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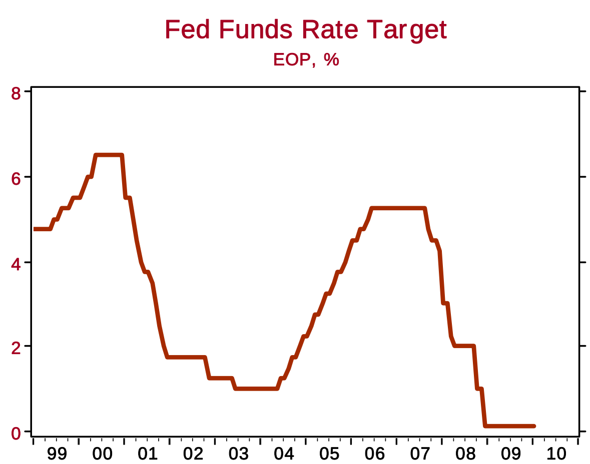
Jan 27, 2010 | Economic Commentary

"Extended Period" of Low Rates Starting to Lose Support

The Federal Reserve made no direct changes to the stance of monetary policy today, leaving the target range for the federal funds rate at 0% to 0.25%. However, one member dissented from the Fed's commitment to keep rates at exceptionally low levels for an extended period of time. In addition, the language of the statement was more bullish on the economy and the Fed indicated some hastening in the pace of ending its special liquidity facilities.

The dissent by Kansas City Fed President Thomas Hoenig was, by far, the most important news in the statement, indicating that support is starting to dwindle for the policy of keeping rates at near zero. It is telling that Mr. Hoenig was not only willing to argue for changing the language of the statement but also air this view publicly.



Meanwhile, several changes in the wording of the statement indicated more bullishness about the economy. The changes include the following:

(1) Economic activity continued to "strengthen" rather than "pick up."
(2) Household spending "is expanding", rather than "appears to be expanding."
(3) Business investment in equipment and software "appears to be picking up," whereas previously the Fed said businesses were still "cutting back" on investment.
(4) Firms have brought inventories into "better alignment" with sales, instead of making "progress" in that direction.
(5) "The pace of the economic recovery is likely to be moderate for a time" rather than "economic activity is likely to remain weak.

The Fed also made a slight change to its language on inflation saying economic slack is continuing to "restrain" inflation rather than "dampen" inflation. This subtle change at least indicates some recognition that there are cost pressures that need restraining, such as in commodities.

The section on special credit facilities described how the Fed was following through on pre-arranged schedules to wind down certain arrangements. The exception was the Fed announcing that the Term Auction Facility will end in early March, whereas it had previously only said it would be "scaled back" in early 2010.

Given our forecast that the unemployment rate will decline more than the Fed anticipates in 2010 and underlying inflation trends will continue to accelerate we think today's statement is consistent with higher short-term interest rates starting mid-year.

Brian S. Wesbury, *Chief Economist*
Robert Stein, *Senior Economist*

Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in December suggests that economic activity has continued to strengthen and that the deterioration in the labor market is abating. Household spending is expanding at a moderate rate but remains constrained by a weak labor market, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software appears to be picking up, but investment in structures is still contracting and employers remain reluctant to add to payrolls. Firms have brought inventory stocks into better alignment with sales. While bank lending continues to contract, financial market *conditions remain supportive of economic growth. Although the pace of economic recovery is likely to be moderate for a time, the Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability.*

With substantial resource slack continuing to restrain cost pressures and with longer-term inflation expectations stable, inflation is likely to be subdued for some time.

The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period. To provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve is in the process of purchasing $1.25 trillion of agency mortgage-backed securities and about $175 billion of agency debt. In order to promote a smooth transition in markets, the Committee is gradually slowing the pace of these purchases, and it anticipates that these transactions will be executed by the end of the first quarter. The Committee will continue to evaluate its purchases of securities in light of the evolving economic outlook and conditions in financial markets.

In light of improved functioning of financial markets, the Federal Reserve will be closing the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility, the Primary Dealer Credit Facility, and the Term Securities Lending Facility on February 1, as previously announced. In addition, the temporary liquidity swap arrangements between the Federal Reserve and other central banks will expire on February 1. The Federal Reserve is in the process of winding down its Term Auction Facility: $50 billion in 28-day credit will be offered on February 8 and $25 billion in 28-day credit wil be offered at the final auction on March 8. The anticipated expiration dates for the Term Asset-Backed Securities Loan Facility remain set at June 30 for loans backed by new-issue commercial mortgage-backed securities and March 31 for loans backed by all other types of collateral. The Federal Reserve is prepared to modify these plans if necessary to support financial stability and economic growth.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; James Bullard; Elizabeth A. Duke; Donald L. Kohn; Sandra Pianalto; Eric S. Rosengren; Daniel K. Tarullo; and Kevin M. Warsh. Voting against the policy action was Thomas M. Hoenig, who believed that economic and financial conditions had changed sufficiently that the expectation of exceptionally low levels of the federal funds rate for an extended period was no longer warranted.