



LMIC Investment Forum with Bill Poole

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Dr. Poole is currently Senior Fellow at the Cato Institute and was formerly President and CEO of the Federal Reserve Bank of St. Louis from 1998-2008. He served on the Federal Open Markets Committee, the Fed's main policy-making body. Dr. Poole is one of the leading experts on U.S. monetary and fiscal policy. He taught at Brown University from 1974-1998 and also served on the Council of Economic Advisors under President Reagan.

Dr. Poole spoke at our Investment Forum last week, the day after the Federal Reserve issued its latest report on the economy. He addressed questions from our clients and staff. A summary of Dr. Poole's key points follows:

The Economic Outlook

- The U.S. economy is close to its trough right now, perhaps reached in July.
- Many forecasters are predicting GDP growth over the third and fourth quarters of 2009 might average 2%. In 2010, GDP might climb to 3.5%.
- Across economic cycles, however, the average forecast error rate is 1-1.5% over four quarters; this suggests that 2010 forecasts of GDP growth might actually range between 2% and 5%.
- The case for stronger GDP growth is based on the fact that the current recession has been much deeper than past recessions, so an accelerated "snap back" is more likely. The case for weaker GDP growth and a slower recovery is based on continued capital impairment of business and additional issues plaguing overleveraged consumers.
- One estimate of the present value of the difference between Medicare and Social Security obligations and tax revenues shows an unfavorable gap of \$60 trillion, and that does not count increased support for health care, education and the environment proposed by Congress.
- The Federal government is going to have to significantly scale back obligations. This is really a question of political will. Optimists point to the historical resourcefulness of the U.S. in asking for sacrifices to overcome wars and economic shocks like the Great Depression. Pessimists point to the possibility that political gridlock and the threat of inflation will derail our best intentions to cut spending and to achieve more balanced budgets.

- While the savings rate is rising, it is doing so today in large part because many households are cut off from credit. The savings rate will continue to rise, though, and consumer behavior might reflect more aversion to cheap credit going forward.
- Federal policy to stimulate business fixed investments would help speed the current recovery. There were very successful programs in 1962, under President Kennedy, and in 1982, under President Reagan, that allowed accelerated depreciation and investment tax credits for business that helped the economy to emerge more quickly from recession.
- The large holdings of U.S. Treasuries by foreign investors make our own economic recovery very interdependent with what takes place abroad, though the investment community is increasingly global in scope and orientation.
- Growing defaults on municipal obligations in the U.S. are a real possibility, though they are difficult to predict because of the absence of good data on accounting for pension liabilities at the state and local level.

The Role of the Federal Reserve

- The current Fed under Ben Bernanke is using the 13.3 clause in the Federal Reserve Act of 1932 to assume extraordinary powers based on “unusual and exigent circumstances.”
- While the bailouts of major financial institutions last fall might have fallen under the 13.3 power, the current commercial paper and mortgage-backed securities buy-back programs, totaling over \$1.5 trillion, do not; the Fed should have asked Congress to authorize these programs.
- At some point, the Fed will have to absorb all the cash that it has put out in the market, or risk serious inflation. When the Fed starts to rein in the balance sheet, it will come at a delicate time in the overall economic recovery and will be therefore be much harder to accomplish.
- The Fed has not demonstrated adequate leadership. For instance, the notion that any company is “too big to fail” is a serious problem. It is unacceptable to have socialized risks and private gains.
- The primary role of the Fed is ensuring price stability. It has one policy instrument at its disposal, the Federal Funds Rate. It is not feasible to achieve multiple policy objectives, such as setting asset prices or the level of the stock market, by manipulating the Federal Funds rate, and the Fed should not overstep its bounds.
- Inevitably, Congress will not delegate matters of huge importance to independent agencies like the Fed, and will reassert its control over spending.