Economic Research Department

BBVA

Fed Watch

August 12, 2009

Fed improves outlook while maintaining target rates

- **Economic activity is stabilizing, but risks remain**
- **Fed will slow Treasury purchases to the end of October**
- **Outlook still warrants low rates for a prolonged period**

Given current economic conditions, the FOMC will maintain its target interest rate at 0% to 0.25%. In line with recent data, the committee stated that *“economic activity is leveling out,”* which is a more positive outlook than the previous meeting’s message that contraction was slowing. Nevertheless, ongoing risk could cause economic activity to remain weak. Although the committee highlighted further improvements in financial markets, household spending and business inventory reductions, job losses, lower household wealth and tight credit are constraining spending and businesses are continuing to reduce staff and fixed investment.

Furthermore, the FOMC’s outlook for inflation remained the same. It continues to believe that sufficient economic slack will counteract some recent upward pressure from energy and commodity prices and keep inflation subdued for an extended period. Nevertheless, the committee remains confident that policy actions, fiscal and monetary stimulus and market forces will result in *“sustainable economic growth in a context of price stability.”*

Even though the committee issued a more positive message overall, it still believes that the current economic environment justifies holding rates constant for a prolonged period of time. On that note, the Fed will maintain previously announced asset purchase levels, but it will slow the purchase of U.S. Treasuries. Rather than completing the $300bn in purchases by autumn as previously announced, it will conclude them by the end of October in order to *“promote a smooth transition in markets.”*

Bottom-line: The main deviation from the previous FOMC statement was the economic outlook. Although the committee expressed a more positive message, it acknowledged that weakness and risks to recovery remain. As a result, it did not find it necessary to either increase or decrease its asset purchases. Furthermore, the FOMC’s position on inflation did not change, which could indicate that it believes that downside risks remain even though the overall economic outlook improved. Looking forward, we still believe that sufficient economic slack and a slow recovery will motivate the Fed to keep interest rates low for a prolonged period of time.

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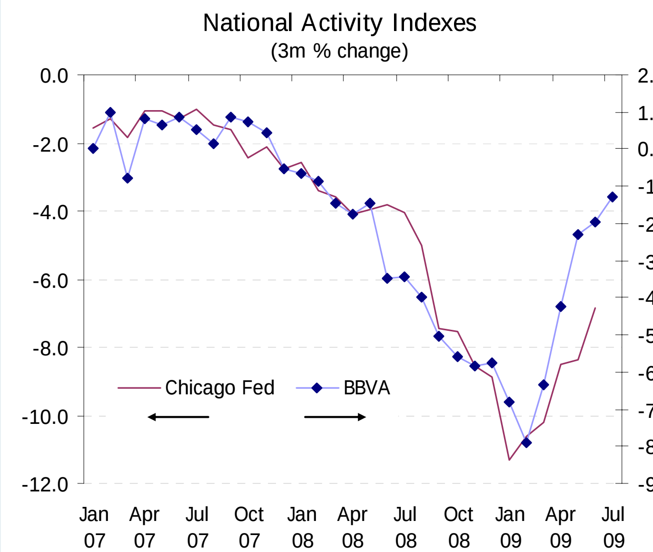
Fed Funds: 0.0-0.25%
Minutes Release: September 2, 2009
Next Meeting: September 22-23, 2009



Source: Chicago Fed & BBVA

Factors Affecting Reserve Balances of Depository Institutions

Millions of dollars

	5-Aug-09	26-Nov-08	Change
Total factors supplying reserve funds	2,029,257	2,143,636	-114,379
U.S. Treasury securities	705,331	476,407	228,924
Federal agency debt securities	108,066	12,221	95,845
Mortgage-backed securities	542,885	0	542,885
Other	672,975	1,655,008	-982,033
TAF	233,598	406,508	-172,910
Commercial paper	61,163	294,094	-232,931
Swap lines, PDCF, AMLF & other	378,214	954,406	-576,192

Source: Federal Reserve