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First Trust

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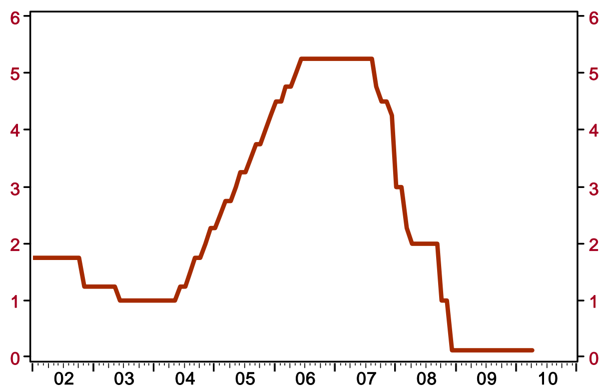
Economic Commentary

Fed Twiddles Its Thumbs

As everyone expected, the Federal Reserve made no direct changes to the stance of monetary policy yesterday, leaving the target range for the federal funds rate at 0% to 0.25%. More importantly, the Fed made no changes to its commitment to keep short-term interest rates at this level for an "extended period."

Minor changes to the statement show the Fed is continuing to gain confidence in the economy. These changes, versus the statement in March, include the following:

(1) The labor market is "beginning to improve," rather than "stabilizing."
(2) Household spending is "picking up" rather than "growing at a moderate rate." (The changed language is the Fed's way of saying consumer spending is now growing faster than moderately.)
(3) Housing starts have "edged up" rather than being "flat."



In addition, Kansas City Fed Bank President Thomas Hoenig reiterated and strengthened his two prior dissents, saying not only that the "extended period" language is no longer warranted but also that continuing to use such language could limit the Fed's flexibility to raise rates.

Economic performance has improved substantially so far this year, consistent with a V-shaped recovery. Real GDP grew at a 3.9% annual rate in the second half of 2009 and is likely to grow even faster in the first half of 2010. Nominal GDP – real GDP growth plus inflation – grew at a 4.3% rate in the second half of 2009 and is also likely to accelerate further. A federal funds rate of essentially 0% is not appropriate for an economy with positive and rising nominal GDP growth.

Given the strength in the economy, going into yesterday's meeting, we had anticipated that the Fed would finally eliminate or water-down the "extended period" phrase, suggesting more dependence on incoming data in determining the course of monetary policy. It is possible that recent financial troubles in Greece, Portugal, Italy and Spain have made the Fed even more reluctant to alter policy until that situation has been resolved, which we think will happen during the next couple of months.

If so, this is a mistake. Not only will the delay intensify market fears about the European debt situation but it is unnecessary. In the early 1980s, under Fed Chairman Paul Volker, the Fed ran a tight monetary policy even though Latin American countries were defaulting on their debts, which threatened the US banking system.

Leaving that issue aside, the Federal Reserve is likely to start lifting the funds rate by the end of the third quarter and ultimately reach 0.75% by year end. That's our baseline scenario. It is certainly plausible the Fed will act more aggressively given the strength in the economy. However, it is equally plausible the Fed will be even less aggressive than our baseline scenario, for a few reasons. First, it may retain the "extended period" language until the European debt issue gets resolved, boxing itself in just as Hoenig wants to avoid. Second, the Fed may be reluctant to start a rate hike cycle near year end, when seasonal demand for liquidity increases. (Traditionally, cycles of rate hikes start in the first half of the year.) And third, President Obama appears likely to appoint three new members to the Board of Governors, not an inflation hawk among them.

A more prolonged period of extremely loose monetary policy will generate more real economic growth in 2011. However, we will eventually pay a price for the Fed's unwillingness to raise rates sooner rather than later. That price will include higher inflation, much faster rate hikes in 2011-12, and an ultimate peak for rates that is higher than it could have been.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in March suggests that economic activity has continued to strengthen and that the labor market is beginning to improve. Growth in household spending has picked up recently but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software has risen significantly; however, investment in nonresidential structures is declining and employers remain reluctant to add to payrolls. Housing starts have edged up but remain at a depressed level. 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 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. The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to promote economic recovery and price stability.

In light of improved functioning of financial markets, the Federal Reserve has closed all but one of the special liquidity facilities that it created to support markets during the crisis. The only remaining such program, the Term Asset-Backed Securities Loan Facility, is scheduled to close on June 30 for loans backed by new-issue commercial mortgage-backed securities; it closed on March 31 for loans backed by all other types of collateral.

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 continuing to express the expectation of exceptionally low levels of the federal funds rate for an extended period was no longer warranted because it could lead to a build-up of future imbalances and increase risks to longer run macroeconomic and financial stability, while limiting the Committee's flexibility to begin raising rates modestly.

This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.