FOMC: low rate of resources utilization warrant zero-interest rate policy

As expected, the FOMC opted to keep interest rates unchanged. With respect to the assessment of current and future economic activity, the FOMC showed increased optimism. Over the course of past three meetings, its assessment of current conditions has changed from a “levelling out” to a “continued pick-up” in activity with the support of household spending. Despite the improving economic backdrop, however, the central bank reiterated its commitment to keep rates exceptionally low for an extended period of time on the back of its assessment of the inflation outlook. More specifically, the press release emphasized that low rates of resource utilization (read unemployment rate) combined with subdued inflation trends (low unit labour costs) and stable inflation expectations were the three conditions that warranted keeping the current policy stance unchanged.

Bottom Line:

This press release retains the status quo for capital markets. By leaving unchanged its guidance on interest rates, the Fed is keeping the reflation trade alive. By making reference to business investment and staffing in the same sentence, the FOMC recognizes the very close link between these two variables. We could not agree more with this view. This relationship is central to our scenario calling for a sustainable economic recovery. We note that business spending actually showed initial signs of firming with spending on machinery & equipment rising in Q3 (+1.1%), the first increase since the onset of the recession. This is a positive development that heralds an improvement in labour market conditions. But until the FOMC actually sees job creation, its dual mandate binds it to a zero-interest rate policy.

Here is the press release (sections highlighted by us).

*Information received since the Federal Open Market Committee met in September suggests that **economic activity has continued to pick up**. Conditions in financial markets were roughly unchanged, on balance, over the intermeeting period. Activity in the housing sector has increased over recent months. **Household spending appears to be expanding** but remains constrained by ongoing job losses, sluggish income growth, lower housing wealth, and tight credit**. Businesses are still cutting back on fixed investment and staffing**, though at a slower pace; they continue to make progress in bringing inventory stocks into better alignment with sales. 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 support 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.

*In these circumstances, the Federal Reserve will continue to employ a wide range of 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, 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 will purchase a total of $1.25 trillion of agency mortgage-backed securities and about*

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$175 billion of agency debt. The amount of agency debt purchases, while somewhat less than the previously announced maximum of $200 billion, is consistent with the recent path of purchases and reflects the limited availability of agency debt. In order to promote a smooth transition in markets, the Committee will gradually slow the pace of its purchases of both agency debt and agency mortgage-backed securities and anticipates that these transactions will be executed by the end of the first quarter of 2010. 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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