**FEDERAL RESERVE**

A bit more upbeat, but still cautious

**ACCORDING TO THE FEDERAL RESERVE (Fed)**

- The Fed will maintain the target range for the federal funds rate at 0.00% to 0.25%.
- Information received since the November meeting suggests that economic activity has continued to pick up and that the deterioration in the labor market is abating. The housing sector has shown some signs of improvement over recent months. Household spending appears to be expanding at a moderate rate, though it remains constrained by a weak labor market, modest income growth, lower housing wealth, and tight credit. Businesses are still cutting back on fixed investment, though at a slower pace. Financial market conditions have become more supportive of economic growth.
- Although economic activity is likely to remain weak for a time, policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a strengthening of economic growth and a gradual return to higher levels of resource utilization.
- With substantial resource slack and with longer-term inflation expectations stable, inflation is expected to remain subdued for some time.
- The federal funds rate will stay at exceptionally low levels for an extended period.
- As for its quantitative policy, the Fed is maintaining its targets for purchasing mortgage securities (US$1,250B) and bonds issued directly by mortgage agencies (US$175B). The purchases should be complete by the end of Q1 2010. Most special liquidity programs are set to expire on February 1, 2010.

**COMMENTS**

The Federal Reserve’s statement clearly reflects the recent improvement in many economic indicators. In particular, it mentions the job market’s slowing deterioration. However, some sentences that had been pointing to improved economic conditions in November are now more equivocal. The expansion in household spending is treated as moderate and the housing sector is showing “signs of improvement” rather than growth. While the Fed is a little more upbeat, it is certainly not being overconfident.

The main thing to remember about today’s statement is that nothing is changing overnight. The Fed continues to signal that its key rates will remain low for a long time. A number of factors argue for caution. Firstly, it will take a long time to resolve the extensive underuse of production resources and the jobless rate will remain elevated all year. Secondly, credit is still contracting in the United States, in mortgages, consumer lending and commercial lending alike. Thirdly, core inflation should continue to moderate and, in 2010, drop below 1%. Fourthly, the Fed must factor in the drop in stimulus from public spending as of 2011. Lastly, with the news that it will be withdrawing some of its own measures, the Fed is also giving the economy less support, particularly the housing market.

**Implications:** Today’s decision does not alter the forecasts for the Fed’s monetary policy. The first rate hikes are only expected in early 2011.

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EXCERPT FROM THE FEDERAL RESERVE PRESS RELEASE

Information received since the Federal Open Market Committee met in November suggests that economic activity has continued to pick up and that the deterioration in the labor market is abating. The housing sector has shown some signs of improvement over recent months. Household spending appears to be expanding at a moderate rate, though it remains constrained by a weak labor market, modest income growth, lower housing wealth, and tight credit. Businesses are still cutting back on fixed investment, though at a slower pace, and remain reluctant to add to payrolls; they continue to make progress in bringing inventory stocks into better alignment with sales. Financial market conditions have become more supportive of economic growth. Although economic activity is likely to remain weak for a time, the Committee anticipates that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a strengthening of economic growth and a gradual return to higher levels of resource utilization in a context of price stability.

With substantial resource slack likely to continue to dampen cost pressures and with longer-term inflation expectations stable, the Committee expects that inflation will remain 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. [...]