



The Big Surprise in the Bernanke Statement

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Yesterday, it was rumored that Chairman Bernanke would announce that the Fed was cutting the interest rate it paid on banks holdings of excess reserves in today's Semiannual Monetary Report to the Congress. Some have suggested that the rumor touched off yesterday's rally in stocks. Bernanke's statement, quite to the contrary, focused on ways the Fed will drain reserves from the system and return its balance sheet to its pre-crisis size and average maturity when the economy approaches full employment—as though that is something the market is worrying about.

There is a real disconnect here, as he began his comments with the admission that the recovery has been weaker than expected. The FOMC reduced its forecast for inflation and economic growth at the June meeting. Of particular concern has been the extremely tepid pace of job market improvement, leaving the unemployment rate at 9.5%, the underemployment rate at a stubbornly high 16.5% and half the number of unemployed suffering more than 6 months of joblessness.

The Fed now estimates that even by the end of 2012, the jobless rate will be as high as 7.0%-to-7.5%; this compares to an unemployment rate averaging only 4.5% in the first half of 2007. And to see even this improvement in the job market takes GDP growth of 3%-to-3.5% this year and 3.5%-to-4.5% in 2011 and 2012—a pace that might well be too optimistic given current conditions.

It is difficult to understand why the Fed is taking this tact, especially as the fiscal stimulus is running out and some are calling for immediate fiscal restraint. Bernanke also confirmed that the availability of credit remains constrained, especially for small businesses, a primary provider of net new jobs in previous cycles. Confidence is falling in the consumer and business sectors, the housing market is softening further and the rise in the number of new business formations and new household formations is much more anemic than in previous recoveries. In fact, this is the only economic recovery in the postwar period that hasn't been led by a rise in housing construction and sales despite the record low level of mortgage rates. As well, with roughly one-quarter of outstanding mortgages underwater, any meaningful rise in mortgage rates could well trigger a jump in strategic foreclosures. The inventory of vacant and unsold homes is at historical highs, the government's programs for mortgage restructuring has had very modest take up and homeownership rates have fallen from over 69% in 2004 to 67% in March of this year.

Bottom Line: Why the Fed finds it prudent to emphasize its ability to re-normalize monetary policy when the output gap closes is beyond me. Deflation, not inflation, will be more troubling for the foreseeable future.

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