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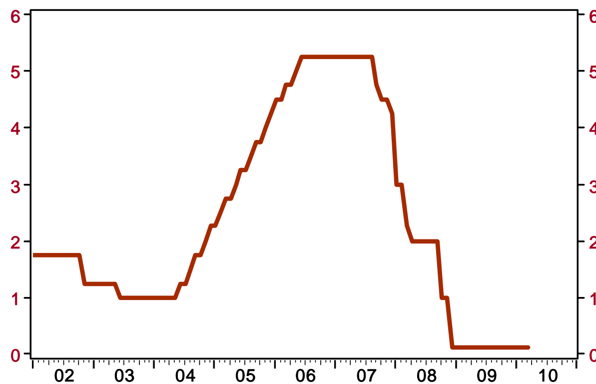
Mar 16, 2010 Economic Commentary

Fed Still Clinging to Extremely Loose Money

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%. However, changes to the statement show the Fed is gaining confidence in the financial markets and economy. In addition, one member reiterated and strengthened his dissent to keeping interest rates at exceptionally low levels for an "extended period" of time.



The changes in the statement that indicate more bullishness include the following:

(1) The labor market is "stabilizing," no longer showing "deterioration."
(2) Business investment in equipment and software "has risen significantly," rather than "appears to be picking up."
(3) Housing starts are "flat" rather than "contracting."

The Fed also more firmly committed to ending its special lending facilities for the mortgage market. It did so by taking out language from the January statement that it would "evaluate its purchase of securities" in light of the economy and financial markets. The Fed similarly omitted language (from the January statement) that it might reconsider the winding down of other special lending facilities, such as the Term Auction Facility or Term Asset-Backed Securities Loan Facility, based on economic and financial conditions. In other words, it is no longer hedging its bets that it might have to resuscitate these programs.

The dissent by Kansas City Fed President Thomas Hoenig went further than last time. In January, Hoenig wanted to omit the "extended period" commitment because it was no longer warranted; now he explains that keeping that phrase could cause financial imbalances and increase risks to the long-term economic outlook. Apparently, unlike Chairman Ben Bernanke, Hoenig thinks loose monetary policy in the previous decade did help to cause the housing bubble.

Change in our Forecast

Late last year we forecasted that the Fed would start raising the federal funds rate in late June and lift the funds rate to 1.75% by the end of 2010. So far this year, the Fed has made some incremental steps toward a cycle of higher interest rates. These steps include winding down its special lending facilities, practice runs for withdrawing some liquidity from the financial system, and raising the discount rate to 0.75%.

Meanwhile, economic performance has improved substantially, consistent with a V-shaped recovery. Real GDP grew at a 4% 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 4.4% 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.

However, it has become increasingly clear that Chairman Bernanke is determined to maintain the current policy of extraordinarily low interest rates even as economic conditions become much more ordinary, and in many ways robust. In early January, Bernanke made a speech saying the Fed's 1% interest rates a decade ago were not at fault for the housing bubble. If Bernanke does not think extremely low rates were problem back then, he is much more willing than he should be to maintain low rates for too long this time around as well.

Second, in speeches and testimony, Bernanke has persistently repeated the "extended period" language used in the FOMC's statements, regarding how long the Fed will maintain exceptionally low levels for the federal funds rate. Back in 2003, the Greenspan Fed was using a similar phrase ("considerable period"). That phrase last appeared in December 2003 and the first rate hike from the Fed was not until six months later (June 2004). Bernanke knows markets are aware of that previous time lag and probably wants to remove the "extended period" phrase well before rate hikes begin. Removing the phrase and then raising rates soon thereafter would not only surprise the financial markets but – to Bernanke's way of thinking – undermine the future ability of the Fed to pre-commit to an "extended period" of low rates, should that type of policy become useful in the future.

Third, the Fed continues to believe the "normal" unemployment rate for the US economy should be about 5%. In addition, its economic philosophy suggests inflation should not be a problem until it can forecast the jobless rate heading below 5%. Given Bernanke's dismissal of the Fed as a source of the housing bubble and his lack of concern about the oil/commodity price spike in late-2007/early-2008, we doubt he will get concerned about the 3.5% overall CPI increase we are forecasting for this year. As long as "core" prices (excluding food and energy) remain relatively subdued, that will give the Fed the excuse it needs to ignore warning signs sent by broader measures of inflation.

Given the improvement in the economy, we believe today's meeting will be the last one in which the Fed uses the "extended period" language. At the next meeting, in late April, the Fed should adopt language signaling greater data dependence. This will set the stage for the Fed to start lifting the funds rate in the third quarter and ultimately reach somewhere in the 0.75% to 1.25% range by year end. It is certainly plausible for the Fed to act more aggressively once it starts raising rates, but we also think the Fed will be reluctant to raise rates more quickly than usual near year end, when seasonal demand for liquidity increases.

A more prolonged period of extremely loose monetary policy will generate more real economic growth in 2011. However, we will eventually pay an economic 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 January suggests that economic activity has continued to strengthen and that the labor market is stabilizing. Household spending is expanding at a moderate rate 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, housing starts have been flat at a depressed level, and employers remain reluctant to add to payrolls. 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. To provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve has been purchasing $1.25 trillion of agency mortgage-backed securities and about $175 billion of agency debt; those purchases are nearing completion, and the remaining transactions will be executed by the end of this month. 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 been closing 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 and 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 the buildup of financial imbalances and increase risks to longer-run macroeconomic and financial stability.

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.