The Fed stays put, but opens the door to further accommodative measures

ACCORDING TO THE FEDERAL RESERVE (Fed)

- The Federal Reserve will maintain the target range for the federal funds rate at 0 to 1/4 percent.
- 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.
- 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.
- The Committee continues to anticipate that economic conditions 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. Moreover, the Fed is prepared to provide additional accommodation if needed to support the economic recovery and inflation.

COMMENTS

The press release issued along with today’s decision includes few pieces of good news about the economy and generally points to growth that is slower than at the beginning of the year. The Fed, however, provided more details on its position on inflation, judging that price growth is too slow to be consistent with its mandate to provide long-term price stability. To the economic risks that were front and centre in previous statements, the Fed just added the risk regarding inflation.

The Fed responded to these risks by opening the door to a new round of expansionary policy. Previous statements mentioned that the Fed would use its policy tools if required to favour economic recovery and price stability. This time, the Fed clearly indicated that, if action is indeed required, it would clearly be for the purpose of stimulating growth and accelerating inflation.

Two questions remain: What and when? We have to go back to the most recent speeches by Fed leaders to answer these questions. First of all, what more can the Fed do? It could very well boost its balance sheet again by buying up more federal government bonds. The extensive purchase of securities would exert downward pressures on bond and retail rates. Other, more conservative measures could also be put in place, such as dropping the interest rates granted on bank reserves.

Second: When could the Fed act? It should opt to enact further measures only if the economic situation worsens dangerously. For example, if the ISM indexes fell below the 50-mark or if private jobs were to contract to any lasting degree, this would be enough to prompt the Fed to act. Today, the Fed opened the door to a response that would depend on the level of inflation. If it moves closer to an annual change of about 0%, the consumer price index, which excludes food and energy (which has been steady at 0.9% for five months now), could force the hand of Fed leaders. It must be noted that these assumptions do not form part of our base case economic scenario.

Implications: By adopting a more negative bias, the Fed is opening the door to more quantitative recovery measures. That said, we are not out of the woods yet and the economic situation would have to worsen for the Fed to take such action. One thing is clear, however: key interest rates should stay put until 2012.

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EXCERPT FROM THE FEDERAL RESERVE PRESS RELEASE

“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 [...]”