Economic Research Department

BBVA

U.S.

Fed Watch

October 7th, 2008

FOMC Minutes September 16th 2008

- Downside risks to growth have intensified
- Members considered to lower rates if conditions worsen
- Thus, we expect further rate cuts

According to the Minutes, economic indicators reviewed at the meeting showed further deterioration in labor markets. In addition, consumer spending weakened noticeably and residential investment continued to decline. Core inflation eased somewhat in August. The staff revised down its 2009 GDP growth forecast as "the earlier run-up in oil prices, weakened balance sheets, and restrictive financial conditions also likely put the finances of many households and businesses under pressure." Real GDP growth was expected to pick up slightly above potential in 2010. Meanwhile, core inflation was expected to edge down as "the prices of imports, energy, and other commodities decelerate and the margin of resource slack remains relatively wide."

Participants stressed greater downside risks to economic activity due to the financial turmoil highlighting that "the capital of banks and other financial institutions would need to be bolstered in order to strengthen the functioning of the financial system and ease constraints on credit." In fact, several members marked down their outlook for GDP growth in 2009 while that for investment worsened: "…new commercial real estate projects were difficult to finance. With credit conditions generally tight and economic prospects relatively uncertain, investment spending was likely to be on the soft side going forward."

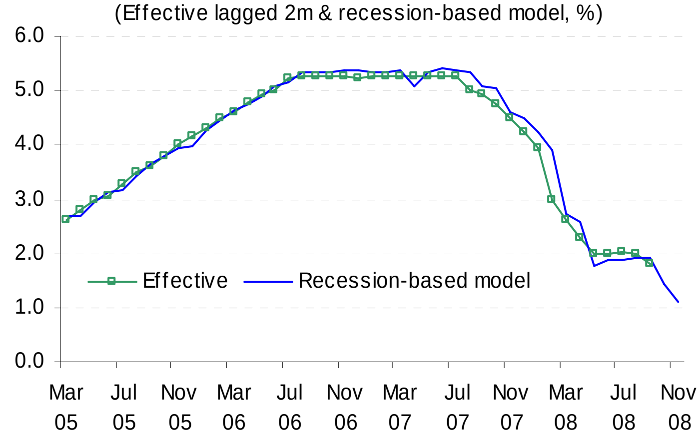
While members agreed that the policy rate was adequate to balance the risks to their outlook, some noted that "if intensifying financial strains led to a significant worsening of the growth outlook, a policy response could be required."

Further rate cuts appear to be imminent

Since the last meeting the significant deterioration in financial and economic conditions has probably surprised even the most pessimistic FOMC member. Therefore, the probability of a rate cut on or even before the next meeting on October 28-29th has increased substantially. In fact, Bernanke's most recent speech supports our view as it acknowledged that "…the Federal Reserve will need to consider whether the current stance of policy remains appropriate." According to a monetary policy rule model which considers the probability of a recession, if economic conditions deteriorate further, Fed could cut rates by as much as 100bp. Thus we have revised down the lower end of our Fed funds forecast range to 1% for year-end 2008 and throughout 2009.

Fed Funds: 2.00%
Next Meeting: October 28-29th, 2008
Minutes Release: November 19th, 2008

Fed Funds
(Effective lagged 2m & recession-based model, %)



Fed Funds Expectations
(Fed Funds futures, end of contract, %)