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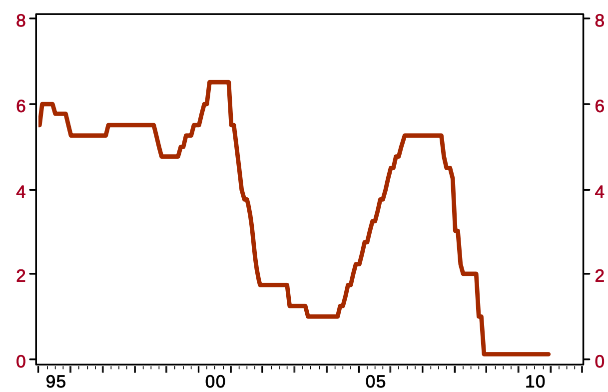
Dec 14, 2010 Economic Commentary

Fed Keeps Monetary Spigot Wide Open

As widely anticipated, the Federal Reserve's statement on monetary policy was almost a carbon copy of last month's statement, when it embarked on a new round of "quantitative easing."

The Fed 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%. In addition, the Fed maintained its pledge to keep the funds rate at this level for an "extended period." The Fed also reiterated its commitment – initially made in early November – to purchase $600 billion in long-term Treasury securities by mid-2011. These purchases are on top of reinvesting (into long-term Treasury securities) principal payments on its pre-existing portfolio of mortgage securities.

Federal Funds Target Rate
%



The Fed only made minor changes to its statement. Last month it said the recovery was "slow." This is now changed to growth being "insufficient to bring down the rate of unemployment." Last month the Fed said consumer spending was growing "gradually." Now the Fed says it's growing at a "moderate" rate. The Fed made no changes to its language on inflation.

These changes are a disappointment. Sometimes we wonder what economy the Fed is looking at. Real GDP growth in the third quarter appears ready to be revised up to about a 3% growth rate (from an original report in late October of 2%). Fourth quarter real GDP looks like it's growing at about a 5% annual rate. In the past five months, retail sales are up at a 12.1% annual rate, close to the fastest five-month period since the bursting of the NASDAQ bubble in 2000. Claims for jobless benefits – both new and continuing – are trending down rapidly. More importantly, this improvement is happening well before quantitative easing should be having an impact on the economy.

In the end, we believe the new round of quantitative easing will have little to no impact on the larger economy. Banks already had roughly $1 trillion in excess reserves prior to that new policy. Adding to this pile of reserves will not influence the desire of financial institutions to lend, nor will it lead to any near-term increase in the supply of currency in circulation. All it will do is sit idle on the liability side of the Fed's balance sheet and on the asset side for the banks.

Once again, Kansas City Fed President Thomas Hoenig was the only dissent. Unlike the Fed's statement, Hoenig's dissent mentioned the "improving economy" and, once again, noted that continued high levels of monetary accommodation could generate future financial imbalances and eventually destabilize the economy. We believe Hoenig is right.

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 November confirms that the economic recovery is continuing, though at a rate that has been insufficient to bring down unemployment. Household spending is increasing at a moderate pace, but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software is rising, though less rapidly than earlier in the year, while investment in nonresidential structures continues to be weak. Employers remain reluctant to add to payrolls. The housing sector continues to be depressed. Longer-term inflation expectations have remained stable, but measures of underlying inflation have continued to trend downward.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. Currently, the unemployment rate is elevated, and measures of underlying inflation are somewhat low, relative to levels that the Committee judges to be consistent, over the longer run, *with its dual mandate. Although the Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability, progress toward its objectives has been disappointingly slow.*

To promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee decided today to continue expanding its holdings of securities as announced in November. The Committee will maintain its existing policy of reinvesting principal payments from its securities holdings. In addition, the Committee intends to purchase $600 billion of longer-term Treasury securities by the end of the second quarter of 2011, a pace of about $75 billion per month. The Committee will regularly review the pace of its securities purchases and the overall size of the asset-purchase program in light of incoming information and will adjust the program as needed to best foster maximum employment and price stability.

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 for the federal funds rate for an extended period.

The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to support the economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; James Bullard; Elizabeth A. Duke; Sandra Pianalto; Sarah Bloom Raskin; Eric S. Rosengren; Daniel K. Tarullo; Kevin M. Warsh; and Janet L. Yellen.

Voting against the policy was Thomas M. Hoenig. In light of the improving economy, Mr. Hoenig was concerned that a continued high level of monetary accommodation would increase the risks of future economic and financial imbalances and, over time, would cause an increase in long-term inflation expectations that could destabilize the economy.