

19 March 2008

Economic News

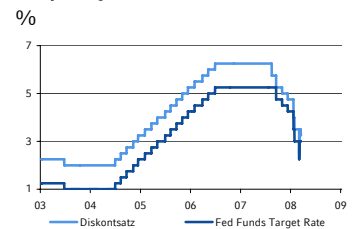
US MONETARY POLICY

The Fed remains in crisis mode

Even though yesterday's 75 basis point cut in the Fed funds target rate did not live up to the most aggressive market expectations, the Fed nevertheless sent a further clear signal. At the moment, there is much to suggest the Fed will lower key rates further in the coming months. We expect the next rate cut at the end of April.

- The formulations "downside risks to growth remain" and "the Committee will act in a timely manner" suggest the **FOMC will continue to ease at short intervals**.
- The section on **inflation risks** was relatively detailed. That and the fact that two FOMC members (Fischer, Plosser) voted for a less aggressive rate cut suggest to us that the Fed will scale the pace of its monetary policy easing back slightly.
- If its sole concern were to stabilize the economy, the Fed could stop now. Since September of last year, the Fed has lowered the Fed Funds Target Rate by three percentage points and the discount rate by almost four. The 10Y UST yield has pulled back roughly 1½ percentage points, and the nominal external value of the dollar has fallen six percent. The **negative real interest rates** and the **weak dollar** – combined with the expansionary fiscal policy – should contribute to overcoming the current recessionary trends and stabilizing the economy, in our assessment as early as the second half of this year. There are, however, no indications of a strong and sustained recovery.
- At the moment, the Fed is being driven by the financial crisis rather than by the macroeconomic data. It continues to pursue its **risk management approach**. That means that – in contrast to, for example, the ECB – it is not acting based on its main scenario but is instead attempting to avert the worst possible scenario of a systemic crisis in the financial system. It has learned from the case of Japan that acting tentatively can prolong the crisis by years.
- It is increasingly being argued that the Fed is indulging in overkill with its policy of easy money. It is, however, not possible to pass judgment on this today, since the extent of the problems in the financial sector and their ramifications for the real economy remain unclear. The **accusation of overkill** would only be justified if the crisis subsides and the Fed does not then tighten expeditiously. Only then would it encourage excessively risky behaviour on financial markets and fuel inflation in the real economy and/or financial markets.
- **Outlook:** Since the inventory of bad news from the financial world and the economy has probably not been exhausted yet, further rate cuts as well as measures to provide liquidity are very probable. We now expect the Fed to lower its key interest rate a further 50 basis points in each of April and June.

US policy rates



Source EcoWin, WestLB Research

FOMC meetings in 2008

29./30. Jan. 2008	5. Aug.
18. Mar.	16. Sep.
29./30. Apr.	28./29. Oct.
24./25. Jun.	16. Dec.

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