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FEDERAL RESERVE NOT READY TO RAISE INTEREST RATES YET

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The Federal Reserve pledged to maintain their position of keeping interest rates low for an “extended period”. This statement was issued following the Federal Reserve’s second of eight policy meetings for this year. However, this meeting was unique because the Fed Chairman, Ben Bernanke, held a news conference immediately after. This was the first time a Fed Chairman answered questions from the press right after a policy making meeting. An indication of his effort to better communicate policy decisions to the public.

In its published statement, the Fed offered a mostly upbeat assessment on the economy. It said the economic recovery is proceeding at a “moderate pace” and hiring is improving gradually.

The focus of the meeting was to discuss whether to raise interest rates or not and whether to adjust the current monetary easing program, better known as QE 2. The program has been given this nickname because it is the second round of quantitative easing by the Fed. The quantitative easing programs were designed to stimulate economic growth. Between December 2008 and March 2010, the Fed bought $1.7 trillion in US Treasuries. Bernanke has said that this first round of stimulus was necessary to end the “economic free fall” of the recession of 2008. In November 2010 the Fed began the $600 million QE2 program. Its current portfolio consists of $2 trillion of securities, when counting Treasury bonds and mortgage debt. The Federal Reserve has been buying 85% of all government debt sold since November 2010. This buying spree is scheduled to end in June. Once this stops, interest rates could begin to rise. Currently the US economy is projected to grow at a 3% rate this year. However, the question is whether growth can continue if interest rates rise.

The QE2 program in particular has come under criticism by some economists, who are worried it will contribute to higher inflation. Chairman Bernanke has defended this criticism saying that the jump in oil and food prices should cause only a temporary increase in inflation. Excluding those prices, which tend to fluctuate a lot, inflation is still low he has argued. The difficulty for the Fed is to find the right balance of stimulating the economy through lower interest rates without causing a large increase in inflation.

Because of these policies, the current fed funds rate is .25%. This is the rate at which banks lend to each other. This rate is important because many other interest rates in this country are based on the level of the fed funds rate. The rate has never been below 1% before 2008.

QE2 was all about chasing away the threat of deflation, or falling consumer prices, and it sent investors into stocks enlarging people’s net worth through the stock market. It kept the dollar low giving US exports a lift by making them more affordable to foreign markets. Since QE2 was announced, the S&P 500 has gained 28%. Commodities are up and even subprime debt has come back in price.

There is little doubt that Fed policies have been good for the stock market and probably the economy in general. The challenge will be to see if the Fed can wean the country off extremely low interest rates without interrupting the current recovery. Because, it is quite likely that rates will start rising later this year or early next year.