AIB Global Treasury
Economic Research

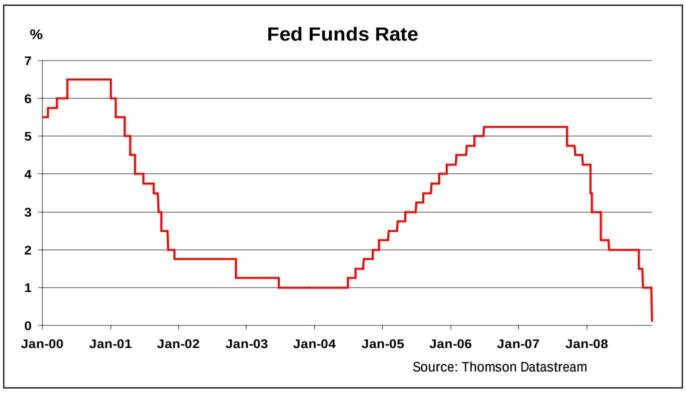
FED WATCH 17th December 2008

FED RATES NEARING ZERO

The US Federal Reserve cut its key interest rate, the Fed funds rate, to a target range of 0 to 0.25 per cent from 1%, at the conclusion of its FOMC policy meeting yesterday. This takes the Fed funds rate down to its lowest ever level since it was first established in 1954. **The move was a big surprise to markets** as evidenced by the subsequent sharp fall in both market interest rates and the dollar. A 0.5% rate cut had been expected.

It is worth noting, though, that the effective overnight Fed cash rate had already fallen to close on zero per cent in the past fortnight as the Fed pumped large amounts of liquidity into the system. The cut in the Fed funds target rate brings it into line with the overnight rate. The Fed statement noted that **weak economic conditions are likely to warrant exceptionally low levels of the Fed funds rate for some time,** which probably means all of 2009 at a minimum.

Not surprisingly, then, **period interest rates fell after the announcement** with one month money market rates declining to 0.7% and three month rates falling to 1.6%. The gap between wholesale rates and official rates, though, is still wide but money market rates can be expected to fall further in early 2009 as year end liquidity pressures ease.



The Fed also indicated in its statement last night that it would employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability. **Some very weak economic data have been published recently** on household spending, industrial production, housing and the labour market. GDP fell by 0.5% annualised in Q3 and could contract by 4-5% in Q4. **There is no end in sight to the downturn, with the recession expected to last most, if not all, of 2009.**

Meanwhile, price pressures have abated and inflation is falling rapidly. The collapse of oil and other commodity prices have seen the headline CPI rate fall to 1.1%, while the core CPI rate has fallen to 2%. Headline inflation can be expected to turn negative in 2009, with core inflation falling to 1%.

With official interest rates now close to zero per cent, the Fed's focus will shift to open market operations and other measures to stimulate the economy and support the functioning of financial markets. These will include large scale purchases of agency debt and mortgage backed securities and possibly longer term Treasuries.

It may be reminiscent of the ZIRP and quantitative easing pursued by the BoJ, but this strikes us as a far more aggressive response from the US Fed. First, the Fed has cut rates far more rapidly than the BoJ. Second, the problems in banks have been tackled in a more up front fashion than in Japan. Third, the Fed is being much more proactive in terms of getting longer term rates down, freeing up credit and boosting lending activity. Let's hope the results come quicker as well.

John Beggs
Chief Economist
john.f.beggs@aib.ie

Oliver Mangan
Chief Bond Economist
oliver.n.mangan@aib.ie

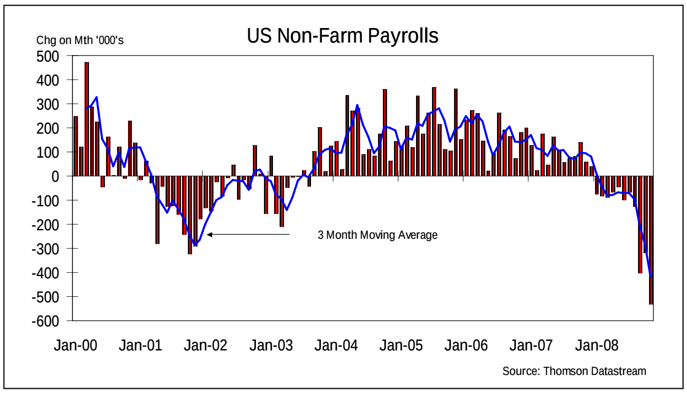
Geraldine Concagh
Senior Economist
geraldine.t.concagh@aib.ie

Jenny Pollock
Senior Economist
jenny.c.pollock@aib.ie

DEEP RECESSION POINTS TO PROLONGED PERIOD OF LOW RATES

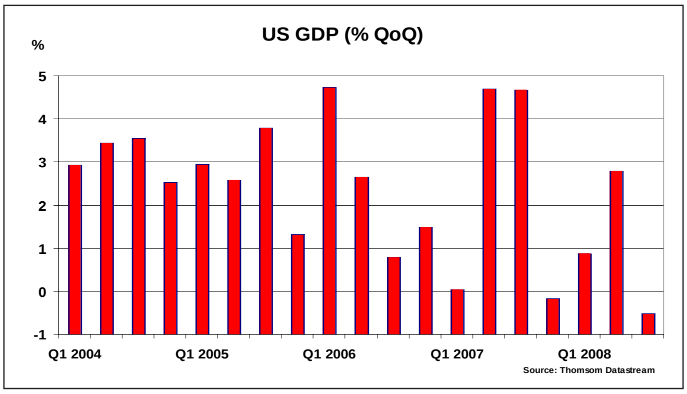
The official view now is that the US recession started in December 2007. Initially, it proved a mild downturn in activity. Indeed, a fiscal stimulus package and a very strong contribution from net trade helped the economy to continue to expand in H1 2008, with GDP rising by 0.9% and 2.8% annualised in Q1 and Q2, respectively. **However, the downturn has morphed into a deep recession since the summer.** After a fall of 0.5% in Q3, the expectation is that GDP could contract by 4-5% annualised in Q4 2008**.**

Nowhere is the deterioration in the economy more evident than in the labour market. Non-farm payrolls have been in decline since January but in the period up to July, the monthly fall remained fairly modest at 50,000-100,000. Since then, **employment levels have collapsed.** In the three months to November, payrolls fell by 1.25 million. The fall in November of 533,000 was the biggest since 1974. It brought the unemployment rate up to 6.7% from 5.5% at mid year and 5% at end 2007.



Consumer spending contracted by 3.7% annualised in Q3 as the impact of the fiscal stimulus package faded while high inflation and rising unemployment dented real spending power. It is set for another steep fall in Q4, with household spending contracting by 0.5% in October and retail sales falling by 1.7% in value terms in November. Meanwhile, **housing remains a big drag on the economy.** Housing investment contracted by 17.6% annualised in Q3, the tenth consecutive quarter that it declined at a double-digit rate. Housing starts and permits have continued to slide in recent months and the NAHB index is mired at record lows indicating that building activity continues to contract at a rapid rate.

Industrial activity has also slumped since the summer, with manufacturing output down by 7.3% in November on year earlier levels. Export growth is also slowing rapidly. Overall, then, economic conditions have worsened a lot since the summer. **A further concern is the sharp tightening of financial conditions** in recent months brought about by numerous factors, including the sharp falls in equity and house prices, widening credit spreads and tightening of lending conditions. This is likely to remain a serious restraint on the economy next year by limiting the ability of households and businesses to obtain credit.



On the plus side, the housing market may find a floor in late 2009, given the sharp falls in output and prices to date, while a marked decline in inflation will provide a boost to disposable income. There is also likely to be a major fiscal stimulus package introduced next year. The monetary easing by the Fed over the past year should also begin to impact on the economy next year. However, **it is hard to see any recovery in activity taking root before late next year.** Furthermore, it is likely to prove a slow economic upswing, given the damage inflicted on the financial system in recent times and the curtailment of access to credit for the foreseeable future. We see GDP contracting by 1.5% in 2009 and expanding by just 1% in 2010. **This suggests that interest rates will remain low for a long period of time.**

AIB International Centre, IFSC, Dublin 1 Tel: 353-1-8740222 Fax: 353-1-6799590