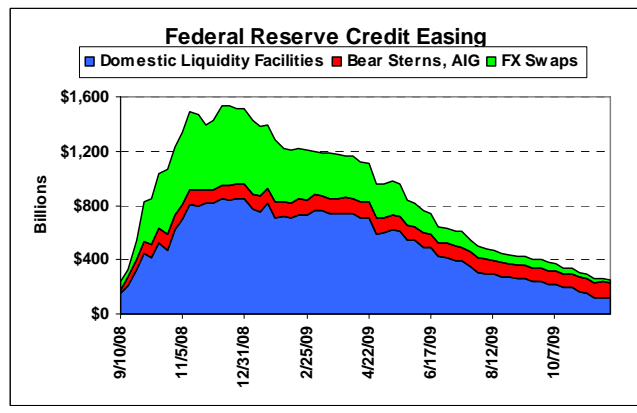


The Fed's Three-Stage Tightening Process

The Fed took extraordinary and unprecedented actions over the past two years as it reacted to the crisis in the credit markets and the severe recession that ensued. The first priority for the Fed was to prevent a catastrophic collapse of the financial infrastructure that could have triggered a far deeper and more prolonged recession than what actually occurred. Now that the credit crisis has subsided and the economy is beginning to recover, the Fed is pivoting toward the more routine task of promoting a sustainable expansion with low inflation. That task will be complicated, however, by these extraordinary measures.

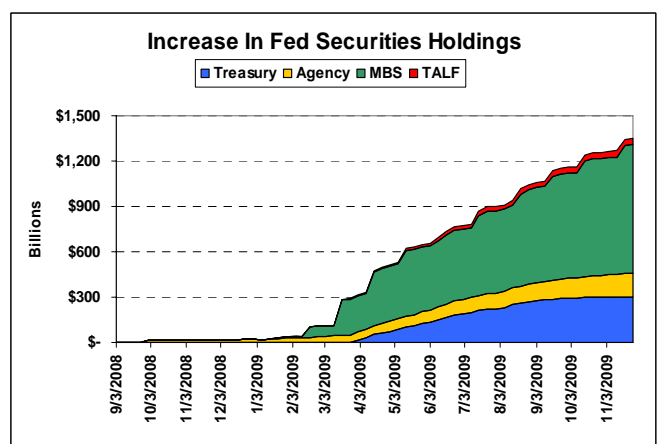
The Fed did three main things as it struggled to combat contractionary forces. It slashed the funds rate to near zero. It invented a variety of new liquidity facilities through which it provided as much as \$1.5 trillion of collateralized loans to a broad range of financial institutions. And it purchased more than \$1.3 trillion of marketable securities in an effort to make mortgages and various types of business and consumer loans more available and affordable. Now the challenge for the Fed is to undo each of these three forms of monetary accommodation at a time and at a pace that sustains the recovery while keeping inflation from rising above 2 percent.



In fact, the Fed began withdrawing some of its monetary accommodation months ago. As strains in the credit market eased and financial firms were able to

borrow through normal channels, the Fed reacted by providing less credit through its new liquidity facilities. In the preceding chart, the new facilities are shown as the red, green and blue-shaded areas. As of November 26, total loans outstanding in the various programs totaled only \$252 billion, down \$1.25 trillion since the end of 2008. Given the extra need for liquidity that often emerges around year end, the Fed will wait until January before paring back this form of lending much further. Regrettably, many of the loans supporting the rescues of AIG and Bear Stearns will probably linger on the Fed's books for the foreseeable future. And Fed officials have commented that some of the other new liquidity facilities may be maintained at low levels on an open-ended basis. But the bulk of these loans should be off the Fed's balance sheet by the end of the first quarter.

Stage two in the Fed's tightening process will be to stop buying marketable debt securities. Since last September, the Fed has purchased \$300 billion of Treasury securities, \$155 billion of Federal Agency debt, and \$852 billion of mortgage-backed securities (MBS). The Fed discontinued buying Treasury debt in October. More recently, the FOMC announced it intends to end its purchases of marketable securities by the end of the first quarter, by which time it will have purchased \$175 billion of agency debt and \$1.25 trillion MBS.



If the Fed completes those purchases as scheduled, it will have bought almost \$1.75 trillion of marketable debt since the end of 2008. Over the first half of 2008, the Fed purchased \$700 billion of securities, which was equal to more than 90 percent of the debt issued by all of the U.S. domestic nonfinancial sectors—households, business, and government. The Fed is on a pace to buy a similar amount of debt in the second half of 2009. Again, that will likely equal close to 90 percent of the net issuance of the nonfinancial sectors.

Given the consistent and mammoth support that the Fed has been providing to the credit markets, the obvious risk is that interest rates on marketable debt will trend higher in the first quarter of 2010 as Fed purchases taper off. Thus, the Fed will need to take time next spring to assess how much longer-term rates are likely to rebound and how big an impact that rebound could have on the speed of the recovery.

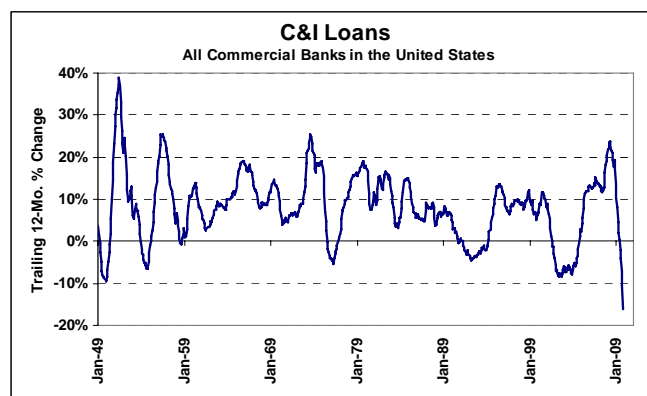
Only after it is clear that the economy is doing well despite any rise in longer-term rates will the Fed seriously consider lifting the Federal funds rate. That will be the start of the third and final stage of its tightening process. For some time to come, the Fed is going to be far more concerned about downside growth risks rather than upside inflation pressures. Their two principal concerns about the recovery are the absence of job growth and the limited availability of credit, particularly for those who are dependent on bank lending.

A sustained and healthy recovery of consumer spending depends critically on renewed job growth. That is the precondition for consistent gains in income that will propel household spending higher and ensure a self-sustaining expansion. Indeed, the Fed is unlikely to start lifting the funds rate until it sees job gains fast enough to create a clear downtrend in the unemployment rate, which would be unequivocal evidence that the economy is growing at an above-trend pace.

Small business companies historically play a crucial role in job growth. And unlike larger businesses, they are particularly dependent on banks for the credit they need to expand. That is why the Fed is so concerned about bank lending. According to Fed data, loans and leases at banks in October 2009 were down 8 percent from their peak in October 2008. Commercial and

industrial (C&I) loans were particularly weak, falling 16 percent since last October and accounting for almost half of the decline in total bank lending.

As the chart below shows, never before have C&I loans dropped so sharply over a 12-month span. Judging from the Fed's survey of senior loan officers, the decline reflects unprecedented adjustments both in the supply and demand for small business loans. Banks are still tightening lending standards. Equally, small businesses have limited need for credit, as they continue to pare inventories and curb their capital spending. However, as prospects improve and small business credit demands grow, the worry is that scarce and expensive bank loans could inhibit the expansion.



Because it expects inflation pressures to remain subdued, the Fed believes it can safely defer Fed funds tightening until compelling evidence emerges that the labor markets and bank lending are supporting the expansion. The Fed operates on the view that the principal driver of inflation is the amount of slack in the economy. As was just detailed in the latest set of FOMC minutes, the consensus at the Fed is that real GDP growth will average about 3 percent in 2010 and 4 percent in 2011. Under that scenario, they expect the unemployment rate to be around 9 ½ percent at the end of 2010 and 8 ½ percent at the end of 2011. The key point is that the Fed expects the economy will operate with large amounts of slack and low inflation over the coming two years unless the recovery is considerably faster than expected.

Another reason that the Fed believes it does not need to be in a rush to begin lifting the funds rate is that fiscal policy will become less stimulative starting in the second half of 2010. By then, the spending authorized

in the February 2009 fiscal package will begin to taper off. That restraint is likely to be reinforced by higher income taxes in 2011 as the Bush tax cuts sunset.

The political atmosphere in Washington also argues for the Fed holding the funds rate steady until it is highly confident that a robust recovery is in place. Never before have I seen the Congress so critical of the Fed's performance. Most threatening by far is the effort being led by Representative Ron Paul to mandate audits of the FOMC's monetary policy decisions. If enacted, his proposal would likely undermine the Fed's ability to implement the type of disciplined monetary policy that has successfully kept inflation generally low for the past 30 years. Thus, as the Fed strives to maintain some autonomy, the last thing it should risk is creating a perception that it is tightening prematurely.

The bottom line is that the Fed is in no hurry to lift the funds rate above the current target of 0 to ¼ percent. In light of the dovish tone of the latest FOMC minutes, the mixed nature of recent economic reports, and the rising criticism of the Fed in Congress, I am now assuming that the Fed will initiate a tightening process for the funds rate at the September 2010 FOMC meeting, three months later than I previously had been assuming. Key to my view is that I continue to forecast that real GDP growth will average somewhat above 4 percent in 2010, with the unemployment rate beginning to trend lower after the first quarter. Should growth disappoint, of course, Fed tightening would recede even further.

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Comerica Forecast Worksheet (November 30, 2009)

	Real GDP SAAR	Nonfarm Payrolls 1,000s	Unemploy. Rate %	PCE Deflator SAAR	Core PCE Deflator SAAR
Actual					
2009Q1	-6.4	-691	8.1	-1.5	1.1
2009Q2	-0.7	-428	9.2	1.3	2.0
2009Q3	2.8	-226	9.6	2.8	1.4
Forecast					
2009Q4	3.0	-120	10.2	1.3	1.0
2010Q1	4.0	100	10.4	0.9	0.8
2010Q2	5.0	225	10.2	1.0	0.8
2010Q3	4.0	200	9.9	1.0	0.9
2010Q4	4.0	200	9.6	1.1	1.0

	Light Veh. Sales Millions	Housing Starts Millions	Fed Funds Rate* %	Bank Prime %	3-Month Libor %
Actual					
2009Q1	9.5	0.53	0.18	3.25	1.24
2009Q2	9.6	0.54	0.18	3.25	0.85
2009Q3	11.5	0.59	0.16	3.25	0.41
Forecast					
2009Q4	11.0	0.66	0.13	3.25	0.28
2010Q1	12.2	0.72	0.13	3.25	0.29
2010Q2	12.8	0.78	0.13	3.25	0.36
2010Q3	13.6	0.85	0.20	3.25	0.47
2010Q4	13.9	0.93	0.76	3.76	0.98

	3-Month Treas. Bill** %	2-Year Treasury %	10-Year Treasury %	Conventional Mortgage %	Fed Major Currency Index Mar73=100
Actual					
2009Q1	0.21	0.91	2.74	5.06	82.7
2009Q2	0.17	1.01	3.31	5.03	79.4
2009Q3	0.16	1.03	3.52	5.16	75.4
Forecast					
2009Q4	0.07	0.91	3.40	4.95	73.4
2010Q1	0.09	1.03	3.65	5.25	74.5
2010Q2	0.16	1.40	3.85	5.60	76.2
2010Q3	0.27	1.65	4.05	5.75	79.0
2010Q4	0.78	1.90	4.15	5.80	81.0

*Our working assumption is that the FOMC will start tightening at its September 2010 meeting and will push the funds rate to 1.25 % by the end of 2010 using a combination of 25 and 50 basis point rate hikes.

**Coupon Equivalent Yield.