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Economic Research Report

The following report is written by our in-house analysts to provide you greater insight into upcoming economic events.

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PREVIEW: FOMC rate-decision due at 1915 BST (1315 CDT)

- The Fed is likely to reinvest from short-dated to long-dated Treasuries, "Operation Twist"
- It is unlikely that the central bank will opt for a fresh round of asset-purchases, "QE3", today
- Markets will keep a close eye on whether the FOMC votes unanimously

All eyes remain fixed on today's FOMC rate decision, where markets anticipate the Fed to take action in order to bolster growth. In his Jackson Hole speech, Fed's Bernanke explicitly said that the FOMC would meet for two days in September instead of the scheduled one day to discuss ways to boost the recovery. The Fed has already pledged to keep the Fed funds rate at its exceptionally low level for at least two years. The doves in the FOMC are likely to argue in the favour of further monetary easing owing to a weaker growth outlook for the US, however other members may differ due to a danger of unsustainably high levels of inflation resulting from an ultra-loose monetary policy. It is worth noting that in the previous FOMC meeting the vote was not unanimous and three members – Fisher, Kocherlakota, and Plosser – dissented, which also marked the largest division among policymakers in nearly two decades.

If the Fed opts for further easing, most analysts expect that it may aim to lower the long-term interest rates by reinvesting the proceeds from maturing government debt into longer-term Treasury securities, commonly known as "operation twist". A more aggressive stance to achieve the same would be to actively sell short-dated debt and reinvest into longer-term maturities. It is unlikely that the central bank would opt for a fresh round of asset-purchases due to the current low-growth rate coupled with a reasonably high inflation, which could stagnate the economy. However, some members may consider fresh stimulus in conjunction with sterilising any new bond purchases via reverse repo operations, which could avoid the problem of induced inflation. The Fed could be explicit by using "extended period" language with respect to asset-purchases or could go a step further by specifying a time period. Owing to a depressed housing market in the US, the central bank may discuss reinvesting proceeds from maturing government debt into MBS. This would result in lowering the yields on MBS, which in turn may provide support to the housing sector.

In terms of other measures, policymakers could discuss the possibility of lowering the interest paid on excess reserves, which currently stands at 0.25%. This would give commercial banks less incentive to park their money with the central bank and may encourage them to lend, however Bernanke has already said that this measure is likely to have limited impact given that the interest rate is already at its historic lows. The Fed could also set specific targets on inflation or growth and by setting higher inflation target it could create room for further monetary manoeuvre. It is worth noting that Bernanke has been a strong supporter of setting an explicit target on inflation. The Fed could open a new lending facility to specific sectors to boost credit availability, however to do that it would have to argue that crisis conditions exist in order to lend to nonbanks, and the Fed may refrain from doing so following criticism of similar action taken during 2007-2009.

It is worth noting that the market has been factoring in the possibility of the Fed reinvesting in longer-term Treasuries, and if this option materialises, there is likely to be limited reaction in the market. However, a more aggressive stance of a fresh stimulus will potentially boost T-Notes and will most likely result in a USD-selloff. Equities may also receive support as by taking that step the Fed would signal additional stimulus to the economy. If the Fed targets specific sectors, lowers interest paid on excess reserves, or signals reinvestment into MBS, equities are likely to gain the most from the move.