Department of Economics Boston College

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Macroeconomic Theory

Supplement 8

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Amidst the withdrawal of Lawrence Summers' likely nomination for the next Federal Reserve chairmanship, the Federal Reserve Open Market Committee begins its two-day policy-setting meeting on Tuesday, September 17. The *Wall Street Journal* article from September 16, 2013.

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THE OUTLOOK

Fed to Meet Amid Trio of Threats to Economy

Central Bank Faces Rising Rates, Turmoil Abroad, Budget Fight at Home

By SUDEEP REDDY

Federal Reserve officials will face at least three sources of economic uncertainty when they gather Tuesday and Wednesday: rising U.S. interest rates, unsettling events abroad and another battle in Washington's long-running budget war.

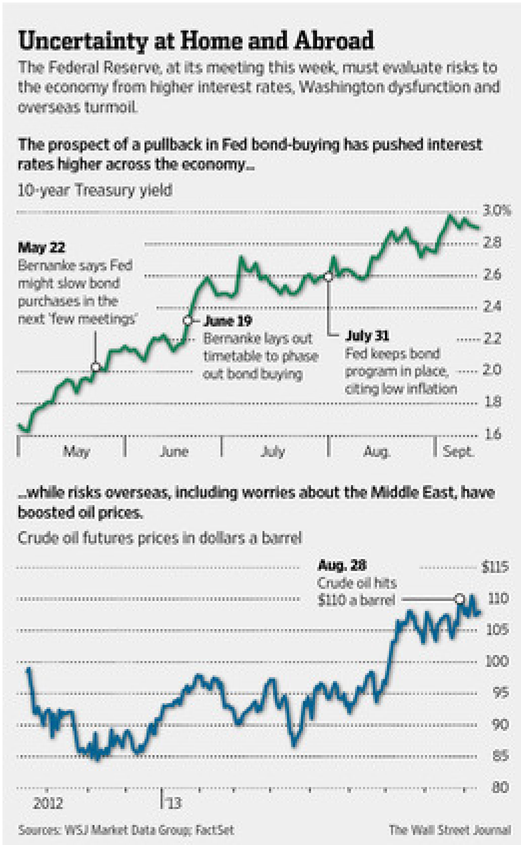
All three could restrain the U.S. economy in coming months. The Fed can influence only one of them directly.

The Fed's assessment of the latest threats will shape its decision about scaling back an $85 billion-a-month bond-buying program that has buoyed markets and key parts of the U.S. economy. That makes the central bank's outlook particularly consequential as the four-year-old recovery again fails to meet the Fed's own projections.

"It's a very difficult decision for them to make," said BNP Paribas economist Julia Coronado. "They've had a forecast for a pickup in growth. It's not materializing."

For interest rates—a factor partly within the Fed's control—the early evidence could spur caution among policy makers.

The Fed's signals about reducing bond-buying have driven interest rates higher. The 10-year Treasury yield now hovers around 3%, up from less than 2% in May.



The bond purchases, designed to spur stronger hiring and investment, helped the housing market recover by pushing mortgage rates to historic lows. The prospect of a Fed pullback has sent mortgage rates in reverse, denting the housing recovery at least temporarily.

Beyond housing, evidence of damage from higher rates remains limited. Auto sales are soaring. Major corporations already took advantage of low rates, and many are sitting on huge cash piles anyway. But the sudden jump could restrain others, including smaller businesses that might rethink an investment amid higher financing costs.

"There's always a lagged impact from higher rates to the real economy," said Ms. Coronado, a former Fed economist. "Those decisions aren't made overnight. A lot of the impact probably lies ahead of us."

Higher rates aren't necessarily bad, particularly if they signal a strengthening economy. Many Fed officials see the recent rise as partly the result of investors unwinding unrealistic bets about never-ending bond purchases. Halting that expectation is key to a self-sustaining recovery.

How that recovery proceeds, however, could rest on outside factors.

A week ago, Fed officials faced the prospect of entering this week's meeting as the U.S. launched airstrikes in Syria. It represented another threat from abroad, on top of brewing troubles in emerging-market economies that could restrain U.S. exports.

Prior American interventions in the region—Iraq in 1991 and 2003, Libya in 2011—demonstrated the potential for military action to spook investors, boost oil prices and restrain parts of the economy. The culprit was usually fear of the unknown; the economy perked up in each case once the worst fears receded.

The weekend deal by the U.S. and Russia for a diplomatic solution to Syria diminishes the prospect of an imminent U.S. military intervention. But continuing tensions in the region will likely keep oil prices elevated, creating another drag on the economy.

Prior Fed meetings offer a road map for central bankers to evaluate geopolitical risks: consider the threat, then stop.

"In the midst of all this uncertainty what does a prudent central banker do?" then-New York Fed President William McDonough asked at the Fed's March 2003 meeting, before the U.S. invaded Iraq. "It seems to me that a prudent central banker thinks a lot, does nothing, talks as little as possible, and makes it very clear that the central bank is very attentive and ready to take action when and if required," he said, according to a transcript of the meeting.

While the Fed might rest easier about the threat of war, domestic political risks still loom large. Budget battles are threatening the economy for the third straight year.

The House GOP leadership failed last week to win support from its members to avert an Oct. 1 government shutdown by delaying major decisions until December. The trouble suggests more drama could be in store to raise the federal borrowing limit by mid-October to avert a devastating U.S. debt default.

The mid-2011 debt-ceiling drama, even though it concluded in a budget deal, triggered a downgrade of the nation's credit rating, sparked a swift stock-market correction and dented confidence among businesses and consumers.

Though an increase in the debt ceiling remains likely, "there's still the potential for some considerable turmoil," said David Stockton, a former top Fed economist now at the Peterson Institute for International Economics. "I hope the message they take is that they can ultimately do some harm even if they get to the right point and not default."

All the while, existing federal budget cuts are likely to remain in place, including a new round of reductions in the coming year.

If the budget battles stretch out through the end of the year, Washington is unlikely to accomplish much to help the economy before a midterm election year raises the political heat further.

That would mean no longer-run budget deal, no major changes to immigration laws and no new investments in infrastructure. Those are all the kinds of structural overhauls U.S. officials frequently urge other nations to enact to boost economic growth.

Without any help from Congress, Fed officials would again be left in the uncomfortable position of trying to revive a struggling U.S. economy while forces largely outside their control push in the other direction.

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