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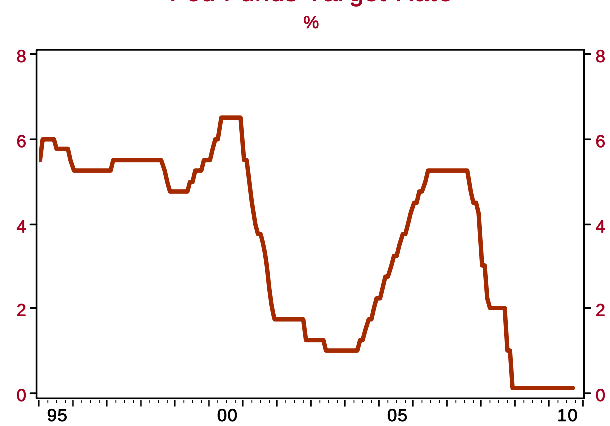
Fed Fills Can of Gas, Threatens to Douse Fire

As everyone expected, 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%. The Fed also made no changes to its commitment to keep the funds rate at this level for an "extended period." Some analysts had suggested, given the mid-year deceleration of economic growth, that the Fed would somehow make this commitment even more iron-clad.

However, the Fed did make significant changes to its statement, signaling a willingness to resort to further "quantitative easing" if it believes economic growth or inflation falters further. As a result, the financial markets reacted by driving up gold, equity values (initially), and bond prices (meaning medium- and long-term interest rates fell).

We would describe the Fed's latest position as "dovish, but data sensitive." If between now and the next meeting in early November, the economy falters further or inflation declines noticeably from here, the Fed is likely to expand its balance sheet once again, likely by purchasing long-term Treasury securities. For the time being, though, the Fed will simply keep its balance sheet steady by reinvesting principal payments.

Fed Funds Target Rate



We are skeptical that renewed expansion of the Fed's balance sheet would actually boost economic growth. More importantly, though, in our view, this potential policy move will not end up happening. After decelerating earlier this year, recent data – including unemployment claims, retail sales, and industrial production outside the auto sector – signal that the economy is re-accelerating.

The two most significant and dovish changes to the Fed's statement were to say that inflation is below where it should be for the Fed to achieve its legislative mandate and that the Fed "is prepared to provide additional accommodation, if needed to support the economic recovery" and get inflation back up to levels consistent with its mandate. It seems the Fed has an implicit inflation target of at least 2% per year, as opposed to the European Central Bank, which still has a target of 0% to 2%. Another way to think about this is that a minimum pre-condition for any Fed tightening is an inflation forecast of at least 2%.

The Fed also made some small changes to its statement, the first two of which were more pessimistic about the economy, the third more optimistic. The two more pessimistic comments were to say the economic recovery "has slowed in recent months" and that business investment in equipment and software is expanding "less rapidly than earlier in the year." The Fed made the same comment about a slowing recovery in August, but by reiterating this message the Fed is saying it thinks things got even slower.

The more optimistic comment was that bank lending is contracting at a slower rate than in prior months. In addition, Kansas City Federal Reserve President Thomas Hoenig maintained his dissent to current policy, saying the Fed should no longer pre-commit to exceptionally low rates for an extended period and the Fed need not even maintain the current size of its balance sheet, much less expand it further.

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 August indicates that the pace of recovery in output and employment has slowed in recent months. Household spending is increasing gradually, 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. Housing starts are at a depressed level. Bank lending has continued to contract, but at a reduced rate in recent months. The Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability, although the pace of economic recovery is likely to be modest in the near term.*

Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability. With substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to remain subdued for some time before rising to levels the Committee considers consistent with its mandate.

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 also will maintain its existing policy of reinvesting principal payments from its securities holdings.

The Committee will continue to monitor the economic outlook and financial developments and is prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to 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; Eric S. Rosengren; Daniel K. Tarullo; and Kevin M. Warsh.

Voting against the policy was Thomas M. Hoenig, who judged that the economy continues to recover at a moderate pace. Accordingly, he believed that continuing to express the expectation of exceptionally low levels of the federal funds rate for an extended period was no longer warranted and will lead to future imbalances that undermine stable long-run growth. In addition, given economic and financial conditions, Mr. Hoenig did not believe that continuing to reinvest principal payments from its securities holdings was required to support the Committee's policy objectives.