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First Trust

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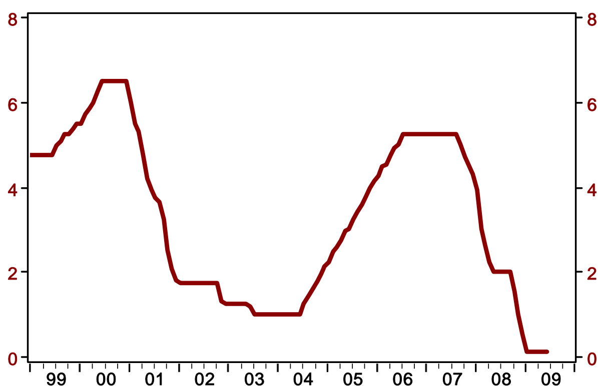
Economic Commentary

Fed Steps Away From Quantitative Easing

Although the Federal Reserve did not change the stance of monetary policy directly today, it made some important changes to the language of its statement, indicating less bearishness about the economy and more concern about inflation, or at least much less concern about deflation. We think the Fed is still much too bearish about economic prospects and should ramp up its concern about inflation even more, but today's steps are in the right direction.



On the economy, the Fed acknowledged better conditions in the financial markets, "further" signs of stabilization in consumer spending, and progress by businesses in reducing inventories. The Fed also omitted references to businesses fearing weak sales and having difficulty getting credit.

On inflation, the Fed acknowledged that energy and other commodity prices are up. But more important was what the Fed left out. In the previous statement back in April, the Fed said "inflation could persist for a time below rates that best foster economic growth and price stability in the longer term." In other words, the Fed feared deflation. Now the Fed says it expects "inflation will remain subdued for some time." So no more deflation fears, just no inflation fears…yet.

In terms of future policy changes, much attention is being paid to the Fed maintaining its language that "economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period."

Some think this means the bar is very high for the Fed to raise rates anytime before next year. However, we think too much attention is being paid to the "extended period of time" portion of the statement and not enough attention is being paid to the start of the quote, "economic conditions are <u>likely</u> to warrant" (our emphasis). This pledge, to keep rates low is based on an assumption that economic conditions are likely to warrant the 0% to 0.25% rate range. We think this means the Fed is still open to raising rates if economic conditions improve more rapidly than it now projects.

In addition, the Fed made two more important changes to its statement. First, it took out a sentence saying the Fed is "facilitating the extension of credit to households and businesses and supporting the functioning of financial markets…." Second, it now says it is "monitoring" the size and composition of its balance sheet rather than "carefully monitoring" like it said after the last meeting. These changes suggest the Fed is not going to expand its limits on purchases of mortgage-backed securities, agency debt, or Treasury securities. It also implies more bullishness on the ability of the financial system to continue to heal without government involvement.

The bottom line is that the Fed was able to affirm its commitment to easy money, but take a small baby step toward an exit strategy.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in April suggests that the pace of economic contraction is slowing. Conditions in financial markets have generally improved in recent months.

Household spending has shown further signs of stabilizing but remains constrained by ongoing job losses, lower housing wealth, and tight credit. Businesses are cutting back on fixed investment and staffing but appear to be making progress in bringing inventory stocks into better alignment with sales. Although economic activity is likely to remain weak for a time, the Committee continues to anticipate that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a gradual resumption of sustainable economic growth in a context of price stability.

The prices of energy and other commodities have risen of late. However, substantial resource slack is likely to dampen cost pressures, and the Committee expects that inflation will remain subdued for some time.

In these circumstances, the Federal Reserve will employ all available tools to promote economic recovery and to preserve 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 are likely to warrant exceptionally low levels of the federal funds rate for an extended period. As previously announced, to provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve will purchase a total of up to $1.25 trillion of agency mortgage-backed securities and up to $200 billion of agency debt by the end of the year. In addition, the Federal Reserve will buy up to $300 billion of Treasury securities by autumn. The Committee will continue to evaluate the timing and overall amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets. The Federal Reserve is monitoring the size and composition of its balance sheet and will make adjustments to its credit and liquidity programs as warranted.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; Charles L. Evans; Donald L. Kohn; Jeffrey M. Lacker; Dennis P. Lockhart; Daniel K. Tarullo; Kevin M. Warsh; and Janet L. Yellen.

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