

DAILY GLOBAL
COMMENTARY

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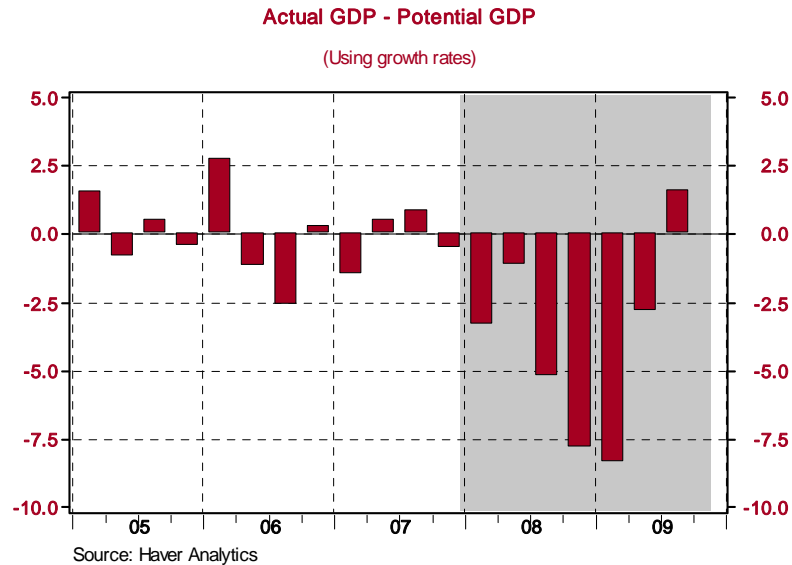
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The November 4 FOMC Policy Statement Revisited
November 5, 2009

The economic threshold to bring about a tightening of monetary conditions, although always implicit, was made explicit in the policy statement of November 4 and this aspect needs further elaboration. “Low rates of resource utilization, subdued inflation trends, and stable inflation expectations” is the key phrase indicating what could trigger a change in monetary policy. Related to this backdrop is our comment of November 4, 2009 which includes a description of economic developments that led to Fed tightening action in June 2004. The underlying justification for Fed action in 2004 was not much different from what is mentioned in the November policy statement. The key variables to track in order to understand the economic conditions that could lead to a reduction in monetary accommodation are overall output gap, unemployment rate, capacity utilization rate of industries, inflationary trends and inflation expectations. (The comparisons to 1994 and 2004 Fed actions should be viewed with caution because Fed tightening policy actions did not follow a major economic and financial crisis. Nevertheless, these comparisons are helpful.)

Output gap is the difference between actual GDP and potential GDP in inflation-adjusted dollars. Actual GDP falls short of potential GDP during recessions. The Congressional Budget Office (CBO) publishes the estimate of potential GDP. At the present time, there is a difference in benchmark years between the Commerce Department (2005) and CBO (2000). The CBO is scheduled to publish the information in 2005 chained dollars in January 2010. A rough approximation of the output gap is a comparison of the growth rates of actual and potential real GDP (see chart 1). There is a significant output gap in place at the present. The third quarter increase in real GDP is partly borrowed growth from future quarters arising from the “cash for clunkers” program.

Chart 1



GDP estimates are quarterly publications; the unemployment rate and operating rate of factories are monthly estimates which give us early hints about resource utilization in the economy.

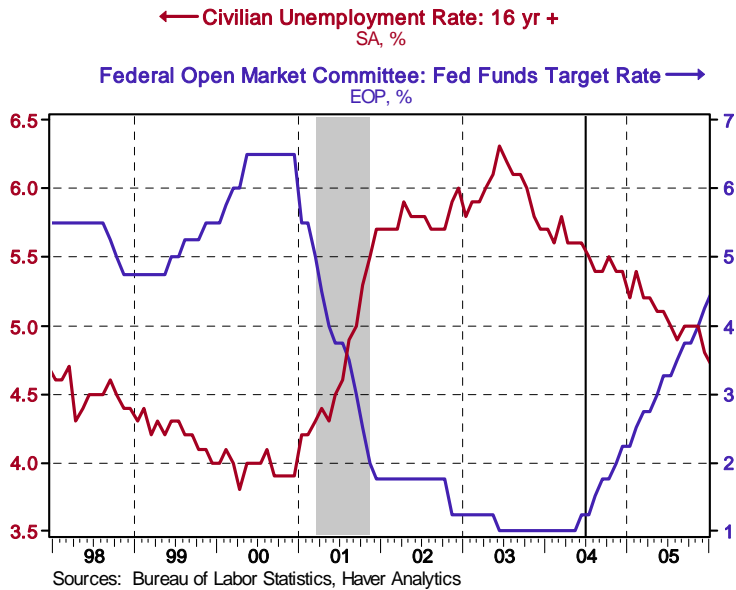
The civilian unemployment rate is a lagging economic indicator. As noted in the November 4 commentary, the Fed took action in 2004 only after the jobless rate was clearly trending down (see chart 3, the vertical line coincides with timing of Fed action in June 2004). The February 1994 episode, when the Fed tightened aggressively after holding the funds rate at 3.0% for an extended period, also indicates that the direction of the jobless rate was key to the timing of Fed action (see chart 4, the vertical line coincides with timing of Fed action in February 1994).

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Chart 2
 Unemployment Rate – September 2009



Chart 3 – Fed Raised Federal Funds Rate on 6/30/2004

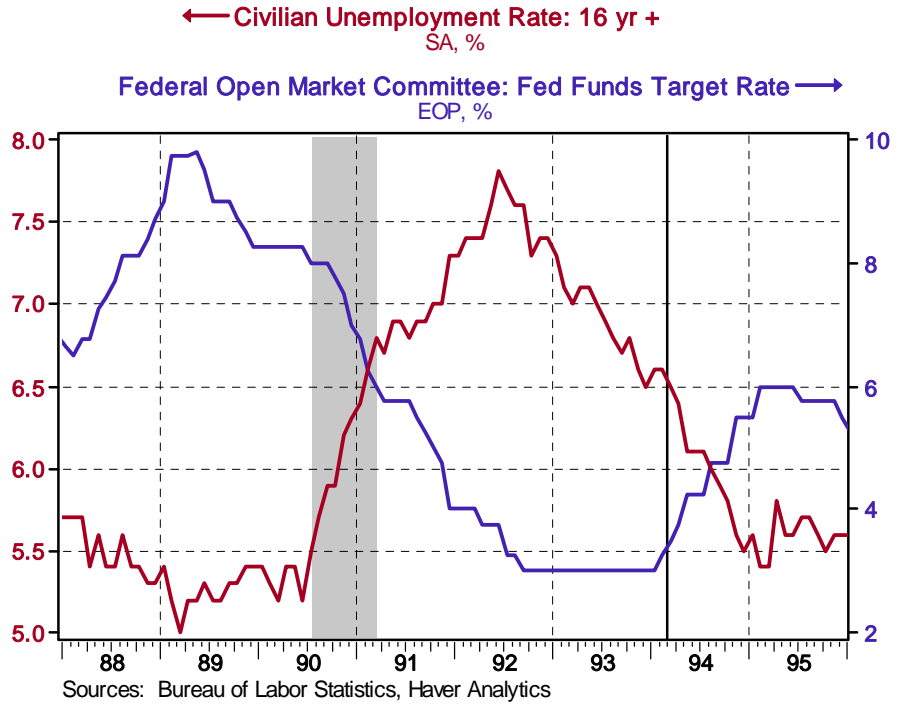


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Chart 4

Fed Raised Federal Funds Rate on 2/4/1994



The operating rate of industries is another indicator of resource utilization in the economy. The operating rate in September 2009 moved up to 70.5% from the record low mark of 68.3% in June (see chart 5). Chart 6 and 7 present the situation in 2004 and 1994.

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Chart 5

Capacity Utilization: Industry

SA, Percent of Capacity

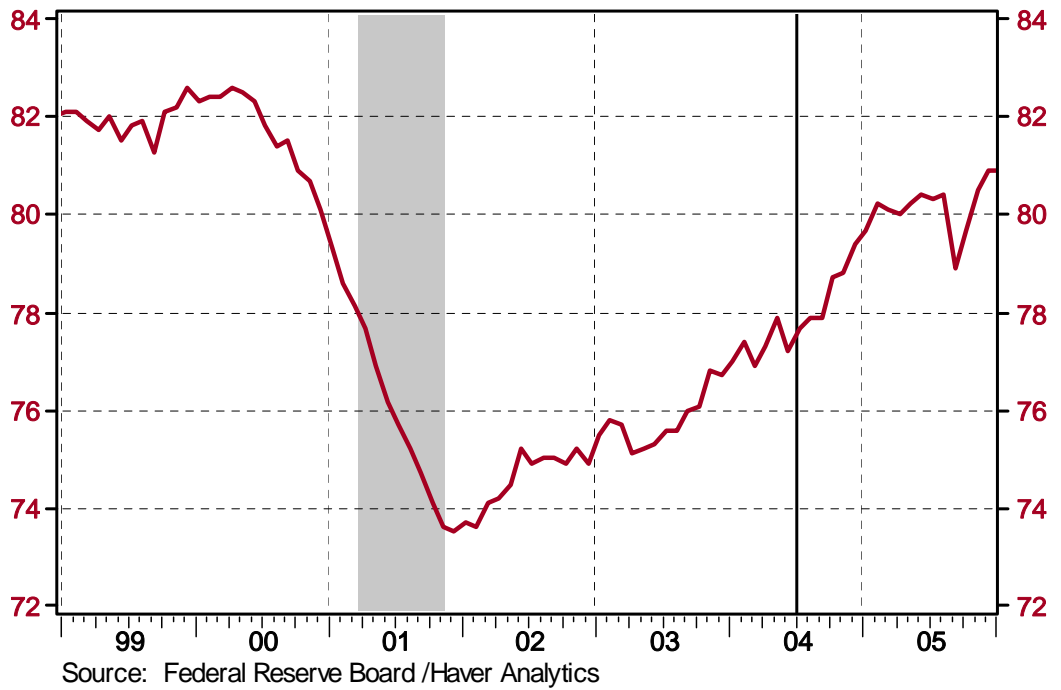


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Chart 6

Capacity Utilization: Industry

SA, Percent of Capacity

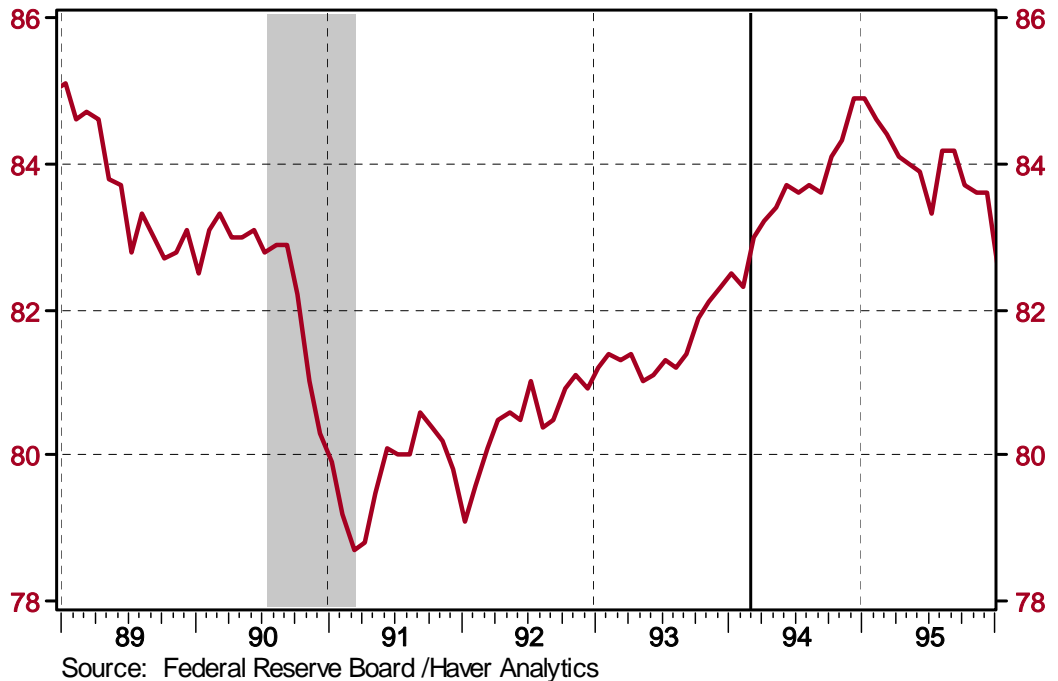


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Chart 7

Capacity Utilization: Industry

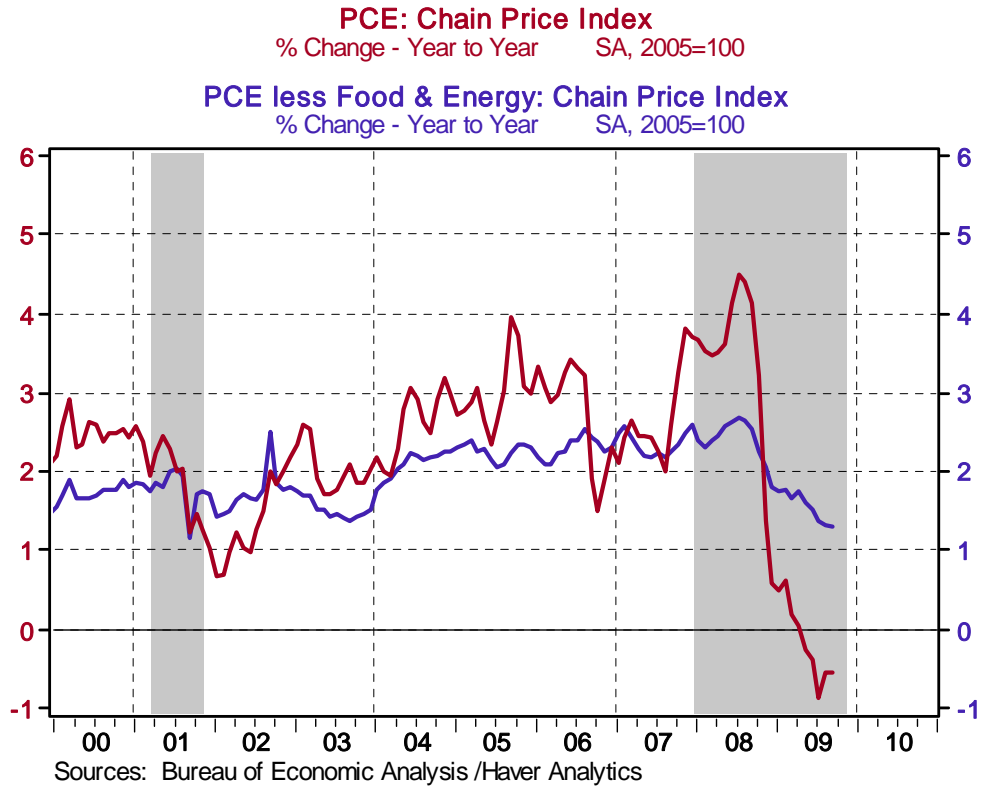
SA, Percent of Capacity



Inflation is not the Fed's major concern and the Fed's policy statements are indicative of the same. Concerns about the sharp increase in the monetary base and depreciating dollar as potential sources of inflation did not feature in the latest policy statement. Chart 8-10 depict the behavior of inflation measures the Fed focuses on – personal consumption expenditure price index and core personal consumption expenditure price index, which excludes food and energy. The core price index, which is less volatile, shows a significant decelerating trend at the present time. This price measure was advancing when the Fed commenced tightening in 2004 (see chart 9). The 1994 period was a special historical case when a disinflationary trend was underway.

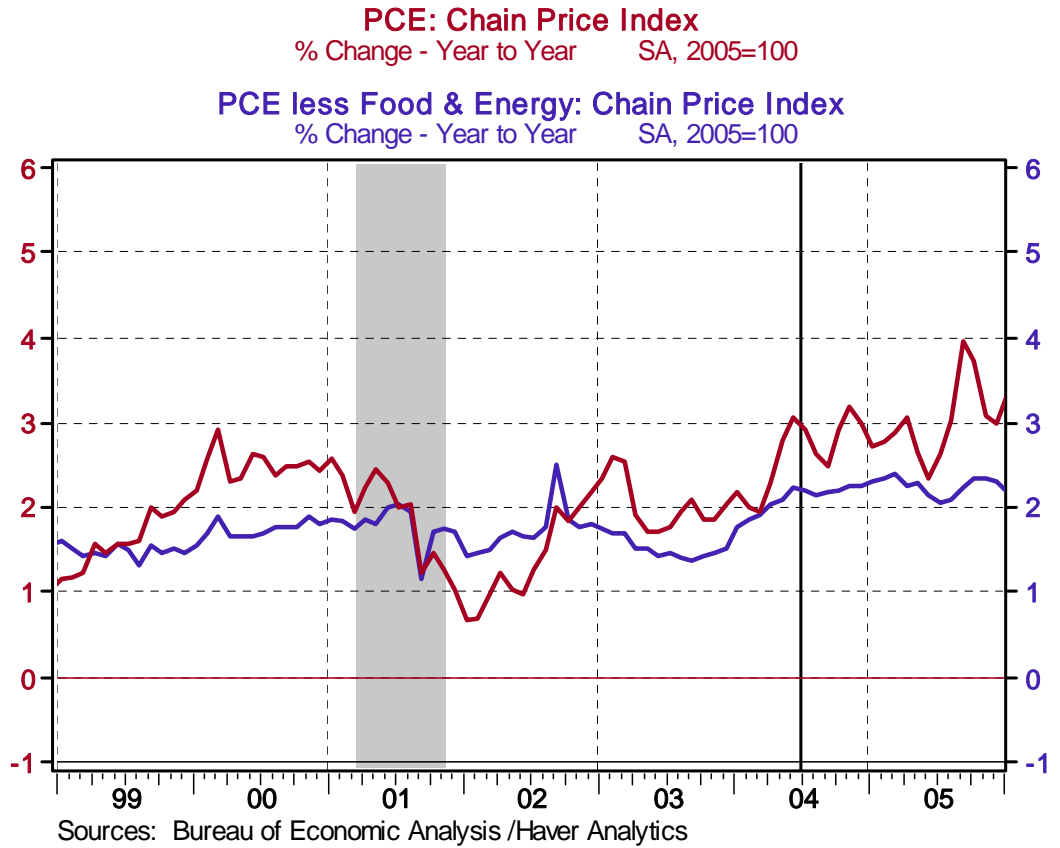
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Chart 8



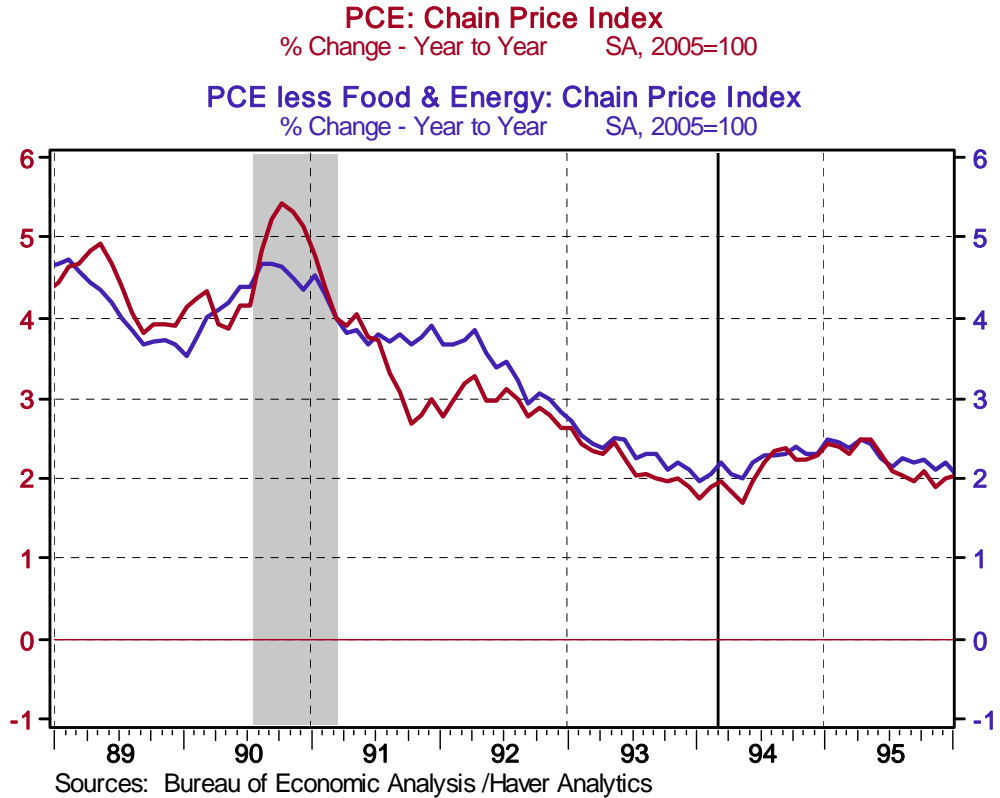
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Chart 9



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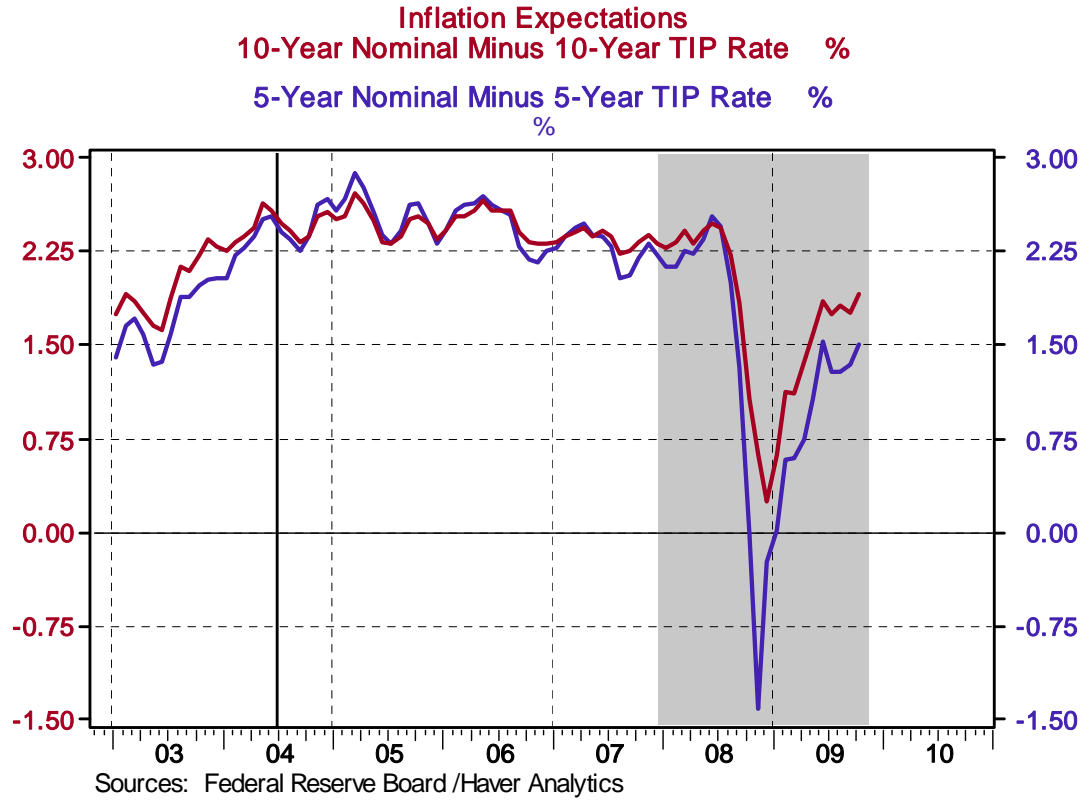
Chart 10



Inflation expectations occupy a prominent position in Fed policy rhetoric. The market-based estimate of inflation expectations (see chart 11) indicates that inflation expectations are contained now after the shock from Lehman Brothers collapse which led to expectations of deflation. Stepping back in time to 2004, between the time the Fed stopped easing and resumed tightening, inflation expectations had risen nearly 100 bps. Pulling together these charts and comments, we can conclude that the Fed's first round of tightening is several months away.

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Chart 11

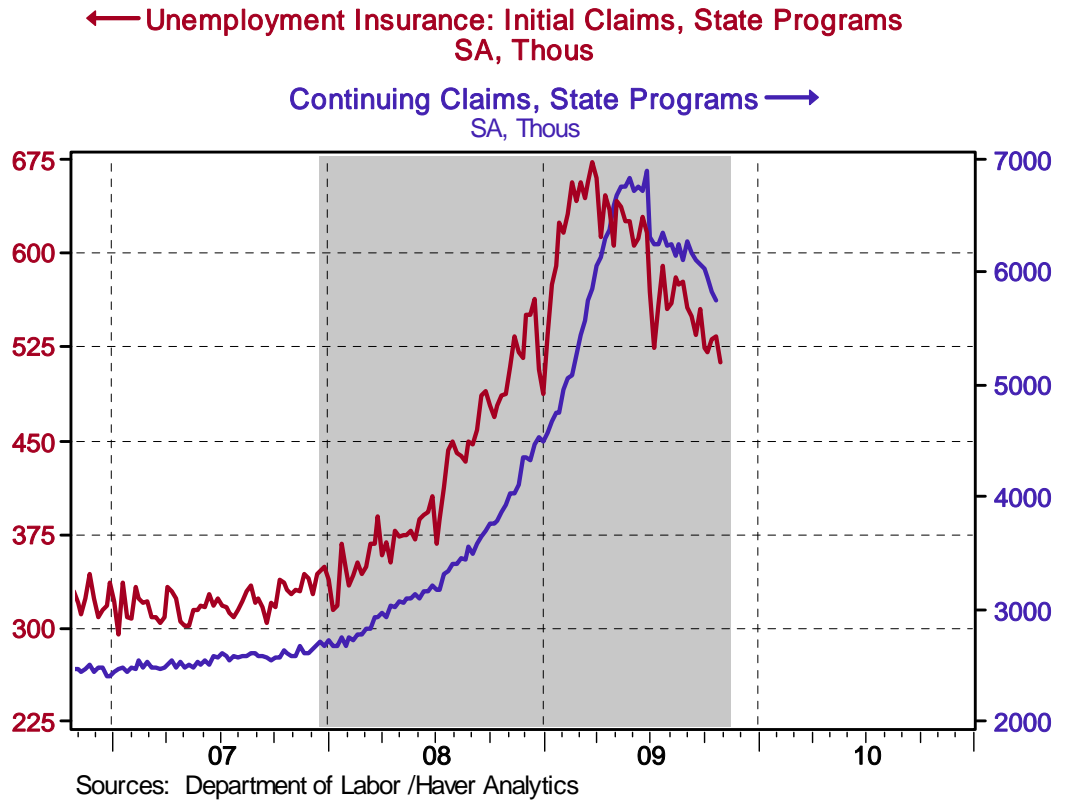


Total Continuing Claims Post Second Weekly Decline

Initial jobless claims fell 20,000 to 512,000 during the week ended October 31. Continuing claims, which lag initial claims by one week, dropped 68,000 to 5.749 million and the insured unemployment rate held steady at 4.4%.

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Chart 12



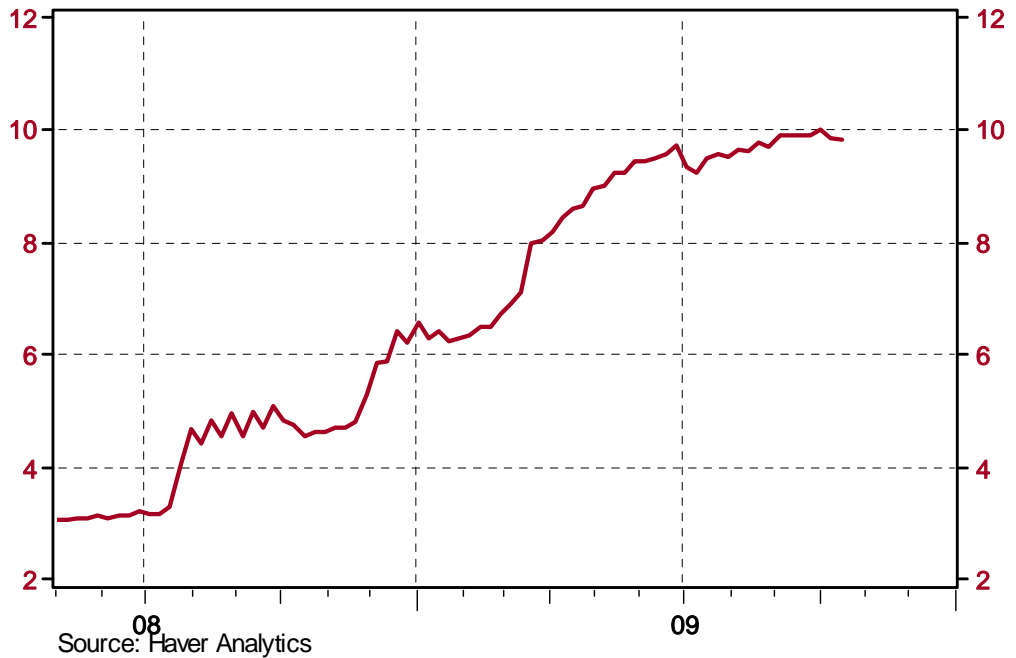
Upon the completion of 26 weeks, recipients can collect unemployment insurance under the Extended Benefits Program and Emergency Unemployment Compensation Program. Therefore, the true size of recipient of unemployment insurance is a sum of recipients under these various programs. Data for the special programs lags initial jobless claims data by two weeks. During the week ended October 17, total continuing claims inclusive of seasonally adjusted continuing claims and those under the special programs dropped to 9.8275 million from a peak of 10 million during the week ended October 3. This indicator should give us an early signal of improving conditions in the labor market.

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Chart 13

Total Continuing Claims Including Special Programs

Regular Claims, SA, Special Programs NSA (millions)



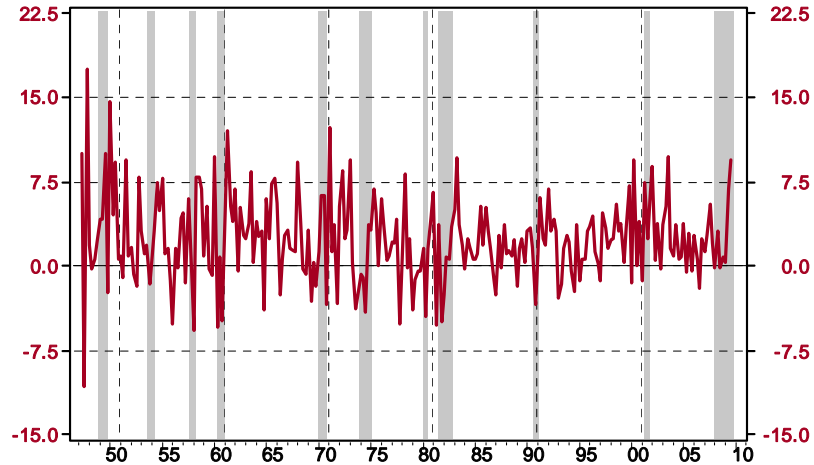
Productivity Gains Are Noteworthy, but Temporary Jump

Productivity of the U.S. economy increased 9.5% in the third quarter of 2009 vs. 6.9% gain in the second quarter. Unit labor costs fell 5.2%, after a 6.1% drop in the prior quarter. Hourly compensation moved up 3.8% in the third quarter vs. a 0.3% increase in the second quarter. Productivity gains are impressive at the early stages of a recovery as output is raised without expanding payrolls. Putting things in perspective, the underlying productivity trend of the U.S. economy is little over 2.0%.

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Chart 14

Nonfarm Business Sector: Output Per Hour of All Persons
SAAR, % Chg



Source: Bureau of Labor Statistics /Haver Analytics

	percent change from previous quarter at annual rate				
	2008-Q3	2008-Q4	2009-Q1	2009-Q2	2009-Q3
Productivity	-0.1	0.8	0.3	6.9	9.5
Output	-4.0	-7.6	-8.8	-1.1	4.0
Hours	-3.9	-8.3	-9.0	-7.5	-5.0
Unit labor costs	4.6	2.0	-5.0	-6.1	-5.2
Hourly Compensation	4.5	2.9	-4.7	0.3	3.8
Real hourly compensation	-1.6	12.3	-2.4	-1.0	0.2
Implicit Price Deflator	4.6	-0.2	2.7	-0.3	0.9
	percent change from corresponding quarter of previous year				
	2008-Q3	2008-Q4	2009-Q1	2009-Q2	2009-Q3
Productivity	1.2	0.9	1.0	1.9	4.3
Output	-0.7	-3.0	-4.8	-5.4	-3.5
Hours	-1.9	-4.0	-5.8	-7.2	-7.5
Unit labor costs	1.9	1.6	-0.1	-1.2	-3.6
Hourly Compensation	3.1	2.6	0.9	0.7	0.5
Real hourly compensation	-2.0	1.0	1.1	1.7	2.1
Implicit Price Deflator	2.0	1.6	2.2	1.7	0.8

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