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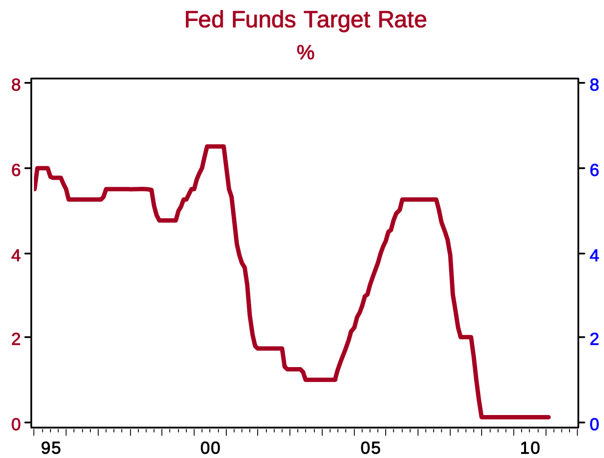
Economic Commentary

Fed Pays Lip Service to Better Economy and Higher Inflation

The Federal Reserve made several changes to the language of its statement today, acknowledging an improving economy and higher overall inflation. However, the Fed also made it clear it does not think any of this warrants a change in the stance of monetary policy.

The Fed was more bullish on the economy, saying it was on a "firmer footing" and that the labor market was "improving gradually." Previously the Fed had said economic growth was not enough to generate "significant improvement" in the labor market. The Fed recognized faster growth in household spending and, importantly, finally omitted long-used language that household spending was being constrained by high unemployment, modest income growth, declining housing wealth and tight credit.



Source: Haver Analytics

On inflation, the Fed noted the rapid rise in commodity prices, such as oil, and said it would pay attention to these prices. However, the Fed also said the higher inflation related to commodity prices was likely to be "transitory" and that underlying inflation is trending downward. This is even more dovish than the prior language that said underlying inflation is "subdued." In other words, the Fed will watch commodity prices but is not going to change policy because of them. In essence, the Fed thinks it's a spectator of, not a participant in, commodity price changes, even though it controls the supply of the currency in which these commodities are denominated.

One subtle change in the statement was that the Fed took out a reference to "slow progress" toward its objectives of maximum employment and price stability.

Otherwise, as everyone expected, 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.

The Fed is not going to raise rates in 2011 but continued economic improvement and gradual increases in the "core" inflation measures the Fed watches should put the Fed in the position to start raising rates early next 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 January suggests that the economic recovery is on a firmer footing, and overall conditions in the labor market appear to be improving gradually. Household spending and business investment in equipment and software continue to expand. However, investment in nonresidential structures is still weak, and the housing sector continues to be depressed. Commodity prices have risen significantly since the summer, and concerns about global supplies of crude oil have contributed to a sharp run-up in oil prices in recent weeks. Nonetheless, longer-term inflation expectations have remained stable, and measures of underlying inflation have been subdued.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. Currently, the unemployment rate remains elevated, and measures of underlying inflation continue to be somewhat low, relative to levels that the Committee judges to be consistent, over the longer run, with its dual mandate. The recent increases in the prices of energy and other commodities are currently putting upward pressure on inflation. The Committee expects these effects to be transitory, but it will pay close attention to the evolution of inflation and inflation expectations. The

Committee continues to anticipate a gradual return to higher levels of resource utilization in a context of price stability.

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. In particular, the Committee is maintaining its existing policy of reinvesting principal payments from its securities holdings and intends to purchase $600 billion of longer-term Treasury securities by the end of the second quarter of 2011. 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; Elizabeth A. Duke; Charles L. Evans; Richard W. Fisher; Narayana Kocherlakota; Charles I. Plosser; Sarah Bloom Raskin; Daniel K. Tarullo; and Janet L. Yellen.