

## 2007 Special Report: U.S. Banks' Interest Rate Review, 1st Quarter

### Mixed Economic Signals Hold Fed in Check

Inflation and Dollar Concerns Mitigate Pressures From Slowing Business Activity

Despite year-end 2006 consensus forecasts that anticipated an early 2007 easing move by the Federal Reserve's Federal Open Market Committee (FOMC), Federal funds still are targeted at 5.25%, and the FOMC appears to be on hold for the near term. Although the economy has continued to show signs of softening, inflation pressures persist, and the U.S. dollar has come under minor selling pressure.

The deepening near-term negative slope in the Treasury yield curve suggests that the markets still are betting on the FOMC easing in response either to weakening economic activity or to possible systemic liquidity problems that could arise from troubled portions of the mortgage market. Slowing retail sales, home construction and weak employment growth all are suggestive of an economy near recession. Such a circumstance usually would have the Fed looking to cut interest rates in an effort to stimulate economic activity.

Further, highly publicized problems in the

subprime and related nontraditional mortgage markets likely have the Fed highly sensitized to any liquidity difficulties that might arise within the system, a circumstance that also could push the U.S. central bank into an easing.

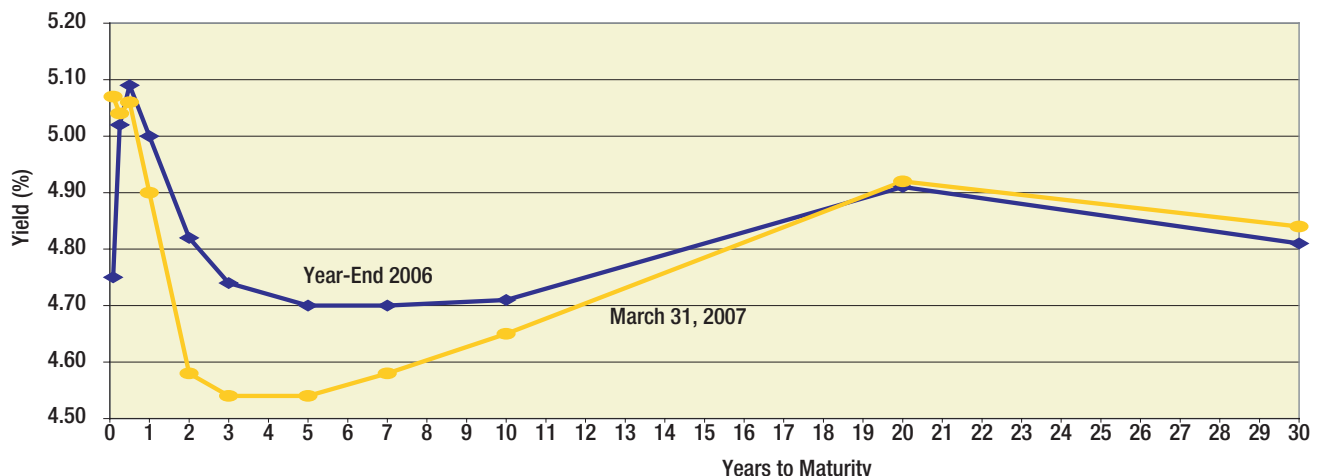
Nonetheless, the FOMC left policy unchanged in its March 21 statement, indicating that its "... predominant policy concern remains the risk that inflation will fail to moderate as expected." Fed Chairman Ben S. Bernanke reconfirmed the Fed's inflation concerns in congressional testimony just a week later.

Oil prices remain volatile and high. More than any other commodity, oil is a major cost component of most products and services, whether it involves transportation and other areas of energy consumption, or materials ranging from plastics, petrochemicals and pharmaceuticals to fertilizer. Accordingly, not only has straight inflation resumed its upward annual climb, but also the so-called "core" rate of inflation—inflation net of food and energy—has shown a disquieting upswing.

Not generally discussed by the Fed are its concerns involving the U.S. dollar. As discussed in the [prior quarterly review of interest rates](#), the U.S. mar-

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### Treasury Yield Curve Year-End 2006, March 31, 2007



Source: Federal Reserve Board.



kets remain heavily dependent on capital from outside the United States for liquidity. Any significant selling of the greenback likely would entail some liquidation of U.S. dollar-denominated assets, which in turn would have the effect of spiking interest rates and dampening equity prices.

Fundamentals that tend to determine a currency's relative value versus its major trading partners include, all on a relative basis: interest rates, inflation, economic activity, trade balance, fiscal balance and political stability. With interest rates rising outside the United States; U.S. inflation rising and the economy softening; high trade and federal deficits; and a contentious White House-Congress relationship, all the major factors are aligned against the dollar and leave the U.S. currency open to selling pressures. A Fed easing would increase those pressures; a Fed tightening would alleviate some of the dollar sell-off risk.

Given this combination of circumstances, what can the FOMC do? Easing in order to stimulate

the economy not only risks triggering a dollar decline; it also could fail to cause a pick-up in business activity. Despite the Fed's raising short-term rates in recent years, growth in the money supply has been picking up, yet the economy is slowing. Raising rates to fight inflation would not help much either. Higher rates can have meaningful impact on inflation when prices are driven by strong economic demand. Yet the economy already is weak, while the inflation is not demand-driven, but rather driven by cartel-influenced commodity prices.

Given only the current economic and inflation pressures, the Fed indeed may be comfortable holding rates as they are for a while, until perhaps other matters might force its hand. A systemic liquidity problem, for example, could force an easing, while significant dollar selling could force a hike in rates. As was the circumstance three months ago, consensus forecasts of a looming Fed easing remain at risk of being frustrated.

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## Special Report

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