



# Economic Research Report

The following report is written by our in-house analysts to provide you greater insight into upcoming economic events.



9<sup>th</sup> August 2011

## PREVIEW: FOMC rate-decision due at 1915 BST (1315 CDT)

Today's FOMC rate-decision comes in the backdrop of a long-term sovereign rating downgrade of the US by S&P to AA+ from AAA, with a negative outlook. The latest move by the S&P may force policymakers to debate the viability of further monetary easing, as the downgrade could see a rise in the long-term interest rates. Moreover, a sustained reaction from the present crisis could translate into a slowdown in growth, which together with sluggish personal income/spending in the US, and fading temporary factors supporting prices may weigh upon the country's core inflation further, and in turn force the Fed to act. Although, in its latest communiqué, the Fed said that S&P's ratings downgrade does not affect the operation of its emergency lending window or its buying and selling of Treasury securities to conduct monetary policy.

The Fed is likely to keep its "exceptionally low" borrowing cost for "an extended period" language, although it may be tempted to use the "extended period" phrase with respect to reinvesting principal payments. A more aggressive approach would be for the Fed to alter its reinvestment policy so as to extend the average maturity of its security portfolio, which currently stands at around 6.1 years. However, this is unlikely to be a favourable option as it may hinder a smooth exit from Fed's current loose monetary policy. The Fed could signal another round of quantitative easing, although it would be reluctant to do so as this may raise questions about whether the Fed is simply monetising the US debt, which could undermine confidence in the USD and drive interest rates higher.

Some policymakers may opt to slash the interest paid on excess reserves and thus in effect encourage enhanced lending by the country's financial institutions. However, in Bernanke's own words, this approach would have little effect on overall financial conditions. A more desirable approach may be for the Fed to open a new lending facility to increase credit availability for targeted sectors of the economy those that need help. The Fed could reduce the secondary credit rate in its discount window or alternatively start to accept a wider range of collateral in exchange for loans offered. This may help the access of funds to a wider economy, and may prevent the danger of big institutions strengthening their own balance sheets as opposed to lending.

Bernanke has been a prominent supporter of an explicit inflation target, and it would be interesting to see any comments along these lines. By setting a higher inflation target the Fed can give itself more room for further monetary easing. Elsewhere, the Fed could lower its 2011 growth forecast for a third consecutive time, which currently stands at 2.7%-2.9%. It may also surprise the market by lowering its core PCE inflation target, which currently stands at 1.5%-1.8%, citing fading temporary factors supporting prices. In terms of market reaction, any indication of further easing would potentially see weakness in the USD, and is likely to support Treasuries and equities. However, if the Fed cuts its growth/inflation forecast, that may exert downward pressure on the currency and equities, and in turn support T-Notes.

It is also worth noting that the FOMC rate-decision is due at 1915 BST (1315 CDT) and there is no press-conference from Fed's Bernanke following the rate-decision. According to the press-release by the Fed, dated March 24<sup>th</sup> 2011, the next press-conference by the Chairman will be on November 2<sup>nd</sup> 2011.