

# ISSUE BRIEF

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## Bernanke's Testimony Confirms Economy Slowing, Fed Meddling

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Federal Reserve Board chairman Ben Bernanke trekked to Congress for his semi-annual congressional testimony<sup>1</sup> this week with a lot on his plate, especially a disappointing economy and an unfortunate penchant for making matters markedly worse while trying to make them a little better—and what he did to protect the U.S. financial system from serious irregularities in setting the benchmark LIBOR rate.

The hearing was dominated by a U.S. economy that has slipped from slow to slower growth and possibly to a full stop. Bernanke's testimony was dominated by three simple themes:

1. The economy is doing much worse than anticipated,
2. The Fed is exploring additional Lilliputian measures it might take to help the economy, and

3. A huge threat facing the economy is Congress's inaction on Taxmageddon—the \$500 billion tax hike set to slam into the economy on January 1, 2013.

Bernanke wants to strengthen the economy. But instead of new measures, the Fed should adopt a do-less-harm policy, especially since monetary policy cannot remove the greatest threat to the stuttering economy—Taxmageddon.

**The Economy.** The most incontrovertible evidence of a slowing economy is from the Labor Department's latest jobs report, which shows that the economy created a very modest 80,000 jobs in June, which is about on par with the prior two months and consistent with the other data indicating an economy that has nearly stalled.<sup>2</sup> The key word in the Labor Department report was *unchanged*: “the number of unemployed persons (12.7 million) was essentially unchanged,” “the number of long-term unemployed (those jobless for 27 weeks and over) was essentially unchanged,” and on and on. An economy that is essentially “unchanged” is not an economy that is growing.

Thus it is not surprising that the respected economic forecasting group the Economic Cycle Research

Institute (ECRI) is now forecasting a recession.<sup>3</sup> As the name suggests, ECRI specializes in seeing turning points in the business cycle, like the onsets of recessions and the starts of recoveries. Right now, they see recession.

**The Fed Responds.** So Bernanke is surely correct in observing the economy is slowing, perhaps badly. Where he errs is in suggesting there is more the Fed can and should do to help. For example, the Fed recently voted to apply another \$267 billion to Operation Twist, a monetary policy operation that seeks to lower long-term interest rates by selling short-term securities and buying long-maturity securities.<sup>4</sup> This policy is likely to prove ineffective for three reasons:

1. Applying \$267 billion to the purchase of long-term securities over a period of months is likely to have an imperceptible effect on long-term interest rates. To put this figure in context, the domestic mortgage market had a total volume of \$13.5 trillion at the end of 2011, nearly 50 times larger than the Fed's purchases, and this is only a portion of the global long-term market that the Fed seeks to influence.

This paper, in its entirety, can be found at <http://report.heritage.org/ib3673>

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2. Long-term interest rates are already astoundingly low. For example, the 10-year Treasury bond rate is already around 1.5 percent—compared to 3.3 percent in 2010 and an average over the past 20 years of about 5 percent. Home mortgage rates have followed a similar track. If long-term rates this low cannot prop up the economy, the imperceptible effects of Operation Twist can have no appreciable effect.

3. The flip side of Operation Twist is selling short-term securities. If twisting has a downward effect on long-term interest rates, as the Fed hopes, it is also likely to have a roughly equivalent upward effect on short-term interest rates with an uncertain net effect, at best, on the economy.

Given the high unemployment rate and Operation Twist's likely negligible economic effect, the policy might still be worth pursuing were it not for the (likely substantial) downsides of this or any of the other small-ball proposals floating around Fed headquarters to stimulate growth. All of these proposals suffer from a major shortcoming—they add confusion and uncertainty to the market. No one can say on any given day whether the policy has had an effect or not, and so it is more difficult to

distinguish interest rate movements due to market forces from movements due to Fed intervention.

Every time the Fed suggests it may have more arrows in the quiver, the market must then decipher the Fed's code to determine what those supposed helps may be and what they would really do. The Fed does not need to do anything to do harm. It just needs to suggest it might do something.

**Do What Works—Do Not Work to Find Something to Do.** The economy's prospects would brighten if the Fed, the President, and Congress each adopted a do-less-harm approach to economic policy. For the President and Congress, do-less-harm starts with disarming Taxmageddon. Increasingly, the prospect of a massive tax hike on January 1 is depressing the economy already.<sup>5</sup> If allowed to hit full force, a severe recession is almost a sure bet. Facing such a bleak prospect, businesses have no choice but to go on the defensive, avoiding hiring and investment whenever possible.

This Taxmageddon effect is exacerbated by a lack of trust that Washington policymakers will get this right. Clumsy past fights over the debt ceiling and the payroll tax extension do not inspire confidence. Only now, halfway through the year, has President Obama engaged on the matter, and he did so by calling

for higher taxes on those who do the hiring. That cannot instill much confidence.

And then the number 4 Democratic leader in the Senate, Patty Murray (D-WA), announces her party is ready, willing, and yearning to play political games in a legislative session after the election, threatening to allow Taxmageddon to hit in full if the Democrats are not allowed to raise taxes on job creators.

The Fed's do-less-harm task is even easier. It needs to:

- End Operation Twist and thereby remove this one source of confusion and uncertainty in the marketplace.
- Acknowledge that there is little that monetary policy can do at this point to support today's economy. This acknowledgement would have the dual benefit of placing the onus to act back on President Obama and Congress and would further reduce market uncertainty by eliminating the suggestion of future Fed meddling.
- Assure market participants that, in the event of another financial crisis, the Fed is prepared to respond in its role as lender of last resort to provide liquidity where and when it is needed. In light of recent economic developments in

1. Ben S. Bernanke, "Semiannual Monetary Policy Report to the Congress," testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 17, 2012, <http://www.federalreserve.gov/newsevents/testimony/bernanke20120717a.htm> (accessed July 19, 2012).

2. News release, "The Employment Situation—June 2012," Bureau of Labor Statistics, July 6, 2012, <http://www.bls.gov/news.release/pdf/empisit.pdf> (accessed July 9, 2012).

3. Economic Cycle Research Institute, "U.S. Economy Tipping into Recession," September 30, 2011, <http://www.businesscycle.com/ecri-reports-indexes/report-summary-details/1091> (accessed July 19, 2012).

4. See J. D. Foster, "Federal Reserve's Operation Twist Takes Wrong Turn," Heritage Foundation *Backgrounder* No. 2710, July 13, 2012, <http://www.heritage.org/research/reports/2012/07/federal-reserves-operation-twist-takes-wrong-turn>.

5. Curtis S. Dubay, "Taxmageddon Is Slowing the Economy Now," The Heritage Foundation, The Foundry, June 20, 2012, <http://blog.heritage.org/2012/06/20/taxmageddon-is-slowing-the-economy-now/>.

Europe and the political gamesmanship in Congress, markets are likely to value this assurance highly.

**No Need to Act.** Bernanke's desire to strengthen the economy is laudable. Unemployment has been too high for too long and threatens to go higher. His fears that Congress and the President will fail to prevent a massive tax hike from slamming into a stuttering economy are

likewise justified. But he should be honest with the American people and admit that the monetary policy cupboard is bare and that the Fed would be powerless to offset the damage from Taxmageddon. The responsibility to act lies with Congress and President Obama.

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