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ECONOMIC RESEARCH REPORT
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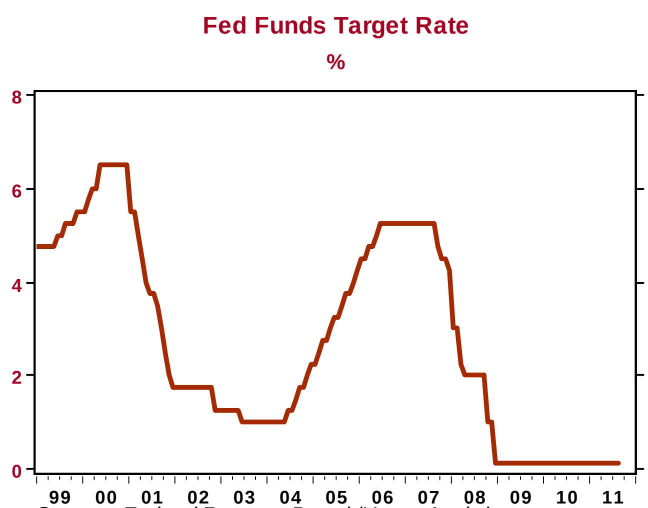
Fed Commits to Low Rates as Far as the Eye Can See

Yesterday's official statement from the Federal Reserve contained several major changes to its language, including a less optimistic view of the economy and a more dovish outlook on inflation. Most importantly, the Fed dropped the phrase "extended period" when describing how long it intended to keep rates "exceptionally low," replacing it with a commitment to keep rates at such levels until at least mid-2013.

The bar to raising rates before mid-2013 is now very high, as doing so before then – even if economic conditions might warrant – could hurt the ability of some future Fed to credibly commit to such a policy again. In other words, as far as the Fed is concerned right now, short-term interest rate hikes are off the table for this year, all of next year and at least the first half of 2013. This may change if "core" inflation escalates more than the Fed now anticipates, or if real economic growth significantly improves, or a combination of the two. The bar, however, is set high.



Source: Federal Reserve Board /Haver Analytics

On the economy, the Fed said the recovery is "considerably slower" than it had expected, the labor market has deteriorated, consumer spending has "flattened out," and downside risk has grown. Just as important, the Fed said only "some" of the recent weakness can be attributed to temporary factors, such as supply chain disruptions from Japan. Previously its language was vaguer, leaving open the notion that most of the soft patch was due to temporary factors. Also, the Fed said it had downgraded its internal forecast for economic growth for the near future.

Meanwhile, the Fed was more dovish on inflation, noting recent moderation and suggesting that the effects of past increases in commodity prices will "dissipate further."

Near the end of recent statements, the Fed has said it would "monitor the economic outlook and financial developments and will act as needed to best foster maximum employment and price stability." Note the reference to price stability being on par with fostering maximum employment.

Instead, in yesterday's statement, the Fed replaced that language with a paragraph saying it discussed "a range of policy tools available to promote a stronger economic recovery in a context of price stability." This shift suggests more emphasis on economic growth than price stability. Obviously, the tools the Fed discussed are not designed to reduce inflation.

The Fed likely discussed a third round of quantitative easing and ideas like shifting its portfolio toward longer-dated Treasury securities and reducing or eliminating the interest it pays banks on excess reserves. We think the bar to such actions is high at this point in time. Notably, three members of the Federal Open Market Committee (Fisher, Kocherlakota and Plosser), all reserve bank presidents, not members of the Washington DC-based Board of Governors, voted against the commitment to keep short-term rates at near zero through at least mid-2013.

The Fed also used today's statement to say it will keep re-investing principal payments on its portfolio of securities. Given its commitment to keep short-term rates near zero through mid-2013, it's unlikely to start allowing its balance sheet to decline in size until very late 2012 at the earliest.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in June indicates that economic growth so far this year has been considerably slower than the Committee had expected. Indicators suggest a deterioration in overall labor market conditions in recent months, and the unemployment rate has moved up. Household spending has flattened out, investment in *nonresidential structures is still weak, and the housing sector remains depressed. However, business investment in equipment and software continues to expand. Temporary factors, including the damping effect of higher food and energy prices on consumer purchasing power and spending as well as supply chain disruptions associated with the tragic events in Japan, appear to account for only some of the recent weakness in economic activity. Inflation picked up earlier in the year, mainly reflecting higher prices for some commodities and imported goods, as well as the supply chain disruptions. More recently, inflation has moderated as prices of energy and some commodities have declined from their earlier peaks. Longer-term inflation expectations have remained stable.*

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee now expects a somewhat slower pace of recovery over coming quarters than it did at the time of the previous meeting and anticipates that the unemployment rate will decline only gradually toward levels that the Committee judges to be consistent with its dual mandate. Moreover, downside risks to the economic outlook have increased. The Committee also anticipates that inflation will settle, over coming quarters, at levels at or below those consistent with the Committee's dual mandate as the effects of past energy and other commodity price increases dissipate further. However, the Committee will continue to pay close attention to the evolution of inflation and inflation expectations.

To promote the ongoing economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee decided today to keep the target range for the federal funds rate at 0 to 1/4 percent. The Committee currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013. The Committee also will maintain its existing policy of reinvesting principal payments from its securities holdings. The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate.

The Committee discussed the range of policy tools available to promote a stronger economic recovery in a context of price stability. It will continue to assess the economic outlook in light of incoming information and is prepared to employ these tools as appropriate.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; Charles L. Evans; Sarah Bloom Raskin; Daniel K. Tarullo; and Janet L. Yellen.

Voting against the action were: Richard W. Fisher, Narayana Kocherlakota, and Charles I. Plosser, who would have preferred to continue to describe economic conditions as likely to warrant exceptionally low levels for the federal funds rate for an extended period.