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CLIENT BULLETIN

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➢ *Who Is the Fed?*

You are probably hearing a lot these days about the "Fed" and its' Chairman Ben Bernanke. So who are they and what do they do? The Federal Reserve Bank (the Fed) has the dual mandate to maintain price stability (i.e. help the country avoid inflation or deflation) and achieve maximum sustainable employment. Fed policy makers include twelve regional bank presidents and seven board governors in Washington. While These 19 individuals often have differing views about which steps should be taken next, Federal Reserve Chairman Ben Bernanke is tasked with pulling together a consensus from these divergent views and implementing monetary policy.

➢ *What do they do?*

The Fed conducts monetary policy to achieve the goals stated above. Monetary policy refers to buying or selling treasury bonds to expand or shrink the money supply and also adjusting interest rates in order to achieve their objectives. In general, increasing the money supply and lowering interest rates tend to spur economic activity. Decreasing the money supply and raising interest rates have the effect of dampening an economy that is in danger of experiencing inflation.

➢ *What have they done?*

In response to the recent financial crises, the Fed has slashed interest rates and injected staggering sums of money into our financial system in an attempt to revive the economy. Interest rates set by the Fed have been pegged between 0%-.25% since December of 2008 and they have promised to keep them there until 2014. Concurrently, the Fed embarked on two rounds of bond buying called QE 1 and QE 2 designed to inject more money into the economy. Those aren't ocean liners - QE stands for quantitative easing which is the Fed's strategy of buying bonds in an attempt to lower interest rates to encourage borrowing and spending. Lastly, the Fed is currently engaged in an unconventional strategy called "Operation Twist" which involves shifting money from short-term to longer-term Treasury bonds in an attempt to further drive down interest rates.

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- ***Is it Working?***

While these strategies have driven down interest rates to microscopic levels and left the U.S. economy awash in liquidity, they have not had much of an effect on economic growth and unemployment. The economy is experiencing the most lackluster recovery in decades and the unemployment rate remains stuck above 8%. The problem is that this liquidity is not making its' way into the economy as the Fed had hoped. Consider the following:

- There is $15 trillion of liquid assets on the balance sheets of non-financial U.S. corporations
- There is roughly $10 trillion of cash sitting in the hands of individuals in the form of bank accounts, money markets and CDs.
- Banks are sitting on $1 ½ trillion of excess reserves
- Apple, Inc. alone has $100 billion worth of corporate cash.

- ***What to Do Now***

There are two basic factions within the Fed that disagree about what to do next. One camp wants to double down on the strategies that have already been taken. Even though the steps taken so far haven't worked, they reason, the Fed should continue to buy bonds (QE3 anyone?) to inject still more liquidity and drive interest rates down further. A second group feels that the Fed has done all they can do and should move to the sidelines. This camp feels that the reason people are holding off on purchasing a home is not because interest rates are too high, and that companies aren't holding off on hiring new employees because they don't have the money to do it. They feel that the Fed has done its' job by "filling the nation's gas tank" with the aforementioned cash reserves and now it is time for someone else to provide the incentive to step on the gas.

- ***Who Is That Someone?***

Forgive me for getting so basic, but it seems reasonably clear that in order to get the economy growing faster and reduce unemployment, companies need to hire more people. So if companies of all sizes have plenty of cash to deploy, why do they remain in a defensive crouch? While there are of course opposing views, the answer appears to be that they are fearful and lack confidence. They are concerned about the future direction of tax, fiscal and regulatory policy coming out of Washington. Companies large and small typically have 3-4 year budgeting cycles. Before expanding or hiring they ask themselves questions such as:

- How much tax will I pay on the additional profits I hope to generate by expanding?
- If I hire more people, how much will my employee benefit package cost next year?
- Are there any new regulations coming down the pike that will drive up my costs?

Until these policy issues become a little friendlier and clearer, businesses of all sizes will keep their powder dry and the economy will be stuck in stall speed. Rather than breathlessly waiting for the next pronouncement from the Fed to solve our economic woes, we should be looking to Congress to pass tax, fiscal and regulatory policies that provide clarity and give companies the confidence necessary to start hiring again.

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