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FOMC keeps its cool, but rescue of AIG clouds the decision

- United FOMC keeps rates unchanged despite signs of extreme stress in markets....
-concentrating on the growth and inflation outlook
-and apparently addressing financial stress by other means
-FOMC gamble succeeds as markets react positively, but
-overnight the Fed actually bailed out AIG....

■ Separate monetary policy decisions and financial stability

The FOMC decided for the third consecutive meeting to keep rates unchanged at 2% in what should have been a very tense and hotly debated meeting. Indeed, the bankruptcy of Lehman over the weekend and the problems of amongst others AIG led to shockwaves in financial markets and fears for a meltdown. Stocks looked into the abyss on Monday when the S&P dropped 4.7%, the steepest one-day loss since 9/11.

It is very telling that the FOMC statement barely mentioned the financial and systemic problems. Only the fact that NY Fed governor Geithner stayed in New York to work on a solution for the AIG (and other) problems reminded observers that it wasn't business as usual. Mr. Geithner was replaced by Ms. Cumming.

The FOMC conveys the message that it wants to separate its dual mandate of maximal sustainable growth and price stability from its duty as safeguard of financial stability. In this respect, the FOMC decision re-enforces its attitude in the Lehman affair, where it (and the Treasury) drew the line under the too big to fail doctrine and restored the moral hazard principle. A rate cut yesterday could have been seen as the Fed retreating from these principles. At the Jackson Hole conference, the Fed got extensive critique for the aggressive easing of policy in early 2008 which was clearly done for financial stability reasons more than for economic ones. After the till now latest rate cut, notably in late April, the Fed signalled that it had probably finished with its easing cycle and explicitly stated that some further wors-

ening of the economy wouldn't force them to cut rates further, given their earlier aggressiveness. The steep rise in inflation in spring and early summer led to a near revolt of a number of regional Fed governors who had before resisted the policy of aggressive easing of chairman Bernanke.

In this sense, the unanimous decision to keep rate unchanged yesterday, Dallas Fed governor Fisher rejoined the majority, signals that the divisions inside the FOMC are healed. Unity is an important asset for the Fed in turbulent times.

Overnight, six hours after the FOMC decision, the **Federal Reserve Board (don't mix up with the FOMC), with the support of the Treasury, authorized the NY Fed to lend up to \$85 billion to AIG.** The statement said that a disorderly failure of AIG could add to the significant levels of financial stress and lead to higher borrowing costs and weaker economic performance. The loan is accorded under (severe) conditions (cf. below), also to protect interests of taxpayers, and the government receives a 79.9% stake in equity interest in the company, giving it the authority to block the payment of dividends to common and preferred shareholders. The objective seems to be an orderly downscaling of the firm (sale of assets) and may even lead to the end of the operations of the biggest insurer.

■ Neutral bias remains unchanged

The Fed not only kept rates unchanged despite the market pressure, **it also kept its neutral bias by citing both infla-**

tion and growth risks as a significant concern. This is a bit of a surprise, as at least an easing bias looked secured. The Fed kept its paragraph on inflation unchanged, including the expectation that it expects inflation to moderate further out. Given the recent decline in oil and other commodity prices and the easing in inflation expectations, the Fed had the opportunity to sound a bit softer on inflation, opening the way for an easing bias.

On growth, the **FOMC states that growth appeared to have slowed recently**, partly reflecting a softening in household spending. This is no surprise following very bad retail sales figures. As in August, the Fed states that it expects a number of factors like tight credit, housing contraction and now also slowing in export growth (in August elevated energy prices were mentioned) to weigh on growth over the next quarters. Over time, the Fed still sees moderate growth.

■ Market reaction subdued

On the decision, equities briefly tested the downside before rallying into positive territory and closing about 1.8% higher. Treasuries declined, the shorter end hit the most. Yields rose between 5 and 17 basis points, which is all in all a modest reversal of previous declines. Despite the decision, the Fed funds futures still discount 80% chance on one rate cut by April and still some residual chances for an intermeeting rate cut in September/October. The dollar showed little

reaction against the euro and was up modestly against the yen. Were markets already aware of the imminent decision of the Fed to bail out AIG? And has that determined the reaction?

■ Conclusion

The FOMC kept its cool and apparently read the markets' mind correctly. There was no selling wave after the decision was taken. The Fed put the moral hazard principle into the limelight, a message the financial sector will have picked up. At the same time, it kept its powder dry for eventual other circumstances where lower rates are needed. Less than six hours later, the Fed engaged in a giant \$85 USD bail out of AIG. Following Freddie & Fannie rescue by Treasury and Fed, the widening of acceptable collateral to equities and now the AIG bail out, it is obvious that an ever bigger part of the financial sector is "nationalized" and the Fed's balance sheet has been weakened.

Piet Lammens, KBC Brussels

September 16 FOMC statement

The Federal Open Market Committee decided today to keep its target for the federal funds rate at 2 percent.

Strains in financial markets have increased significantly and labor markets have weakened further. Economic growth appears to have slowed recently, partly reflecting a softening of household spending. Tight credit conditions, the ongoing housing contraction, and some slowing in export growth are likely to weigh on economic growth over the next few quarters. Over time, the substantial easing of monetary policy, combined with ongoing measures to foster market liquidity, should help to promote moderate economic growth.

Inflation has been high, spurred by the earlier increases in the prices of energy and some other commodities. The Committee expects inflation to moderate later this year and next year, but the inflation outlook remains highly uncertain.

The downside risks to growth and the upside risks to inflation are both of significant concern to the Committee. The Committee will monitor economic and financial developments carefully and will act as needed to promote sustainable economic growth and price stability.

September 16 Fed statement (on AIG)

The Federal Reserve Board on Tuesday, with the full support of the Treasury Department, authorized the Federal Reserve Bank of New York to lend up to \$85 billion to the American International Group (AIG) under section 13(3) of the Federal Reserve Act. The secured loan has terms and conditions designed to protect the interests of the U.S. government and taxpayers.

The Board determined that, in current circumstances, a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance.

The purpose of this liquidity facility is to assist AIG in meeting its obligations as they come due. This loan will facilitate

a process under which AIG will sell certain of its businesses in an orderly manner, with the least possible disruption to the overall economy.

The AIG facility has a 24-month term. Interest will accrue on the outstanding balance at a rate of three-month Libor plus 850 basis points. AIG will be permitted to draw up to \$85 billion under the facility.

The interests of taxpayers are protected by key terms of the loan. The loan is collateralized by all the assets of AIG, and of its primary non-regulated subsidiaries. These assets include the stock of substantially all of the regulated subsidiaries. The loan is expected to be repaid from the proceeds of the sale of the firm's assets. The U.S. government will receive a 79.9 percent equity interest in AIG and has the right to veto the payment of dividends to common and preferred shareholders.

Brussels Research (KBC)		Global Sales Force	
Piet Lammens	+32 2 417 59 41		
Peter Wuyts	+32 2 417 32 35	Brussels	
Didier Hanesse	+32 2 417 59 43	Corporate Desk	+32 2 417 45 82
Bob Maes	+32 2 417 51 94	Commercial Desk	+32 2 417 53 23
		Institutional Desk	+32 2 417 46 25
Dublin Research (IIB)			
Austin Hughes	+353 1 6646889	London	+44 207 256 4848
Prague Research (CSOB)		Frankfurt	+49 69 756 19372
Jan Cermak	+420 2 6135 3578	Paris	+33 153 89 83 15
Zdenek Safka	+420 2 6135 3570	New York	+1 212 541 06 97
Jan Bures	+420 2 6135 3574	Singapore	+65 533 34 10
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8400	Prague	+420 2 6135 3535
Silvia Cechovicova	+421 2 5966 8405	Bratislava	+421 2 5966 8436
Warsaw Research (Kredybank)		Budapest	+36 1 328 99 63
Piotr Radzewicz	+48 22 6345 946	Warsaw	+48 22 634 5210
Budapest Research (K&H)			
Gyorgy Barcza	+36 1 328 99 89		
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