WITH OUTPUT STUMBLING, FED TAKES A MODEST STEP

The US Federal Reserve (or 'US Fed' as the central bank is called) on Wednesday delivered another round of monetary stimulus. Fed extends a bond-swap program dubbed Operation Twist until year's end to keep interest rates down and trigger more borrowing and spending. It also sharply lowers its U.S. economic growth forecast. The program, dubbed Operation Twist, began in September and was set to expire June 30. The Fed opted to keep the program running through the end of the year, hoping it will keep loan rates low and trigger more borrowing and spending.

Key Announcements

The central bank expanded its "Operation Twist" by $267 billion, meaning it will sell that amount of short-term securities to buy longer-term ones to keep long-term borrowing costs down. The program, which was due to expire this month, will now run through the end of the year.

The Fed slashed its estimates for U.S. economic growth this year to a range of 1.9 percent to 2.4 percent, down from an April projection of 2.4 percent to 2.9 percent.

The Fed, which has held overnight interest rates near zero since December 2008, reiterated its expectation that rates would stay "exceptionally low" through at least late 2014.

The unemployment rate will be 8% to 8.2% in 2012, the Fed said. That's an increase from the 7.8% to 8% that policymakers had forecast in April. Next year, the Fed expects an unemployment rate of 7.5% to 8%.

Assessment

The Fed’s move, although likely to have a limited effect, is still welcome news for an economy growing too slowly to create enough jobs for the millions of Americans looking for work. The economic picture threatens to slip into reverse for the third consecutive year with gross domestic product expected to increase just 2 percent in 2012. The outlook for 2013 isn’t much better. Europe’s implosion, Asia’s slowdown and the pending withdrawal of more than $600 billion from the U.S. economy are creating stiff headwinds.

The Fed’s extension of Operation Twist, in which it will replace $267 billion in short-term debt with longer-term securities, continues its efforts to stimulate the economy by driving down interest rates. The theory is that cheap credit will spur consumers to buy and refinance homes, purchase new cars and other goods, and encourage businesses to invest and hire.

One side effect of the Fed’s debt-buying spree is that it helps the U.S. government finance its budget deficit. After all, the Fed is a motivated buyer of U.S. debt -- which enables all that government spending -- and lower interest rates make it cheaper for the U.S. to borrow. The Bank of International Settlements estimates Operation Twist lowered the 10-year bond yield by 0.85 percentage point, which lowers borrowing costs for the U.S. Treasury.

Impact on markets

Investors appeared to respond with disappointment. Major equity indexes fell after the Fed’s policy was announced, rose for a while, and then fell throughout Mr. Bernanke’s 45-minute news conference before staging a late rally to end the day little changed. The Standard & Poor’s 500-stock index fell 0.2 percent.

Indexes dipped right after the Fed's announcement came out at 12:30 p.m., and then quickly went back to where they were. It was the latest knee-jerk response to news headlines in a stock market that has been buffeted in recent weeks by fears that Europe's 17-nation currency union could rupture.

Brent crude plunged to 17-month lows on Wednesday as US inventories swelled and traders weighed the Federal Reserve's vote to extend a program to stimulate the economy.

Conclusion

If Fed opted for QE, The move would be highly controversial in an election year given the strong opposition by many Republicans to the two previous rounds of so-called quantitative easing, which dramatically expanded the Fed's balance sheet. But the Fed has few tools left to combat a sluggish economy, considering that short-term interest rates are already near zero. Policymakers have only a limited set of options available and appear to be holding back for now. A possible – although optimistic — interpretation is that the economic stimulus provided by these Federal Reserve actions caused the economy to pick up. Another interpretation is that markets initially overreacted to the news of these quantitative easing actions. Unconventional monetary policy at the zero bound has had a stimulative effect on the economy, but it might have been quite modest.

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