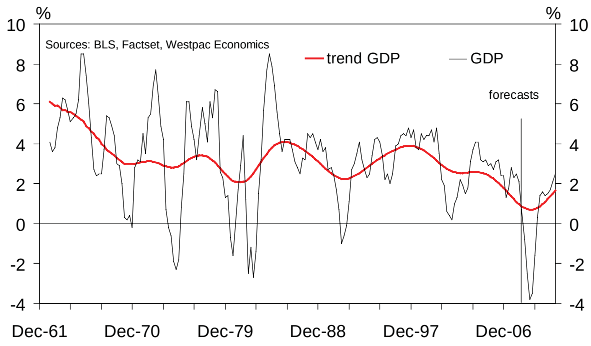
24 June 2007

US growth far from inflationary.
The Fed can remain on hold though 2010.

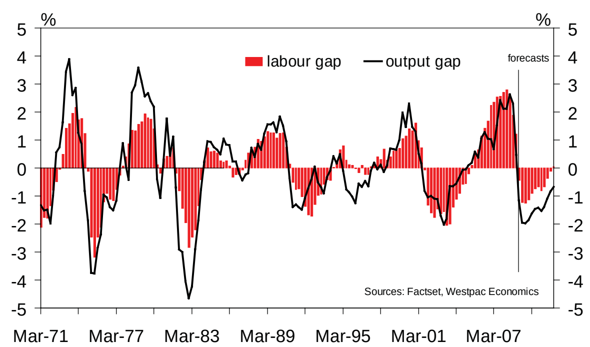
- We have updated our Fed Funds rate model to test the hypothesis that "green shoots mean early Fed hikes".
- The model uses fundamental variables to explain the Fed Funds rate (FFR): core PCE, non-farm payrolls, unemployment expectations and the share market. It does not include lags of the FFR nor market pricing.
- While not perfect, the model has broadly tracked the official FFR rate since the late 1980s. As such, it can be used to approximate future Fed behaviour that would be consistent with our current economic forecasts.
- Westpac is forecasting economic growth to contract almost 3% in 2009 before growing a very modest 1.2% in 2010, the unemployment rate to peak at more than 11% in late 2010 and core PCE inflation to moderate to a 1%yr pace by mid 2010. We have assumed equities make only very modest gains over the next 12 months.
- The central tendency of our model points to the FFR bottoming at around –2% in mid 2010. Of course, the FFR can't go negative but the level of negativity is indicative of the relative magnitude of the quantitative easing (QE) required, in interest rate terms, to offset current events.
- This negativity may also highlight the possible two step process for tightening policy; that is removing QE first (negative interest rates) and then raising rates. So even if QE is removed though 2010, the model suggests that the Fed is unlikely to raise rate until the second half of 2011.

Justin Smirk, Senior Economist

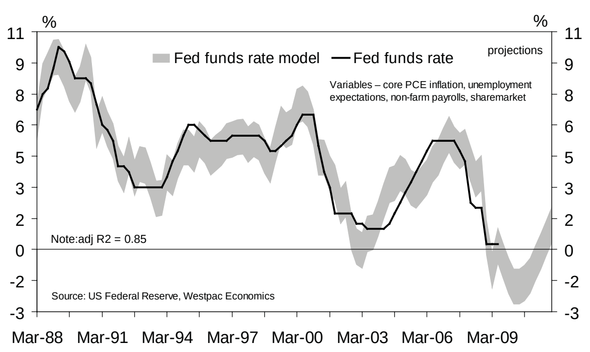
US economic growth still contracting



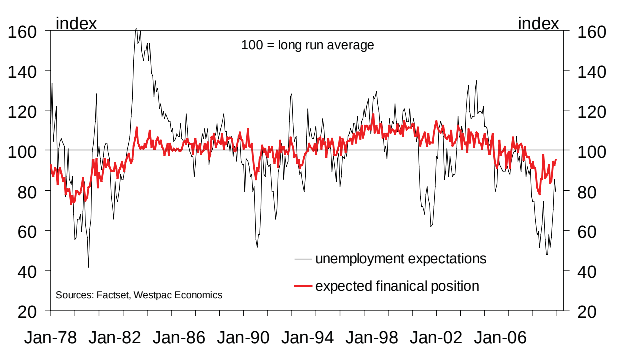
Disinflationary pulse to remain to 2011



Fed funds model



Households remain nervous about finance



Forecasts – United States

Interest rate forecasts

	Latest (Jun 24)	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10
Fed Funds*	0.125	0.125	0.125	0.125	0.125	0.125
Market implied^	na	0.217	0.250	0.320	0.459	0.610
10 Year Bond	3.64	3.00	3.55	3.75	4.00	4.00

	Latest (Jun 24)	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10
USD vs						
USD index*	**100**	**101.76**	**102.43**	**101.10**	**99.80**	**97.75**
JPY	95.54	95	92	96	99	103
EUR	1.4038	1.38	1.36	1.39	1.42	1.45
AUD	0.7959	0.76	0.74	0.77	0.80	0.82
NZD	0.6407	0.60	0.59	0.62	0.65	0.68
CAD	1.1480	1.13	1.16	1.12	1.08	1.06
GBP	1.6469	1.59	1.58	1.64	1.69	1.75
CHF	1.0670	1.09	1.14	1.08	1.06	1.07
ZAR	8.1671	8.21	8.32	8.19	8.07	8.03
SGD	1.4550	1.45	1.44	1.43	1.42	1.41
HKD	7.7501	7.75	7.75	7.75	7.75	7.75
PHP	48.23	47.5	47.7	47.3	46.9	46.5
THB	34.13	34.5	34.5	35.1	34.8	34.3
MYR	3.54	3.51	3.51	3.49	3.48	3.46
CNY	6.8341	6.82	6.82	6.79	6.75	6.72
IDR	10450	10600	10600	10350	10100	9500
TWD	32.86	32.74	32.82	32.69	32.56	32.43
KRW	1283	1264	1288	1248	1228	1226
INR	48.54	47.70	47.23	46.98	46.73	46.49

		2009				2010			Calendar years		
% annualised, s/adj	**Q4**	**Q1**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**2007**	**2008**	**2009f**	**2010f**
Private consumption	–4.3	1.6	–0.9	–0.4	–2.0	0.8	1.2	2.8	0.2	–1.2	0.1
Dwelling investment	–22.7	–38.7	–25.2	–18.5	–7.8	–3.9	0.0	–17.9	–20.8	–24.9	–6.0
Business investment	–21.7	–36.9	–32.2	–20.3	–10.5	–5.8	–4.9	3.9	0.2	–23.9	–9.5
Public demand	1.3	–3.5	10.4	10.4	9.1	8.2	7.0	2.1	2.9	4.0	8.0
Domestic final demand	–6.1	–5.6	–3.3	–0.9	–0.9	1.5	1.7	1.8	–0.1	–3.6	0.6
Inventories contribution ppt	0.1	–2.3	–0.1	0.4	0.4	0.1	0.0	–0.4	–0.2	–0.3	0.6
Net exports contribution ppt	–0.1	0.5	0.3	–0.1	0.1	0.0	0.0	0.6	1.4	1.0	–0.1
GDP	**–6.3**	**–5.7**	**–2.6**	**0.6**	**1.4**	**1.9**	**1.7**	**2.0**	**1.1**	**–2.9**	**1.2**
%yr annual chg	–0.8	–2.5	–3.8	–3.5	–1.6	0.3	1.4	–	–	–	–
Other macroeconomic variables											
Non–farm payrolls mth avg	–426	–688	–401	–309	–263	–263	–263	103	–189	–415	–44
Unemployment rate %	6.9	8.1	9.5	10.2	10.8	10.8	10.8	4.6	5.8	9.7	11.1
CPI headline %yr	1.5	–0.2	–1.0	–2.3	0.1	1.0	1.2	2.9	3.8	–0.9	1.5
PCE deflator, core %yr	1.9	1.8	1.5	1.2	1.2	1.1	1.1	2.2	2.2	1.4	1.1
Current account %GDP	–4.4	–2.9	–2.3	–2.1	–2.0	–2.0	–1.9	–5.3	–4.9	–2.3	–2.0

Sources: Official agencies, Factset, Westpac Economics