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Fed in Hot Seat Again on Economic Stimulus

By SEWELL CHAN

WASHINGTON — With unemployment high and inflation low, a question is being asked more often and more loudly: Can and should the [Federal Reserve](#) do more to get the economy moving?

In two days of Congressional testimony that begin on Wednesday afternoon, [Ben S. Bernanke](#), the Fed chairman, is likely to answer yes, but not just yet.

Mr. Bernanke's view is that the economic recovery is continuing, though at a modest clip, and that recent developments — the stock market's swoon, Europe's financial turmoil and weak job creation — are discouraging but do not yet justify additional monetary stimulus.

Mr. Bernanke says he believes that there are situations that could justify new measures on top of what the Fed has done so far: keeping short-term interest rates to near-record lows and amassing a portfolio of government bonds and mortgage-backed securities, which has put downward pressure on long-term rates.

But to take new action, Mr. Bernanke and other Fed officials would have to be convinced that the economy was moving onto a perilous path of [deflation](#), or that the recovery was so painfully sluggish that it lacked enough momentum to generate private sector job growth.

Some economists are urging the Fed to resume purchases of mortgage bonds or [Treasury securities](#), or even buy new categories of assets, which could have the effect of further lowering long-term interest rates.

So far, the debate within the Fed has occurred largely outside of public view, but it reflects how the economic picture has darkened from just a few months ago, when the prospects for a gradually improving economy and a robust stock market seemed more hopeful. Back then, the dominant talk was when to start tightening monetary policy and selling assets on the Fed's balance sheet.

"Now there is a general recognition that that talk was premature," said Peter N. Ireland, a professor of economics at [Boston College](#) and a former economist at the Federal Reserve Bank of Richmond.

Though far from a consensus, a growing number of experts seem to be in favor of additional easing of the supply of credit, given that interest rates the central bank directly controls can go no lower.

"The unemployment rate is so high, and there is such misallocation of labor in the economy, that the Fed should be willing to experiment with stuff that is pretty risky and untested," said Peter J. Klenow, a professor of economics at Stanford and a former economist at the Federal Reserve Bank of Minneapolis.

Karen E. Dynan, a former Fed economist who is now co-director of economic studies at the [Brookings Institution](#), said that new data on retail sales, consumer confidence and housing starts were all discouraging.

"Recent indicators suggest a loss of momentum, and suggest that the recovery is not on a firm footing," she said. "All of this has increased pressure on the Fed to do more."

Mr. Ireland said it was imperative that the Fed consider additional measures as part of its "contingency planning" for a further weakening of the recovery.

"There has to be a discussion about whether asset purchases should be resumed if we move into the

late summer, and especially into the fall, and we're seeing a bounce in the unemployment rate and further declines in spending," he said, while cautioning that he still did not believe such steps were needed.

But all three of those economists agreed that new asset purchases would entail risk.

Professor Klenow noted that buying longer-term **Treasury** debt might not have much effect on long-term interest rates, because government securities were very liquid.

The Fed might instead consider buying corporate bonds, or assets backed by consumer loans. Doing so could spur the willingness of private investors to lend, Professor Klenow said, but it might not help small businesses, the sector of the economy that needs loans the most. And it would surely spur criticism by economists and others who are fearful about the Fed making decisions to allocate credit by favoring some sectors over others.

In addition, although core inflation, which excludes the highly volatile prices of food and energy, has been running at about half of the Fed's target of nearly 2 percent, inflation expectations "have not come down nearly as much as one would expect, given how much slack there is in the economy," Ms. Dynan said.

The size of the Fed's balance sheet, which has more than doubled since the **financial crisis** of 2008, and the large amount of bank reserves sitting at the Fed has made officials at the central bank nervous about the potential for rapid inflation once banks decide to start lending more vigorously again, she noted.

"Their caution about deploying more expansionary measures has been warranted, but they need to be watching economic conditions very carefully," Ms. Dynan said.

A speech Mr. Bernanke gave in 2002, shortly after he left a professorship at Princeton to join the Fed's board of governors, has been widely cited of late. In it, Mr. Bernanke argued that a determined central bank could always reverse deflation, and generate inflation, through its control of the money supply.

But generating inflation is not the same thing as putting people back to work, a goal that the Fed's monetary toolbox seems less equipped to meet.

Long-term interest rates are already quite low. The yield on the benchmark 10-year Treasury note has fallen below 3 percent, and the average yield for a 30-year fixed-rate mortgage has hovered around 4.5 percent. With the cost of borrowing so low, the Fed might have reached the point of diminishing returns in its capacity to lower rates further.

Furthermore, if the Fed were to suddenly announce a big new program of asset purchases, it could cause inflation expectations to jump. That could raise nominal interest rates and lead to a rise in the price of oil as investors use commodities to hedge against inflation. In such a worst-case situation, the recession could become even worse.

Mr. Bernanke has been known to recite the first precept of the Hippocratic Oath: do no harm. Those familiar with his thinking compare additional monetary easing to a powerful but experimental drug whose side effects are not fully known.

So for now the Fed is very much in the role of the anxious doctor, waiting to see if the patient can recover on his own without an additional dose of untested medicine.



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