

24 April 2008

Economic News

US MONETARY POLICY

The Fed shifts down a gear

Prospects for US growth have worsened since the last FOMC meeting in March. As a result, the Fed is likely to cut policy rates again on 30 April. A number of reasons lead us to conclude, however, that the Fed funds target rate will probably not now be reduced as sharply as in the previous months. We envisage no more than a 25bp cut to 2.0%.

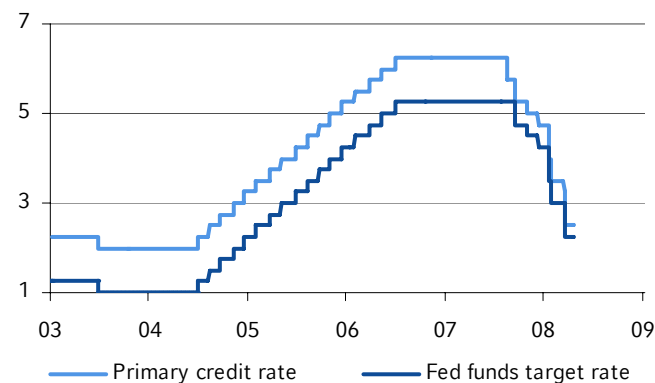
- Since last summer, **US monetary policy** has been heavily **event-driven**. With its contribution to the bailout of Bear Stearns and the newly created liquidity management facilities, the Fed has proven not only that it responds quickly to extraordinary events but also that it is ready to take exceptional steps to remedy the financial crisis.
- The possibility of further events that might call for immediate action by the Fed cannot be ruled out or predicted for the near term, so it is not foreseeable whether the Fed will need to move into crisis management mode again.
- The latest performance data for US banks kindled **hope** that the **worst of the financial crisis may be over**. At least the situation has not escalated any further recently and the extent of the write-downs was not as large as some had feared. The renewed slight fall in risk premiums is a vote of confidence that investment banks are now communicating more proactively with the financial markets.
- A few more hurdles and imponderables will probably need to be overcome on the road to normalisation. Notwithstanding the uncertainties about future developments, further aggressive tightening of policy rates no longer appears to be necessary at present. Provided that the situation in the financial markets does not escalate further, the Fed could resume its traditional role as risk manager, i.e. weighing up the risks of growth and inflation.

FOMC-meetings 2008

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

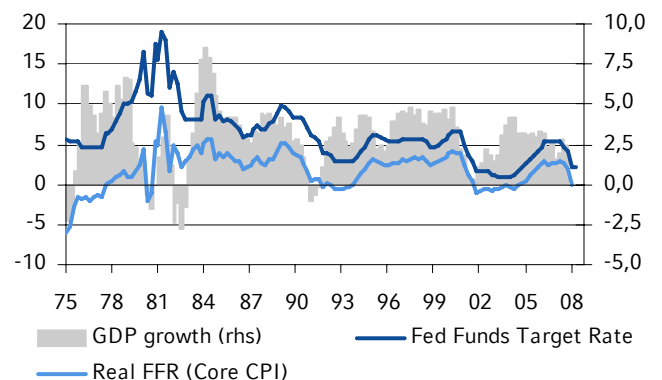
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US key rates
in %



Source: EcoWin, WestLB Research

USA: GDP growth and real policy rate
% y/y and %



Source EcoWin, WestLB Research

- Financial markets are **largely pricing in a small rate cut** at the next FOMC meeting on April 30. A bigger cut would not only come as a surprise but could even prove counterproductive. It would be a clear indication that the Fed sees further risks – a deeper slump and/or the danger of a credit crunch – than do the markets.
- Another argument against a more substantial rate cut is the fact that **monetary policy is already highly expansionary**. Since the summer of 2007, the Fed has lowered the main key rate at breakneck speed by 300bp based on concerns over the US economy and the stability of the financial sector. The real interest rate – key rate adjusted for the core rate of the private consumption expenditures deflator – is now close to zero and will fall deeper into negative territory with each further rate cut. This, together with the government's economic package, should be sufficient to put the US economy back on track.
- There is also little scope for another aggressive rate cut given that **inflation rates remain high** despite the gloomy economic outlook. As a result, there are concerns that inflation expectations will no longer be anchored at a low level. Two FOMC members, Richard Fisher and Charles Plosser, voted for a less aggressive rate cut in March for this reason. Other Fed officials have also commented on this recently, placing greater emphasis on inflation risks. A rate cut that is deemed excessive by the markets would lead to a rise in longer-term bond yields and would therefore be counterproductive.
- Accordingly, there are many factors to suggest that the Fed will meet market players' interest rate expectations and lower the **Fed funds target rate by only 25 points to 2.0% on 30 April**. At the same time, it will refer to prevailing economic and inflation risks in its statement on the rate decision and leave the door open for further monetary policy measures based on the data situation.
- However, provided that the situation on the financial markets does not escalate further, it is likely that the Fed will **then initially wait and see** what effect the economic package will have. If our forecast of a mild, albeit sluggish, recovery in the US economy in H2 proves correct, further rate cuts would not actually be necessary. We have therefore **significantly lowered our policy rate forecast** based on our assumption that the Fed will leave interest rates on hold at the FOMC meeting on June 24/25, which will probably mark the end of the rate cut cycle.
- We believe that rate hikes by the Fed are likely in 2009. However, we have not yet included this in our 12-month forecast. If the financial market crisis ends surprisingly rapidly or inflation gets out of hand, the turnaround in monetary policy could be sooner than expected.

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