First Trust
ECONOMIC RESEARCH REPORT
Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Senior Economist*
Strider Elass – *Economic Analyst*
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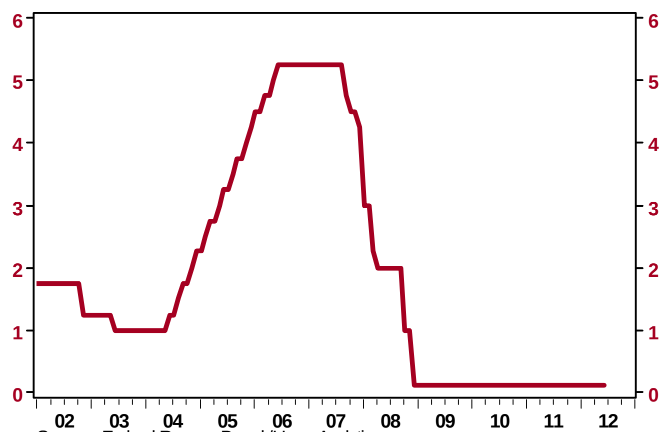
Fed Does the Least

In the past few days, news outlets have breathlessly reported that the Federal Reserve would today launch into another round of quantitative easing, probably including major purchases of mortgage backed securities. Instead, the Fed did the least that was expected, extending Operation Twist until the end of the year, but not altering the size of its balance sheet at all and not – as some analysts suggested it might – changing when it thinks it will start raising rates (still late 2014).



Operation Twist was originally implemented last September and has the Fed selling short-term Treasury securities and using the proceeds to buy long-term Treasury securities. We don't think this program makes a dime's worth of difference for the economy. In the end, it's really an act of fiscal policy, not monetary policy, no different than if the US Treasury Department financed the federal debt by issuing more short-term debt and issuing less long-term debt. (By the way, given very low long-term interest rates, this would be an awful idea.)

Compared to the last statement from April 25, the Fed did make some changes to its language, all in the dovish direction. The Fed said "growth in employment has slowed," "household spending appears to be rising at a somewhat slower pace," and unemployment looks likely to decline "slowly," rather than "gradually." It also said inflation "has declined."

In addition, the Fed made it clear that it "is prepared to take further action" if either the situation in Europe deteriorates or the labor market fails to improve.

These changes are consistent with the new economic and interest rate forecast from the Fed. The Fed now projects real GDP growth of 1.9% to 2.4% in 2012, a downgrade from April, when the range was 2.4% to 2.9%. The Fed also reduced its estimate for growth in 2013, to roughly 2.5%, and projects unemployment will still be 7.5% to 8% at the end of 2013. Previously, the Fed was more confident the jobless rate would be down to 7.5% by that point in time. The Fed also slightly reduced its estimate of inflation for 2012.

While the Fed still projects near zero short-term interest rates through the end of 2014, the median forecast among members of the Federal Open Market Committee is that the funds rate will end 2014 at 0.5%, not the 1% previously forecast. In addition, the range for the federal funds rate over the long term fell slightly. It's now 3% to 4.5%, but used to be 3.5% to 4.5%.

Once again, the lone dissent from the Fed's statement was from Richmond Fed President Jeffrey Lacker, who opposed the extension of Operation Twist.

Brian S. Wesbury, *Chief Economist*
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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in April suggests that the economy has been expanding moderately this year. However, growth in employment has slowed in recent months, and the unemployment rate remains elevated. Business fixed investment has continued to advance. Household spending appears to be rising at a somewhat slower pace than earlier in the year. Despite some signs of improvement, the housing sector remains depressed. Inflation has declined, mainly reflecting lower prices of crude oil and gasoline, and longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects economic growth to remain moderate over coming quarters and then to pick up very gradually. Consequently, the Committee anticipates that the unemployment rate will decline only slowly toward levels that it judges to be consistent with its dual mandate. Furthermore, strains in global financial markets continue to pose significant downside risks to the economic outlook.

The Committee anticipates that inflation over the medium term will run at or below the rate that it judges most consistent with its dual mandate.

To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the Committee expects to maintain a highly accommodative stance for monetary policy. In particular, the Committee decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.

The Committee also decided to continue through the end of the year its program to extend the average maturity of its holdings of securities. Specifically, the Committee intends to purchase Treasury securities with remaining maturities of 6 years to 30 years at the current pace and to sell or redeem an equal amount of Treasury securities with remaining maturities of approximately 3 years or less. This continuation of the maturity extension program should put downward pressure on longer-term interest rates and help to make broader financial conditions more accommodative. The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities. The Committee is prepared to take further action as appropriate to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; Dennis P. Lockhart; Sandra Pianalto; Jerome H. Powell; Sarah Bloom Raskin; Jeremy C. Stein; Daniel K. Tarullo; John C. Williams; and Janet L. Yellen. Voting against the action was Jeffrey M. Lacker, who opposed continuation of the maturity extension program..