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Monetary policy's diminishing returns

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By Emily Kaiser

WASHINGTON (Reuters) - The Federal Reserve runs the risk of diminishing returns from its next round of money printing to amplify the subdued economic recovery, but that won't stop it from trying.

Minutes due on Tuesday from the Fed's most recent policy-setting meeting may reflect some divisions among officials over whether to launch another round of asset purchases, known as quantitative easing.

Investors, however, assume the Fed will pull the trigger, likely at its next policy-setting meeting in November.

A Reuters poll of 16 primary dealers -- investment firms that deal directly with the Fed -- showed all expected the central bank to return to buying bonds. All but one predicted the announcement would come at the November 2-3 meeting.

The Fed cannot sit idly by with unemployment stuck near 10 percent and inflation below the central bank's perceived target, economists say. Statements from some of the Fed's top officials in recent days have made it increasingly clear that action is likely, even though others remain vocally opposed.

The next batch of U.S. inflation data comes Thursday and Friday, and is likely to show price pressures remain low, particularly for consumers. The Fed said in its latest statement that inflation was lower than it would like.

Low inflation raises concerns about the risk of deflation, a vicious circle of a downward spiral in prices and the economy.

While action seems assured, don't bank on the Fed performing economic miracles.

"One should not expect too much from further quantitative or credit easing," said Olivier Blanchard, the chief economist of the International Monetary Fund. "It should be done but the implications for the economy will be limited."

Christina Romer, who recently stepped down as a White House economic adviser, said the Fed is in uncharted waters and it is unclear how much further easing will accomplish.

"There's a lot of questions about quantitative easing and how it works and how communications policies work, but they need to be tried because this is still a crisis," she said.

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The Fed, which has held interest rates near zero since December 2008, launched its asset-buying spree nearly two years ago, swelling its balance sheet to nearly $2.3 trillion from a pre-crisis level of around $800 billion.

The program succeeded in driving down borrowing costs, yet it did not spur as much lending as the Fed would have liked. Banks hoarded cash, fearful of racking up more loan losses so soon after the crippling financial crisis. Many companies balked at borrowing because of concerns about sluggish sales.

Paul Kasriel, director of economic research at Northern Trust in Chicago, said commercial bank credit will be the measure by which he judges the Fed's success this time. The central bank releases weekly statistics on commercial and industrial loans on Fridays.

"I will be charting the course of QE2 every Friday afternoon," Kasriel said, using a popular acronym for the Fed's expected second round of quantitative easing.

Printing money is not without consequences, at home and abroad. Eswar Prasad, an economist at Cornell University, said he is concerned that investors will abruptly shift from worrying about deflation to predicting inflation as the Fed's actions debase the value of the dollar.

In that scenario, "we get spiraling inflation that the Fed will have to move aggressively to counter, leading to another bust just as the economy recovers," he said.

Emerging economies have their own concerns. The weak dollar has sent investors searching for fatter returns in faster-growing emerging markets, driving up inflation and asset prices. South African Finance Minister Pravin Gordhan said this forces emerging markets to tighten monetary and fiscal policy sooner than they would like.

"A lower dollar and a lower euro is fine for all of you, but it's not fine for us. You are making us uncompetitive and we are the people sitting on the 25 percent unemployment and we need to work our way out of it," he said.

(Additional reporting by David Lawder; Editing by Leslie Adler)
