

FED WATCHING

Bernanke's Testimony Suggests Fed on Hold in 2008

- Fed Chairman Bernanke presented his semiannual testimony on the economy and monetary policy to the Senate Banking Committee today. We would draw particular attention to the following quotes:

On the financial markets

- “In general, healthy economic growth depends on well-functioning financial markets. Consequently, helping the financial markets to return to more normal functioning will continue to be a top priority of the Federal Reserve.”

On the real economy

- “FOMC participants indicated that considerable uncertainty surrounded their outlook for economic growth and viewed the risks to their forecasts as skewed to the downside.”
- “...with the labor market softening and consumer price inflation elevated, real earnings have been stagnant so far this year; declining values of equities and houses have taken their toll on household balance sheets; credit conditions have tightened; and indicators of consumer sentiment have fallen sharply. More positively, the fiscal stimulus package is providing some timely support to household incomes. Overall, consumption spending seems likely to be restrained over coming quarters.”
- “...surveys of capital spending plans indicate that firms remain concerned about the economic and financial environment, including sharply rising costs of inputs and indications of tightening credit, and they are likely to be cautious with spending in the second half of the year.”

| FOMC CENTRAL TENDENCY FORECAST | | | |
|---------------------------------------|-------------|-------------|-------------|
| For 2008 | | | |
| made in: | January '08 | April '08 | July '08 |
| Real GDP | 1.3% - 2.0% | 0.3% - 1.2% | 1.0% - 1.6% |
| Unemployment rate ⁺ | 5.2% - 5.3% | 5.5% - 5.7% | 5.5% - 5.7% |
| Overall PCE prices | 2.1% - 2.4% | 3.1% - 3.4% | 3.8% - 4.2% |
| Core PCE prices | 2.0% - 2.2% | 2.2% - 2.4% | 2.2% - 2.4% |
| For 2009 | | | |
| made in: | January '08 | April '08 | July '08 |
| Real GDP | 2.1% - 2.7% | 2.0% - 2.8% | 2.0% - 2.8% |
| Unemployment rate ⁺ | 5.0% - 5.3% | 5.2% - 5.7% | 5.3% - 5.8% |
| Overall PCE prices | 1.7% - 2.0% | 1.9% - 2.3% | 2.0% - 2.3% |
| Core PCE prices | 1.7% - 2.0% | 1.9% - 2.1% | 2.0% - 2.2% |
| For 2010 | | | |
| made in: | January '08 | April '08 | July '08 |
| Real GDP | 2.5% - 3.0% | 2.6% - 3.1% | 2.5% - 3.0% |
| Unemployment rate ⁺ | 4.9% - 5.1% | 4.9% - 5.5% | 5.0% - 5.6% |
| Overall PCE prices | 1.7% - 2.0% | 1.8% - 2.0% | 1.8% - 2.0% |
| Core PCE prices | 1.7% - 1.9% | 1.7% - 1.9% | 1.8% - 2.0% |
| ⁺ average level in Q4 | | | |

- “...most FOMC participants expected that, over the remainder of this year, output would expand at a pace appreciably below its trend rate, primarily because of continued weakness in housing markets, elevated energy prices, and tight credit conditions. Growth is projected to pick up gradually over the next two years as residential construction bottoms out and begins a slow recovery and as credit conditions gradually improve.”

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On inflation

- “Inflation has remained high, running at nearly a 3-1/2 percent annual rate over the first five months of this year as measured by the price index for personal consumption expenditures. And, with gasoline and other consumer energy prices rising in recent weeks, inflation seems likely to move temporarily higher in the near term.”
- “The decline in the foreign exchange value of the dollar has also contributed somewhat to the increase in oil prices. The precise size of this effect is difficult to ascertain, as the causal relationships between oil prices and the dollar are complex and run in both directions. However, the price of oil has risen significantly in terms of all major currencies, suggesting that factors other than the dollar, notably shifts in the underlying global demand for and supply of oil, have been the principal drivers of the increase in prices.
- “Although the inflationary effect of rising oil and agricultural commodity prices is evident in the retail prices of energy and food, the extent to which the high prices of oil and other raw materials have been passed through to the prices of non-energy, non-food finished goods and services seems thus far to have been limited.”
- “...with businesses facing persistently higher input prices, they may attempt to pass through such costs into prices of final goods and services more aggressively than they have so far. Moreover, as the foreign exchange value of the dollar has declined, rises in import prices have put greater upward pressure on business costs and consumer prices.”
- “...FOMC participants continue to expect inflation to moderate in 2009 and 2010, as slower global growth leads to a cooling of commodity markets, as pressures on resource utilization decline, and as longer-term inflation expectations remain reasonably well anchored.”
- “FOMC participants viewed the inflation outlook as unusually uncertain and cited the possibility that commodity prices will continue to rise as an important risk to the inflation forecast. Moreover, the currently high level of inflation, if sustained, might lead the public to revise up its expectations for longer-term inflation. If that were to occur, and those revised expectations were to become embedded in the domestic wage- and price-setting process, we could see an unwelcome rise in actual inflation over the longer term. A critical responsibility of monetary policy makers is to prevent that process from taking hold.”

On policy challenges

- “At present, accurately assessing and appropriately balancing the risks to the outlook for growth and inflation is a significant challenge for monetary policy makers. The possibility of higher energy prices, tighter credit conditions, and a still-deeper contraction in housing markets all represent significant downside risks to the outlook for growth. At the same time, upside risks to the inflation outlook have intensified lately, as the rising prices of energy and some other commodities have led to a sharp pickup in inflation and some measures of inflation expectations have moved higher. Given the high degree of uncertainty, monetary policy makers will need to carefully assess incoming information bearing on the outlook for both inflation and growth. In light of the increase in upside inflation risk, we must be particularly alert to any indications, such as an erosion of longer-term inflation expectations, that the inflationary impulses from commodity prices are becoming embedded in the domestic wage- and price-setting process.”

BOTTOM LINE: Fed Chairman Bernanke’s testimony portrayed monetary policy as facing very significant challenges and on three occasions emphasized the high degree of uncertainty facing policymakers. On the one hand, the Fed’s “top” priority of returning financial markets to more normal conditions and the outlook for sluggish economic growth (with downside risks to that projection) argue against any rate hike in the second half of the year. On the other hand, elevated inflation pressures (some of which Bernanke admits come from a weaker dollar) argue for a firming of monetary policy. As a result, Bernanke said “At present, accurately assessing and appropriately balancing the risks to the outlook for growth and inflation is a significant challenge for monetary policy makers.” Our reading of the testimony, however, is that the Fed continues to play down the risks of the pickup in inflation being sustained, largely due to Phillips Curve reasoning, and that the hurdle to a rate hike in the second half of the year is very high. In particular, Bernanke’s testimony suggests that the Fed is now relying on subdued domestic wage increases to restrain core inflation.

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