WELLS FARGO ADVISORS

The Week

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The Fed is ready and able

Many investors are worried that the economy is headed for a double-dip recession and believe the Fed is powerless to prevent it. We disagree. In fact, Fed Chairman Bernanke, speaking at the Kansas City Fed's annual conference on monetary policy, repeated that the Fed has the tools and is ready to use them to support the economy if needed.

As Labor Day approaches, summer is coming to a close, families are returning from vacations and children are returning to school. One of the final rituals of summer is the annual conference on monetary policy hosted by the Kansas City Federal Reserve in Jackson Hole, Wyoming. Every August, the Kansas City Fed invites U.S. and foreign policymakers to this beautiful resort to discuss the state of the economy and policymakers' options. When the economy is healthy, these discussions often seem academic, and the news media pays little attention to what is discussed. However, when the economy is weak, as it is now, these meetings are widely monitored for any signals about the Fed's intentions. This year, Fed officials knew that many investors were listening and used this opportunity to manage expectations and dampen concerns about deflation.

Deflation (declining asset values and falling consumer prices) is a major concern to investors because it destroys wealth, leaving people with debt burdens that do not decline in value when asset prices drop. At the other end of the economic spectrum, inflation (rising asset values and consumer prices) reduces debt burdens because inflation boosts incomes making it easier to pay debts. The Fed's job is to prevent both deflation and inflation. Deflation is caused by too little credit, whereas inflation is caused by too much credit. The Fed tries to provide just enough credit to keep the economy growing, avoiding deflation and inflation along the way. It was just a year ago that the Fed was being criticized for doing too much to boost the economy, causing inflation expectations to increase. Now the Fed is being criticized, because investors believe policymakers have run out of bullets and cannot prevent deflation.

One of the many problems that policymakers confront is that investors' actions can negate the Fed's efforts. Investors, who were worried about inflation last year, caused long-term interest rates to go up just when the Fed was trying to keep interest rates low. Investors, who are worried about deflation today, have reduced spending, just when the economy needs more spending.

This shows that the reaction to Fed policy is frequently as important as what the Fed is actually doing to help the economy. Therefore, the Fed needs to manage expectations to prevent any adverse reactions that would make its policy ineffective. For example, a year ago when the Fed was trying to boost economic activity, policymakers had to talk about how they would remove excess liquidity once it was no longer needed. This discussion of its exit strategy was designed to reduce inflation concerns to prevent long-term interest rates from increasing because of rising inflation expectations.

This year, the Fed is talking about what it is ready to do, if necessary, to avoid deflation. Policymakers are reminding investors that they can cut interest rates on deposits at the Fed, promise to keep rates down for an even longer time period, or buy additional securities, expanding its quantitative easing program. In other words, the Fed is ready and able to support economic growth and avoid another recession.

Unfortunately, investors have short memories. Many investors, who are worried about deflation this year, are probably the same ones who were worried about inflation a year ago. Inflation concerns last year were unwarranted and deflation concerns this year are probably unwarranted too. In both cases, the Fed must manage expectations

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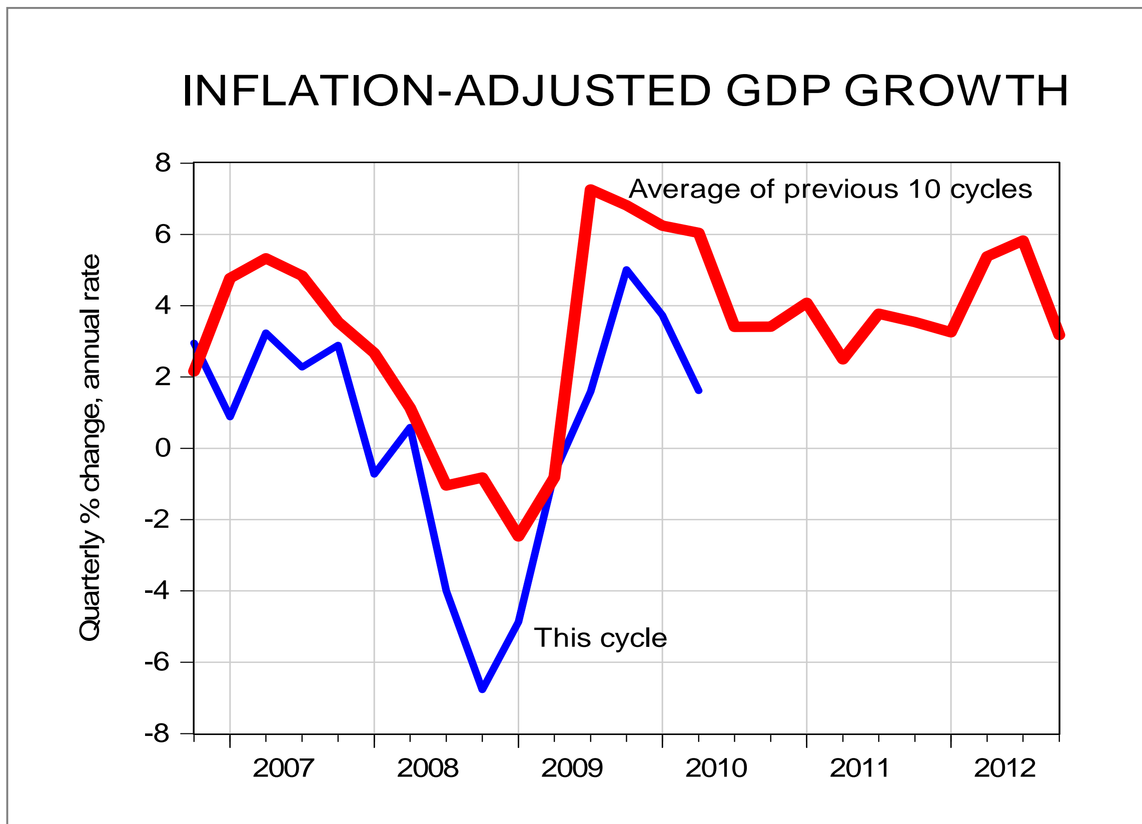
and prevent investors from adversely reacting to its policy. Today, the Fed is trying to tell businesses, consumers and investors that it has the tools to prevent deflation and will use them if economic conditions take a turn for the worse. Of course, many investors would probably have preferred that the Fed do something rather than just talk about doing something. However, the Fed does not want to take unnecessary action. Policymakers did not need to implement its exit strategy last year even though there was a lot of discussion about doing so. Similarly, policymakers probably do not need to implement further quantitative easing now even though they are discussing these tools at the Jackson Hole conference.



Source: Haver, Wells Fargo Advisors
Past performance is no guarantee of future results.

The Fed may not feel a need to boost the economy because the current slowdown is normal at this point in the economic recovery. The accompanying chart compares the quarterly growth rate in gross domestic product (GDP) in this cycle versus the average of growth rates during the previous ten cycles. This shows that the economy often cools off in the second year of recovery as it is doing again this time. Past performance does not guarantee similar results. But policymakers may only be talking about easing because further easing may not be necessary, if the economy is just slowing down as it has at this point in previous economic recoveries.

In summary, the Fed is trying to dampen deflation concerns by telling investors that it has the tools and is willing to act to prevent deflation from occurring. A year ago, the Fed was doing the opposite, telling investors how it would exit its easy money policy, if inflation became a problem. By telling investors what it is willing and able to do, the Fed may prevent adverse reactions that would make its policy less effective. If Chairman Bernanke is successful in reducing deflation concerns, the flight to the safety of bonds and out of stocks may subside, once investors believe that the economy is likely to grow and avoid another recession.

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