rates were likely to remain "exceptionally low" for an "extended period."

Big Balance Sheet

Feroli, who doesn't expect the Fed will raise rates until 2013, said the central bank may decide to make the same sort of statement about the size of its balance sheet if the economy fails to pick up in the next few months.

One option, according to Feroli: The central bank could commit to maintaining an enlarged balance sheet for an extended period, thus reassuring investors it won't be quick to reduce its holdings of securities such as Treasuries.

A delayed tightening of policy is effectively a form of easing because it acts to restrain long-term interest rates on everything from home mortgages to corporate bonds, Meyer said. The impact, though, is smaller and less persistent than actual easing through additional bond purchases or a reduction in the funds rate, he added.

Bernanke defended the Fed's performance at a press conference following the central bank's last meeting in April.

'Extraordinary Things'

"We have done extraordinary things in order to try to help this economy recover," he said, pointing to the near-zero fed funds rate and two rounds of securities purchases.

The U.S. is on firmer ground than it was last year when the Fed started discussing QE2, according to Neal Soss and his fellow economists at Credit Suisse Holdings USA Inc.

"An extra year of economic growth, profits, retained earnings and cash holdings has added a layer of insulation for the corporate sector," they wrote in a June 10 note to clients. Soss, the bank's chief economist in New York, served as an aide to former Fed Chairman Paul Volcker.

The recent rise in core inflation may have convinced Bernanke to hold off on QE3 for now, said Joseph Gagnon, a former Fed official who is now a senior fellow at the Peterson Institute for International Economics in Washington. Excluding food and energy costs, consumer prices increased at a rate of 1.5 percent in May from a year earlier, up from 0.6 percent in October.

'Transitory' Increase

If the increase proves “transitory” -- as Bernanke has suggested -- then the central bank should push ahead with more bond purchases, Gagnon said, adding that “the unemployment rate is just way too high.” Joblessness was 9.1 percent in May, compared with a 5 percent rate in December 2007 when the last recession began.

If Bernanke says the “little blip in inflation is temporary and it’s going to go back below target, and he says he’s very unhappy with the unemployment rate, then why isn’t he doing more?” Gagnon asked. “It’s really ironic. It’s a self- induced paralysis.”

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