

6 August 2008

Economic News

US MONETARY POLICY

US key rate left unchanged at 2.0% until further notice

The Fed left its key rate unchanged at 2.0% yesterday. Weighing up the growth risks against the inflation risks the Fed struck a more neutral position than at its June meeting. There is no sign of its raising rates any time soon.

- As expected, the Fed left its key rate unchanged yesterday at 2.0%. As at the June meeting, Richard Fisher (Dallas Fed) voted against the majority, again speaking out in favour of an interest rate increase.
- The FOMC's **description of the economic situation** referred to growth reviving in the second quarter on the back of consumption and exports. It also drew attention to the slacker trend in the employment market and to the ongoing tensions in the financial markets. The constraints on growth were identified in the banks' stricter lending standards, the ongoing correction in the housing market and the high energy prices. The substantial easing together with the continuing liquidity policy measures should, however, support growth.
- The statement describes **inflation** as **high** and draws attention to inflation expectations, which have increased in some cases. But the Fed expects inflationary pressures will ease later in the year and in 2009, even if the inflation outlook remains very uncertain.
- The FOMC **edged back** again as regards its overall weighting of the downside risks to growth and the upside inflation risks. In June it saw growth risks waning and inflationary risks waxing.

FOMC sessions 2008/2009

16 Sep. 08	27/28 Jan. 09
28/29 Oct. 08	17 Mar. 09
16 Dec.. 08	28/29 Apr. 09

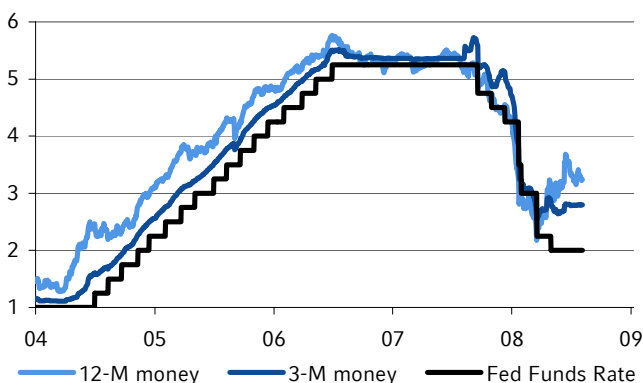
Further FOMC sessions 2009:
23/24 June, 11 Aug., 22 Sep., 3/4 Nov.
15 Dec.

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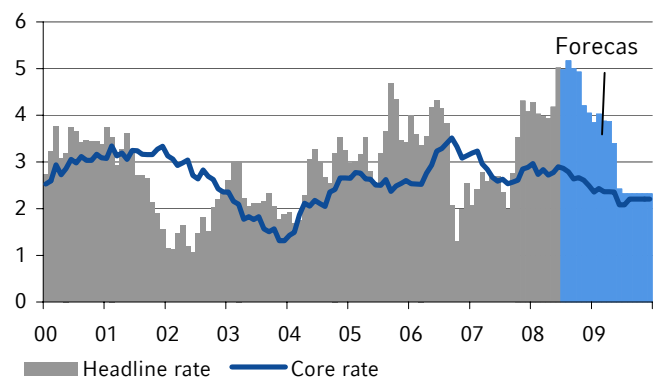
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US key rate and money-market rates (in %)



Source EcoWin, WestLB Research

Consumer prices (% year-on-year change)



Source EcoWin, WestLB Research

The press release now says that with downside growth risks still in place, inflation risks continue to be a cause of substantial concern, but that they have not increased despite the high inflation rates published recently. Overall, the **risks to growth and the inflation risks more or less balance each other out.**

- Yesterday's interest rate decision suggests that the Fed is in no hurry to reverse part of the aggressive rate cuts made in the wake of the crisis in the financial markets. The outlook for the economy is still too uncertain, and the stability of the financial markets remains at risk.
- The FOMC is currently faced with a **difficult decision**. Measured by the negative real interest rates, monetary policy remains very loose. Some Fed representatives had, therefore, already publicised their concern about an excessively loose monetary policy. But there are still **downside growth risks** that make a rate tightening less appropriate. At the same time, inflation is rising and there is a danger that the steep increase in food and energy prices will also spill over into the prices for other goods and services, thus leading to an increase in the core inflation rate. As a result, there is an increasing risk that the Fed will not be able to pin down inflation expectations firmly as this would require a tightening of the monetary policy reins.
- All this is overshadowed by the latest **resurgence of the crisis in the financial markets**. More than a year after the crisis broke out, it is clear that the Fed is still engaged in **crisis management** and is having to combat the repercussions of the crisis by prolonging and extending its liquidity policy measures and by retaining its looser monetary policy.
- **Outlook:** In the near future US monetary policy will remain in thrall to events in the financial markets. Since there is no sign of an early return to **normality in the financial and especially the money markets** and given the fact that the economic setting remains uncertain, the Fed will probably **delay reducing** the degree of looseness of its **monetary-policy** until the beginning of 2009 (January 28). It would then have more scope for an interest rate increase at a later point in time than we had expected provided the massive recent decline in the oil price is sustained. In this case the pressure from energy prices would ease significantly in the next few months, which would also notably reduce the inflationary pressures.
- The **hurdle for an interest rate increase** this year is **high**. A rate hike would require an early and substantial improvement in the financial markets and a stabilisation of the situation in the labour and housing markets. Only then will the majority of the members of the FOMC agree to a change of course and a tightening of monetary policy.

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