

Fed shifts to wait and see mode

- *Improving economic and financial conditions mean additional QE unlikely*
- *Nevertheless, we're still years away from policy being tightened*
- *Statement will incorporate a more upbeat tone on economy*

Improving economic and financial conditions mean that there is now less pressure on the Fed to expand its quantitative easing, particularly when it still needs to purchase almost \$1,000bn of Treasury and mortgage-backed securities to fulfil its existing pledges. Similarly, it is far too soon to consider tightening policy when the unemployment rate is still rising and the latest GDP revisions show that the recession was much deeper than previously thought (suggesting that the output gap is presumably even bigger).

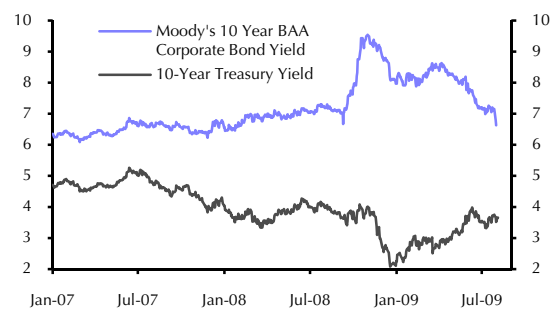
Under the circumstances, we expect the two-day FOMC meeting that concludes on Wednesday 12th August to be largely a non-event. The accompanying statement is bound to take a more upbeat tone, noting the improvement in most of the economic data, at least with the notable exception of the labour market. The statement might also include an acknowledgement that the Fed intends eventually to reverse quantitative easing (or at least nullify the inflationary impact) by raising the interest rate payable on excess reserves. As Chairman Ben Bernanke explained recently to Congress and in a *Wall Street Journal* op-ed piece, the Fed has no intention of exposing itself to potential capital losses by selling the assets it has bought. Instead, it will hold those assets to maturity and profit from the interest payments.

Is quantitative easing working?

Bernanke has always argued that the primary aim of the Fed's quantitative easing efforts is to reduce the borrowing costs facing households and firms. Accordingly, the Fed should be encouraged by the

recent sharp drop in corporate bond yields. That decline has taken the 10-year BAA yield down to an 18-month low of 6.7%, well below the peak of almost 10% reached last September. (See Chart 1.)

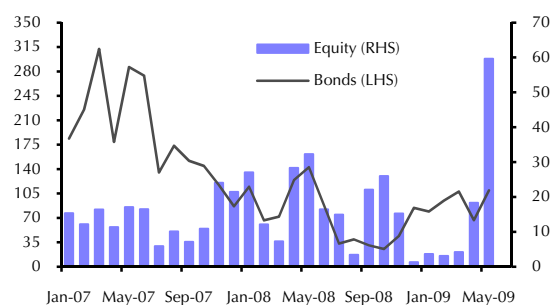
CHART 1: LONG-TERM INTEREST RATES (%)



Source – Thomson Datastream

Treasury yields are still well above the lows reached at the end of last year. Nevertheless, the 10-year yield has fallen back since the Fed last met in late June and, given the enormous amount of new debt the Treasury is issuing, is still at a surprisingly low level.

CHART 2: ISSUANCE OF CORPORATE SECURITIES (%)

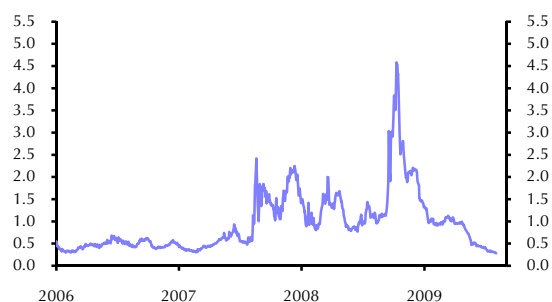


Source – Thomson Datastream

Not only has the cost of corporate borrowing fallen, but the availability of external financing has improved too. The issuance of corporate debt and equity has rebounded sharply over the past few months. (See Chart 2.) Admittedly, most of the surge in equity issuance in May reflects the fundraising by banks eager to repay TARP funds, but issuance by non-financials increased as well.

The Fed will be encouraged by other signs of improving financial conditions, including the continued rally in stock markets and the decline in interbank lending rates. The three-month LIBOR rate has fallen below 0.5% and the spread over Treasury bill rates is at a two-and-a-half year low. (See Chart 3.)

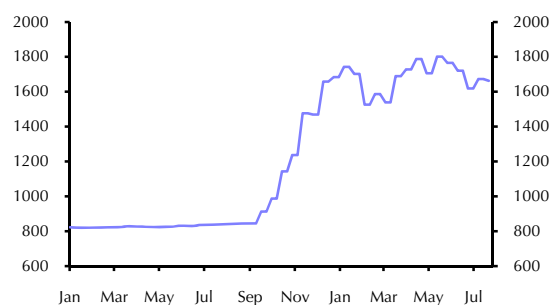
CHART 3: SPREAD BETWEEN 3M LIBOR & T-BILL RATES (%)



Source – Thomson Datastream

Unfortunately, the improvement in financial conditions, particularly the return to something like normality in the interbank lending market, is having some unwanted side-effects on the size of the Fed’s balance sheet.

CHART 4: MONETARY BASE (\$BN)

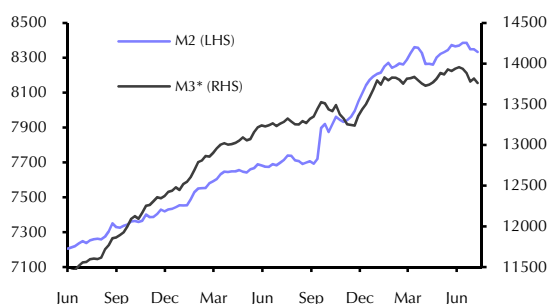


Source – Thomson Datastream

The drop in demand for emergency loans from the Fed is more than offsetting its asset purchases and, as a result, over the past couple of months the monetary base has actually shrunk. (See Chart 4.) The Fed now has less than \$100bn outstanding in central bank swaps and its commercial paper funding facility. It also recently announced a reduction in the size of the bi-monthly auctions of term credit because demand had fallen so much.

The stagnation in the size of the monetary base has led to a similar levelling out in the broader monetary aggregates. (See Chart 5.) Those aggregates have even shrunk slightly since the FOMC last met in late June. Nevertheless, on balance, we expect that Fed officials will be fairly content with recent developments.

CHART 5: BROAD MONETARY AGGREGATES (\$BN)



Source – Thomson Datastream

Looking beyond next week’s meeting, it will be some considerable time yet before interest rates begin to rise. The fed funds futures market has the first rate hike priced in for March 2010. In contrast, we suspect it could be 2011 before the Fed’s starts to tighten policy. The recession may have ended in mid-2009, but it will take a long time before the economy is growing at a fast enough pace to start lowering the unemployment rate and reduce the amount of spare capacity lying idle. Even when that point is reached, Fed officials will probably want to see some of that capacity absorbed before they start to hike rates.

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TABLE: FOMC BACKGROUND INFORMATION

Interest Rate Meetings	The Federal Open Market Committee (FOMC) holds eight regularly scheduled meetings a year, meaning that it meets once every six weeks. Meetings have traditionally lasted one day, normally a Tuesday. But more meetings are being held over two days now, with a rate announcement on Wednesday, to allow for more discussion of the issues.	
Release of Minutes	Yes, minutes are published three weeks after the meeting. Full transcripts of FOMC meetings are published with a five-year delay.	
Disclosure of Voting	Yes, full breakdown of vote announced in accompanying statement.	
Inflation Target	No formal target, but the Fed's long-term forecasts suggest that it sees a PCE inflation rate of between 1.5% and 2.0% as consistent with price stability.	
Policy Framework	The Federal Reserve Act instructs the FOMC "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." That makes the Fed unusual in having a dual mandate. The FOMC is responsible for interest rate policy. However, the Board of Governors has responsibility for quantitative easing, all extraordinary credit facilities and the size/composition of the Fed's balance sheet.	
Membership of FOMC	The Federal Open Market Committee (FOMC) consists of 12 members: the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining 11 Reserve Bank presidents, who serve one-year terms, beginning each January, on a rotating basis.	
Chairman	Ben Bernanke, Board of Governors	
Vice Chairman	Donald Kohn, Board of Governors	
Other members of the FOMC	Elizabeth Duke, Board Of Governors Daniel Tarullo, Board Of Governors Kevin M. Warsh, Board of Governors William Dudley, New York Charles Evans, Chicago Jeffrey Lacker, Richmond Dennis Lockhart, Atlanta Janet Yellen, San Francisco	
Alternate members	Sandra Pianalto, Cleveland Eric Rosengren, Boston James Bullard, St Louis Thomas Hoenig, Kansas Christine M. Cumming, First Vice President, New York	
Meetings	Date March 17 th -18 th April 28 th - 29 th June 23 rd - 24 th August 11th -12th September 22 nd -23 rd November 3 rd -4 th December 15 th -16 th	Outcome / Our Forecast No Change (Rates at 0% to 0.25%) No Change (Rates at 0% to 0.25%) No Change (Rates at 0% to 0.25%) No Change (Rates at 0% to 0.25%) No Change (Rates at 0% to 0.25%) No Change (Rates at 0% to 0.25%) No Change (Rates at 0% to 0.25%)

Source – Federal Reserve Board of Governors