

DAILY GLOBAL
COMMENTARY

Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Paul Kasriel
plk1@ntrs.com

Bernanke Hints at Near-Term FOMC Pause

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In his testimony to the Joint Economic Committee today, Fed Chairman Bernanke sent a strong hint of an imminent FOMC pause in its funds rate increases. Mind you, a May 10 rate hike of 25 basis points is almost a done deal as implied by the following excerpt from Bernanke's prepared comments of today:

"In the statement issued after its March meeting, the FOMC noted that economic growth had rebounded strongly in the first quarter but appeared likely to moderate to a more sustainable pace. It further noted that a number of factors have contributed to the stability in core inflation. However, the Committee also viewed the possibility that core inflation might rise as a risk to the achievement of its mandated objectives, and it judged that some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance. *In my view, data arriving since the meeting have not materially changed that assessment of the risks.*" [emphasis added]

The "pause" hint comes from the following excerpts:

"Focusing on the *medium-term forecast horizon* is necessary because of the lags with which monetary policy affects the economy." [emphasis added]

"In particular, *even if in the Committee's judgment the risks to its objectives are not entirely balanced*, at some point in the future the Committee may decide to take no action at one or more meetings in the interest of allowing more time to receive information relevant to the outlook. Of course, a decision to take no action at a particular meeting does not preclude actions at subsequent meetings, and the Committee will not hesitate to act when it determines that doing so is needed to foster the achievement of the Federal Reserve's mandated objectives." [emphasis added]

Firstly, from these excerpts we learn that the FOMC is trying to look *ahead* at likely economic performance rather than just behind at *past* performance, hence the reference to "the medium-term forecast horizon." Secondly, we learn that the FOMC implicitly appreciates the lagged effects of past interest rate increases when Bernanke states that the FOMC might decide to "take no action" in order to "receive information relevant to the outlook" even if the perceived "risks to its objectives are not entirely balanced." If the FOMC does pause, it does not want the financial markets to prejudge its next policy moves. In order to control these expectations, Bernanke threw in that "a decision to take no action at a particular meeting does not preclude actions at subsequent meetings."

Putting all of this together, along with the FOMC's heightened concern about the housing market, I think there is a better than 50% probability that the FOMC will signal a pause after increasing the funds rate by 25 basis points to 5% at its May 10 meeting.

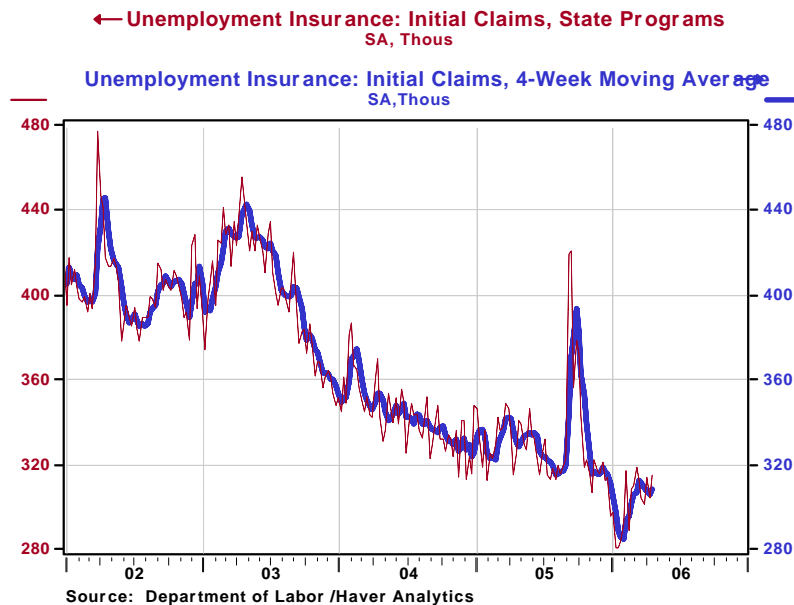
The Housing Market Environment – Government Stats vs. Company Stats

It was reported yesterday by the Census Bureau that new single-family-home sales rose 13.8% in March. Hmm. All this talk about the housing sector weakening must be just that – talk. But wait a minute. Yesterday afternoon and this morning some large national homebuilding corporations announced their first quarter results. Both Centex and Pulte said their year-over-year new order *fell* 11%. Centex cut its forecast and Pulte's forecast is below that of the consensus. Beazer reported orders down 19% overall, with a decline of 46% in the West. Government statistics are more likely to be revised than are these results from homebuilders. Believe what you want, folks, but the shaky foundation of the housing industry is showing severe cracks. And, as goes housing, so goes the U.S .economy.

Asha Bangalore
agb3@ntrs.com

Jobless Claims – Mixed Trend, With Slight Bearish Tone

Initial jobless claims rose 11,000 to 315,000 during the week ended April 22. The number of people filing for unemployment insurance has shown a see-saw movement in the past four weeks. The cumulative impact is that a bearish tone to the jobless claims numbers is now visible. On a monthly average basis, initial jobless claims have risen from a low of 286,000 in January to 302,000 in February, 309,000 in March and a reading of 311,000 in the first three weeks of April. Also, the year-to-year change in seasonally unadjusted jobless claims is a decline 3.2% during the week ended April 22 from a drop of 6.2% in the prior week, which reinforces the bearish message from the initial claims data. Continuing claims, which lag initial jobless claims by one week, rose 22,000 to 2.449 million. The insured unemployment rate held at 1.9% for the tenth straight week.



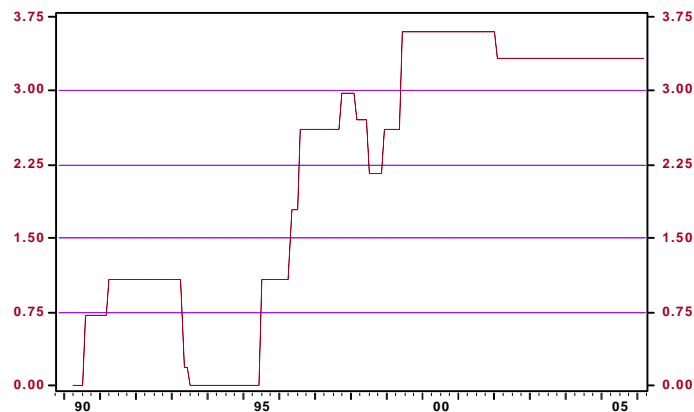
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China: Sudden Rate Hike Could Be First of Many Surprises

In a move that caught almost everyone off-guard, the People's Bank of China (PBoC, the central bank) announced a 27-basis point hike to the prime lending rate, raising it to 5.85%. While some tightening measure had been expected, this particular move was a surprise – most analysts were wagering on an increase in reserve levels or other liquidity-draining measures. Now that this first step has been taken to cool down the economy, there is every chance that more unanticipated moves are in the offing. How effective they will be is another issue.


Including today's rate hike, the PBoC has only raised rates twice in the current cycle; the last hike being another 27-basis point increase in October 2004. The central bank has initiated plenty of other measures to cool down credit growth, including sector-specific restrictions on investment and caps on development lending, all of which have had only a limited effect. Interest rate adjustments have been used sparingly, however; presumably to spare the struggling banking system from further burden. The fact that the PBoC has raised interest rates as an initial move suggests that it acknowledges that the economy is running hot and in need of a little less credit, but since the central bank held the deposit rate at 2.25%, we also think this is a market-driven way of supporting the banking system in the near-term.

China: Percentage Point Difference Between Prime and Deposit Rates



While rate hikes are meant to reduce the market's pursuit of credit, a steady deposit rate offers banks a chance to be more profitable with the loans they create. With the spread between the prime and deposit rates now at 360 basis points, matching the widest funding gap in Chinese banking since the sector was reformed in 1990, there is a stronger incentive for banks to utilize funds through loans, even though demand is marginally reduced. In effect, this move assumes that investment will still be strong, so a better return gives local banks a chance to fix their books. While far more affordable than a system-wide bail-out, such a move also acknowledges the use of market operations to remedy the ailing financial system rather than Beijing's very visible guiding hand.

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We are assuming that today's move is the first in a wave of tightening moves that go beyond just interest rates. Reserve level increases and further broad-brush maneuvers cannot and should not be ruled out. However, this approach to both the growing credit situation and the ailing bank problem is admirable. If subsequent moves have the same degree of promise, it might just be time to become a little optimistic.

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