Although growth has improved, the Fed remains dovish

According to the Federal Reserve (Fed)

- The Federal Reserve decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.

- To support the economy, the Fed decided to continue its program to extend the average maturity of its holdings of securities. It is maintaining its existing policies of reinvesting principal payments from its holdings of mortgage-backed securities and of rolling over maturing Treasury securities at auction.

- Economic growth strengthened somewhat in the third quarter, reflecting in part a reversal of the temporary factors that had weighed on growth earlier in the year. Nonetheless, recent indicators point to continuing weakness in overall labor market conditions. Household spending has increased at a somewhat faster pace in recent months. Business investment in equipment and software has continued to expand, but investment in nonresidential structures is still weak, and the housing sector remains depressed.

- Inflation appears to have moderated since earlier in the year as prices of energy and some commodities have declined from their peaks. Longer-term inflation expectations have remained stable.

- The Committee continues to expect a modest pace of economic growth over coming quarters. Moreover, there are significant downside risks to the economic outlook, including strains in global financial markets.

Comments

Subsequent to the announcement and implementation of Operation Twist at its previous meeting, it was clear that the Fed would not announce anything really extravagant. Aside from the fact that Fed leaders appear to have liked the third quarter’s real GDP growth, nothing new appeared in the statement that accompanied today’s decision. However, the tone seemed to be a little less optimistic about the U.S. economy’s future growth. After the summer’s gain, which was buoyed by consumer spending and business investment, the Fed is now signalling that it anticipates modest growth. This is also reflected in its official forecasts. The annual real GDP change forecast for the end of 2012 has gone from a range of 3.3% to 3.7% in June to a range of 2.5% to 2.9% today. The forecasts for 2011 have also been downgraded, from a range of 2.7% to 2.9% to a range of 1.6% to 1.7%, but this primarily reflects the annual revision of the national accounts that took place this summer.

Another thing to note is the change in trend for the dissent expressed by monetary policy committee members. We had grown accustomed to seeing some of the more hawkish presidents of regional federal reserves come out against some committee decisions. This is what happened with September’s Operation Twist announcement. This time, these members joined the majority, while the Chicago Fed’s Charles Evans dissented, stating that additional expansionary policy was already needed. The last time we saw dovish dissonance on the committee was at the end of 2007.

Implications: Neither today’s statement nor Ben Bernanke’s remarks at the press conference clearly indicate additional Fed action. However, if economic growth and the labour market are disappointing again in the coming months and the inflation situation allows it—which seems to be the case, according to the recent slowdown by prices excluding food and energy—it is easy to see the Fed going ahead with additional securities purchases, which would expand its balance sheet even further. At that time, perhaps in early 2012, the Fed could focus more on non-federal government securities, particularly mortgage securities. We do not expect the target for the federal funds rate to go up before the start of 2014.

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EXCERPT FROM THE FEDERAL RESERVE PRESS RELEASE

[...] Information received since the Federal Open Market Committee met in September indicates that economic growth strengthened somewhat in the third quarter, reflecting in part a reversal of the temporary factors that had weighed on growth earlier in the year. Nonetheless, recent indicators point to continuing weakness in overall labor market conditions, and the unemployment rate remains elevated. Household spending has increased at a somewhat faster pace in recent months. Business investment in equipment and software has continued to expand, but investment in nonresidential structures is still weak, and the housing sector remains depressed. Inflation appears to have moderated since earlier in the year as prices of energy and some commodities have declined from their 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 continues to expect a moderate pace of economic growth over coming quarters and consequently anticipates that the unemployment rate will decline only gradually toward levels that the Committee judges to be consistent with its dual mandate. Moreover, there are significant downside risks to the economic outlook, including strains in global financial markets. 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 support a stronger economic recovery and to help ensure that inflation, over time, is at levels consistent with the dual mandate, the Committee decided today to continue its program to extend the average maturity of its holdings of securities as announced in September. The Committee is maintaining its existing policies of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate. [...] The Committee also decided to keep the target range for the federal funds rate at 0 to 1/4 percent and 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 will continue to assess the economic outlook in light of incoming information and is prepared to employ its tools to promote a stronger economic recovery in a context of price stability. [...]