AIB Global Treasury
Economic Research

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Fed Promises More Action If Recovery Stalls

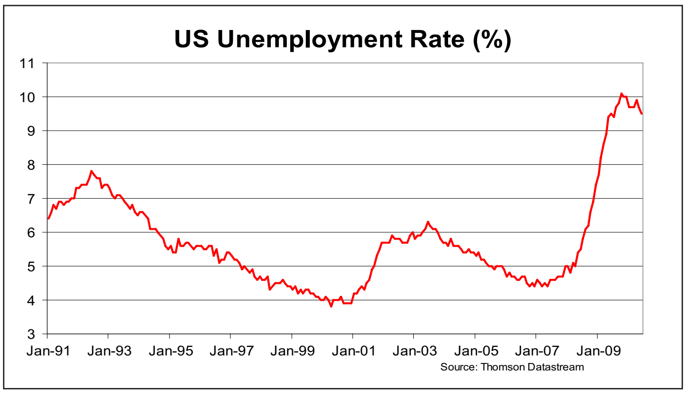
The US Federal Reserve has kept its key interest rate, the Fed funds rate, at an historically low target range of 0 to 0.25 per cent since December 2008. In its FOMC statements, it has consistently reiterated that **economic conditions are likely to warrant continuing exceptionally low levels of the Fed funds rate for an extended period.** This is interpreted as meaning that the Fed is nowhere near raising interest rates.

Markets do not expect any increase in the Fed funds rate until mid-2011 at the earliest. They have been steadily pushing back the date of the first Fed rate hike for the past year in the face of a subdued upturn in activity, a weak labour market and low inflationary pressures. **We feel that the very high level of unemployment is a major impediment to any Fed rate hikes.**

Indeed, there have been signs that the pace of recovery will weaken in H2 2010 as the temporary factors which have been boosting activity, such as stockbuilding and the impact of the fiscal stimulus, abate. Thus, **there was considerable interest in Fed Chairman, Ben Bernanke's, testimony to Congress this week on monetary policy and the state of the economy.**

The minutes of the last FOMC meeting in mid-June revealed that the Fed "would need to consider whether further policy stimulus might become appropriate if the outlook were to worsen appreciably". Thus, there was some expectation that Bernanke might go further than this in his testimony given the recent marked weakening of many indicators.

He described the economic outlook as "unusually uncertain" and said that **the Fed is ready to take further action to support the economy if needed,** especially if the kind of improvements that the Fed is hoping for and expecting in the labour market do not materialise. **However, he did not give much indication that any such actions are imminent.**



The Fed expects the recovery to continue at a moderate pace, with private demand offsetting the impact of the waning fiscal stimulus and slower inventory buildup. It would seem that the Fed believes that any slowdown will prove temporary as it sees GDP growth accelerating to 3.5-4.5% year-on-year by Q4 2011. It is worth noting also that **one FOMC member, Thomas Hoenig, has dissented at the last four FOMC meetings.** He has argued that the expectation of exceptionally low interest rates for an extended period is no longer warranted.

Thus, there will be resistance within the Fed to loosening policy any further. However, it cannot be ruled out with the economy losing momentum and unemployment still at a very high level. With short term rates already close to zero, any further Fed loosening is likely to be aimed at lowering longer term rates via renewed asset purchases and changes to FOMC statements indicating that the Fed will keep official rates low for an even more prolonged period of time.

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

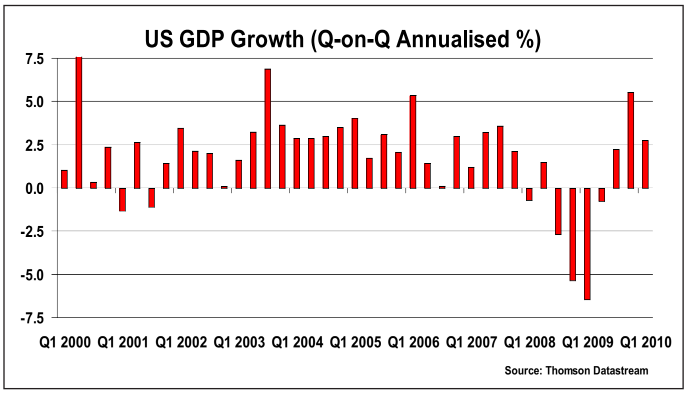
Oliver Mangan
Chief Bond Economist
oliver.n.mangan@aib.ie

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

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

Economy Slowing But Should Avoid Double-Dip

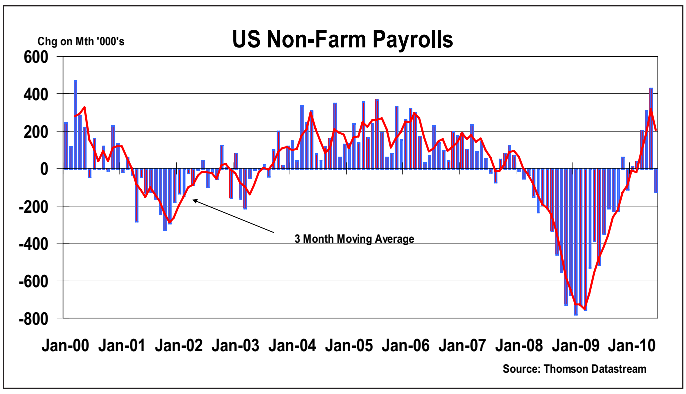
The US recession which began at the end of 2007 finally ended in Q3 2009. **GDP growth averaged 3.5% annualised in the period Q3 2009 to Q1 2010 and is estimated at around 3% in Q2 2010. However, much of the rise in GDP is due to a marked deceleration in the pace of destocking** rather than a pick up in spending - growth in real final sales of domestic product averaged just 1.3% in the first three quarters of the upswing. It is also the case that activity has been helped by fiscal stimulus measures which resulted in a boost to the housing market, auto sector and general consumer spending. These measures, though, were temporary and have generally run their course at this stage.



Thus, it is not that surprising that leading economic indicators are now pointing to a slowdown in the pace of growth in the second half of 2010 as the support from fiscal policy and inventories fades. There are even fears of a double-dip recession.

Recent indicators have generally been disappointing, coming in well below expectations. The ISM indices for manufacturing and services both fell in June, while the Empire and Philly Fed surveys were down again in July. Housing data have been particularly weak, with big declines in housing starts and sales in May and June. Mortgage applications have fallen to a 13 year low. Factory orders fell in May for the first time in nine months, while manufacturing output declined in June. Both headline and core retail sales fell for a second consecutive month in June. Consumer confidence fell sharply in June, with the Michigan consumer sentiment index declining sharply in July. Payrolls also declined in June as temporary census workers were laid off, while the trade deficit widened unexpectedly in May. It's very clear then that the economy has lost considerable momentum.

The economy continues to be saddled with many problems. Household balance sheets are weighed down by heavy debts and pressures on disposable income, with the focus very much on rebuilding savings. Meanwhile, credit availability is still very constrained, especially for smaller firms. There are also large overhangs of unused industrial capacity and vacant homes which are holding back investment, while firms are reluctant to hire. **Given all these headwinds, the prospects are for below trend GDP growth in the second half of the year.**



The economy, though, should avoid a double-dip recession. Income growth is reasonably strong and spending power is being boosted by falling inflation. Business surveys such as the ISMs, although off their peak, remain at levels consistent with relatively solid growth. The housing sector is contracting again but it is now a small part of the economy. The world economy is also performing reasonably well, which should help exports. It is also the case that if the US economy does lurch towards a double-dip, we are likely to get a response from both monetary and fiscal policymakers to stimulate activity.

Thus, it looks like we are in for a period of below trend growth in H2 2010 and possibly into early 2011, but not a double-dip. **However, unemployment will still remain high in these circumstances.**

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