Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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AUGUST FOMC STATEMENT: ON HOLD FOR LONGER

At today's FOMC meeting, the "wait-and-see" Fed chose not to engage in additional quantitative easing (QE) as many had hoped. Instead, the FOMC chose Option 1 from the list of possible additional policy measures: staying on hold for a more specific period of time.

Specifically, the FOMC statement said: "The Committee currently anticipates that economic conditions" are "likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013."

The FOMC decision was based on the fact that "downside risks to the economic outlook have increased" and that they expect "a slower pace of recovery over coming quarters than it did at the time of the previous meeting."

Why did the Fed go this route? Simple: it is the easy option. The public and the market are already familiar with the use of the federal funds rate as a policy lever. Additional measures (QE, inflation rate targeting, lowering interest on excess reserves) may prove difficult to explain in a transparent matter the goals of the FOMC. Further, faced with the pressure to "do something" in the wake of weak economic data reports and market volatility, it does not require a more controversial, unconventional action to be accepted by FOMC members.

Here is Chairman Bernanke discussing the "extended period" language change option at last year's Jackson Hole Fed Conference: "A step the Committee could consider, if conditions called for it, would be to modify the language in the statement to communicate to investors that it anticipates keeping the target for the federal funds rate low for a longer period than is currently priced in markets. Such a change would presumably lower longer-term rates by an amount related to the revision in policy expectations."

In short, the FOMC's goal is this: to influence expectations of Fed rate hikes and lower longer-term rates. Lower longer-term interest rates, in the Fed's view, will boost economic activity.

What are the risks? At Jackson Hole last year, Bernanke stated them himself: "**committing to keep the policy rate fixed for a specific period carries the risk that market participants may not fully appreciate that any such commitment must ultimately be conditional on how the economy evolves."**

Has this been tried before? Yes, there are two recent instances. The Bank of Canada tried this option in 2009. In March 2001, the Bank of Japan took a similar approach, but with one key difference: it made the low level of rates contingent upon an economic policy goal. The BOJ committed to keeping rates low until consumer price inflation turned positive on a year-over-year basis. My reading of the FOMC statement finds no explicit conditionality, but I assume the FOMC statement was the most agreed upon approach possible.

What motivates the dissenters (Kocherlakota, Fisher, Plosser)? Our "Hawks versus Doves" presentation earlier in the year highlighted the split nature of the FOMC and a key concern of the Hawks: that low rates will fan inflation pressures down the road (Fisher). In my view, that's the entire point! But hawks worry about the Fed's ability to engineer the precise rate of inflation desired. And, frankly, economic history is on the side of the hawks. A second Hawk view -- a view I think is held by Kocherlakota -- is that if the economic downturn is structural (e.g., skills mismatches, too many homes built during the boom, malinvestment in certain sectors and underinvestment in others, etc.) then additional doses of Fed-administered liquidity are not the answer. On this point—which emphasizes the structural nature of the downturn—we tend to agree with the Hawks.

Dissenters will not necessarily prevent the Fed from "doing more". In the last sentence of the FOMC statement it says the Committee "will continue to assess the economic outlook in light of incoming information and is prepared to employ these tools as appropriate." What's the limiting factor? Inflation. In their jargon, the Fed seeks "to promote a stronger economic recovery in a context of price stability."

Although "the bar" has been lowered for additional action, it is still too high (given core inflation trends) to pursue further "QE" at this time. On hold for longer was the easy policy option.