

DAILY GLOBAL COMMENTARY

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Bernanke Hints More May Be Necessary and Notes That “Premature Removal of Fiscal Stimulus Could Blunt Recovery”

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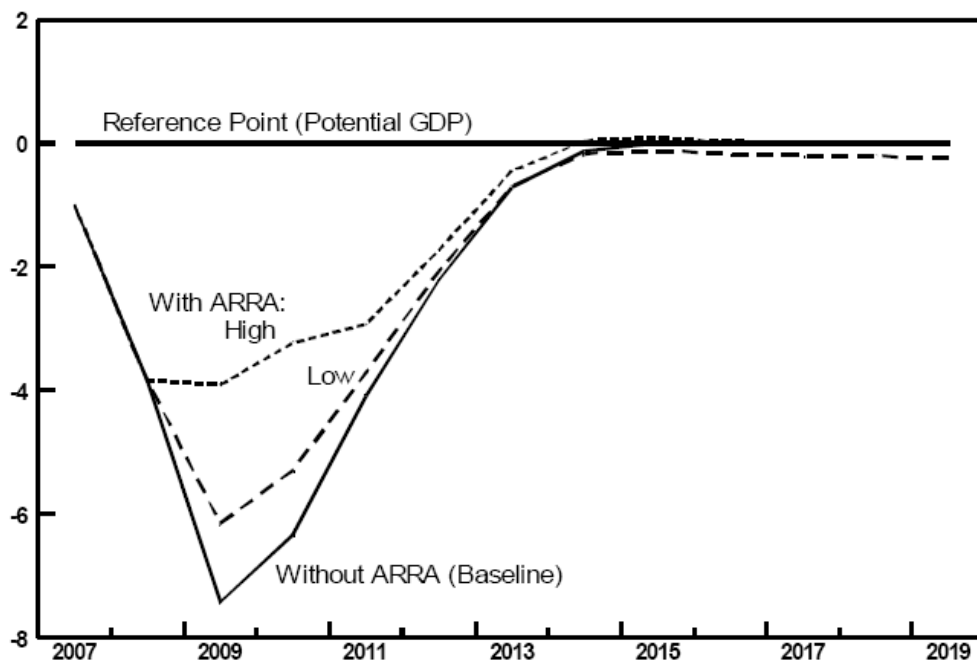
Chairman Bernanke’s testimony before the Senate Budget Committee was noteworthy in two respects. **One**, he hinted that more policy action may be necessary when he noted the following: *“The goal of the fiscal package is not just to provide a one-time boost to the economy, but to lay the groundwork for a self-sustaining, broad-based recovery. Historical experience strongly suggests that without a reasonable degree of financial stability, a sustainable recovery will not occur. Although progress has been made on the financial front since last fall, more needs to be done. As you know, in response to ongoing concerns about the health of financial institutions, the Treasury recently announced plans for further steps to ensure the strength and soundness of the financial system and to promote a more smooth flow of credit to households and businesses. The plan would use the remaining resources appropriated to the Treasury under the Emergency Economic Stabilization Act--approximately \$350 billion--and also involve additional spending to support the activities of Fannie Mae and Freddie Mac. **Whether further funds will be needed depends on the results of the current supervisory assessment of banks, the evolution of the economy, and other factors. The Administration has included a placeholder in its budget for more funding for financial stabilization, should it be necessary**”* (emphasis is our own). **Two**, he also indicated that any early consideration of reducing the accommodation from easy monetary and fiscal policy action carries the risk of stopping the recovery process. In other words, caution is the key. Here is the excerpt from the testimony: *“In particular, the Congress will need to weigh the costs of running large budget deficits for a time against the possibility of a premature removal of fiscal stimulus that could blunt the recovery. We at the Federal Reserve will face similar difficult judgment calls regarding monetary policy.”*

The Impact of Fiscal Stimulus in a Picture from the Congressional Budget Office

A picture is worth a thousand words. In line with this view, here is the Congressional Budget Office’s latest estimate of the impact of the American Recovery and Reinvestment Act (ARRA) of 2009 on the economy. The optimism reflected in the picture is encouraging.

Figure 1. Difference Between Potential GDP in CBO's Baseline and Actual GDP Without and With the Impact of the American Recovery and Reinvestment Act of 2009

(Percentage difference in the fourth quarter of each year)



Source: Congressional Budget Office.

Notes: CBO's January 2009 baseline projection of potential gross domestic product (GDP) is set as a reference point. The projection of actual GDP without the effects of the American Recovery and Reinvestment Act of 2009 (ARRA) is CBO's January 2009 estimate, as presented in *The Budget and Economic Outlook: Fiscal Years 2009-2019*. The projections of actual GDP with the effects of ARRA incorporated (the high and low estimates) reflect a range of assumptions.

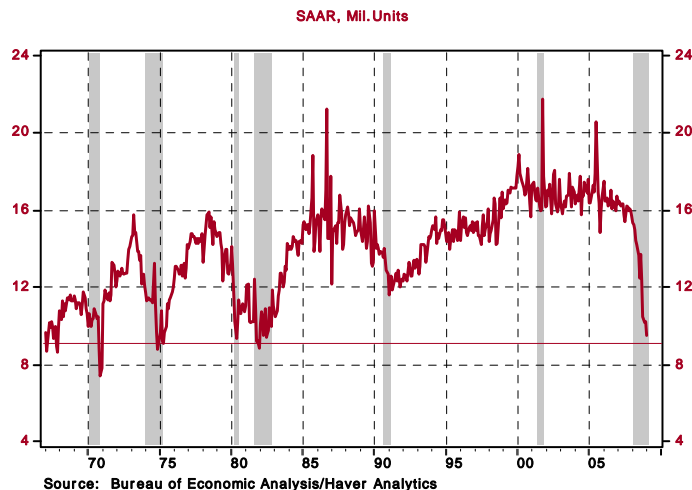
Source: <http://www.cbo.gov/doc.cfm?index=10008>

Auto Sales Decline Once Again

Sales of autos dropped to annual rate of 9.12 million units in February vs. 9.54 million in the prior month. The February sales pace of autos is the lowest since December 1981 when 8.849 million units were sold (see Figure 2, data plotted until 1/09, horizontal marker stands for the February sales pace). Consumer spending in January rose 0.4% after adjusting for inflation, which pointed to the possibility of less-than-expected weakness in consumer purchases in the first quarter. However, today's auto sales numbers dampens these expectations somewhat.

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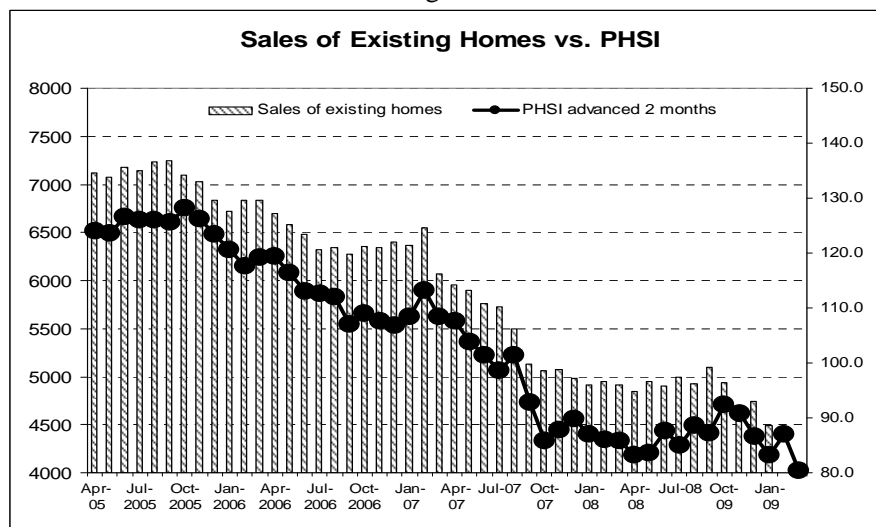
Figure 2
Light Weight Vehicle Sales (Autos+Light Trucks)



The Decline of the Pending Home Sales Index Suggests Home Sales Remain Under Stress

The National Association of Realtors Pending Home Sales Index (PHSI) fell 7.7% to 80.4 in January, after a 4.7% increase in December. The PHSI leads actual sales of existing homes by one-to-two months. The pickup in PHSI during December was not reflected in sales of existing homes in January (-5.3%). The Mortgage Purchase Index during the first three weeks of February was down roughly 20% from the first three weeks of January. There is only a small chance the increase in the PHSI in December may translate into actual sales in February.

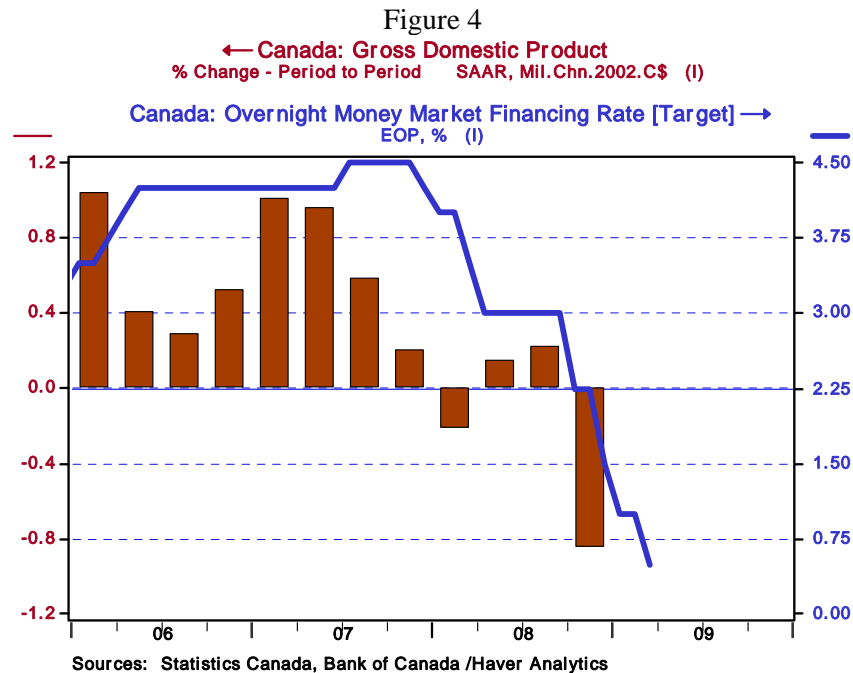
Figure 3



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Canada: How Low Do We Need To Go?

After yesterday's underwhelming Q4 GDP report, we felt that another rate cut by the Bank of Canada (BoC) was inevitable. This morning, the central bank obliged with a stronger-than-expected 50-basis point reduction of the overnight rate to a mere 0.50%. This brings the total easing since the BoC started its current cycle in late-2007 to 400 basis points. And, according to the accompanying statement, it may not be the last cut.



Yesterday's GDP report was well below market expectations, posting growth of -0.85% on the quarter and -0.71% on the year. This had the same degree of disappointment as did the other Q4 GDP reports throughout the industrialized world, and came with expectations that three months from now Canada will be able to officially declare itself in technical recession. What intrigued us, however, are some of the phrases used in today's accompanying statement from the BoC. While making a thinly-veiled request for the US to kindly fix its own financial system, it also brought up a term increasingly associated with stressed monetary policy environments – “quantitative easing”.

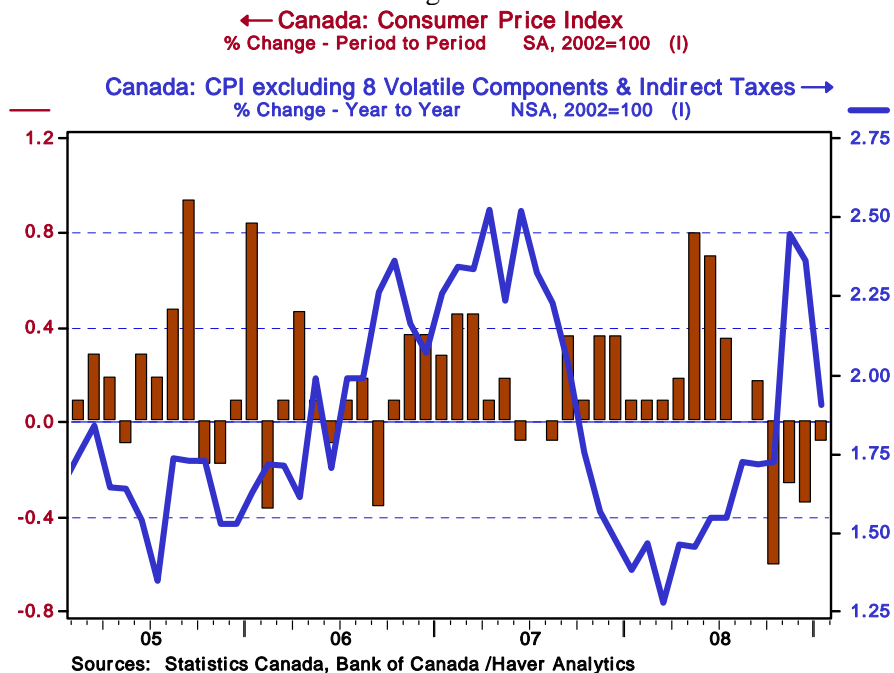
In context, the BoC mentioned that if further monetary stimulus was required, the central bank could resort to its own form of credit and quantitative easing. The statement promised to elaborate on this in the BoC's Monetary Policy Report due out in April, and until then it would be watching indicators closely. Are things so bad in Canada that the central bank is preparing to flood the market with Canadian dollars to get things going?

Well, not really (or at least so we think). The BoC follows a fairly strict inflation-targeting policy that dictates core CPI (CPI less eight volatile components) remain in the lower half of a 1-3%

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band on a year-over-year basis. Core CPI has been in that target range since late-2007, save for a one-off anomalous spike in the November 2008 data that threw the year-over-year calculations briefly above 2.0%. With low inflation throughout the past year, the central bank has had plenty of freedom to ease. As long as the core CPI remains below 2.00%, the good folks at the BoC are basically obligated to cut rates – even if the overnight rate is down to 0.50%. With overall CPI pressures all but extinct for the past four months of data, we believe the BoC is simply figuring out ways to offer yet more monetary stimulus per its inflation-targeting mandate. And with the overnight rate so low, a flood of loonies into the market seems like a logical, though drastic, step.

Figure 5



Hopefully, the BoC will make it clear in its April report that the quantitative easing plan is not due to a damaged economy in need of extraordinary priming but the continuation of stimulus once lower interest rates are not enough. It did note in today's statement that the effects of all these previous rate cuts should show up in the second half of 2009, so any quantitative measures should be temporary unless Canada is in more trouble than we thought. Needless to say, we do not expect any form of monetary tightening until well into 2010.

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