

## UBS Investment Research

## US Economic Comment

## Discount rate raised from 0.5% to 0.75%

**■ The Fed cited “improvement in financial market conditions” but cautioned that the hike does “not signal any change” in the economic or policy outlook**

At 4:30 pm, the Federal Reserve Board increased the discount rate from ½% to ¾%, effective Feb. 19. In testimony released on Feb 10, Fed Chairman Bernanke had warned that a discount rate hike would likely come “before long”; as such, markets appear to have taken it in stride. (2-year Treasury yields rose about 6 bps to 0.92% after the announcement; 10-year yields rose in the immediate aftermath but then reversed. The dollar rose somewhat against major currencies.) The Fed also shortened the typical maximum maturity for “primary credit” (i.e., discount window) loans to overnight.

The Fed statement cited “continued improvement in financial market conditions” but described the move as “like the closure of a number of extraordinary credit programs earlier this month”. It emphasized that this was a step toward normalization of the Fed’s emergency lending facilities and does “not signal any change in the outlook for the economy or for monetary policy.” Indeed, “the modifications are not expected to lead to tighter financial conditions for households and businesses.”

The Fed’s move emphasizes that the danger to the broad economy from financial market dysfunction has diminished. “The increase in the spread and reduction in maximum maturity will encourage depository institutions to rely on private funding markets for short-term credit and to use the Federal Reserve’s primary credit facility only as a backup source of funds.” In that regard, the Fed’s move should not tighten borrowing conditions.

The Fed statement also repeated Mr. Bernanke’s assessment that the outlook “remains about as it was at the January meeting” of the FOMC, and that “economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period”.

However, while the Fed cautions that the moves should not be seen as a change in policy, they nevertheless are the first step of a sequence toward Fed tightening that Mr. Bernanke outlined in his speech last week (more below).

The timing of the move may put additional weight on Mr. Bernanke’s semiannual monetary policy testimony scheduled for Feb 24-25 (which also will allow him to address any unanticipated market reactions). The timing also may have been contingent on a stabilizing stock market.

18 February 2010

[www.ubs.com/economics](http://www.ubs.com/economics)**Maury N. Harris**Economist  
maury.harris@ubs.com  
+1-212-713 2472**Samuel D. Coffin**Economist  
samuel.coffin@ubs.com  
+1-203-719 1252**Kevin Cummins**Economist  
kevin.cummins@ubs.com  
+1-203-719 1676

Although Fed Chairman Bernanke's testimony last week repeated that he saw no change in the economic outlook since the January FOMC meeting, he allowed that "In due course... as the expansion matures the Federal Reserve will need to begin to tighten" policy. He outlined a possible sequence for policy changes: a rise in the discount rate "before long", increased use of reverse repos and term deposits, followed eventually by rate hikes. Asset sales probably do not occur until later. And he wrote about the possibility that the Fed may shift to targeting "the interest rate paid on reserves, in combination with reserve quantities" rather than the Fed funds rate.

The Fed statement on Thursday and Mr. Bernanke's testimony specified that a discount rate rise should not be seen as a policy shift. However, Mr. Bernanke's testimony also described a framework for policy in which the Fed would "bracket its target for the Federal funds rate with the discount rate above and interest rate on excess reserves below." An increase in the discount rate is therefore suggestive. It may not suggest that the policy outlook is changing, but it is consistent with this shift toward use of a policy rate corridor formed by the discount rate and the rates on reserves. (Currently, the rate on excess reserves is 0.25%.)

In this "corridor system", banks' ability to borrow at the discount rate would limit spikes in the effective funds rate; their ability to lend to the Fed at the excess reserves rate would limit declines. Of course, these bands are not currently holding the funds rate above the 0.25% rate on excess reserves. The sheer volume of excess reserves has held the funds rate below this so-called floor. Technical factors also make some difference: GSEs lend overnight funds in quantity, but they are ineligible to earn interest on reserves and perhaps prefer to place funds with the larger, well-known banks that trade in the Fed funds market. Both factors would tend to depress the overnight funds rate relative to the rates on reserves.

But as excess reserves shrink (led either by a pickup in bank lending or by the Fed's increased use of term deposits and reverse repos), the higher rates on reserves will be more likely to put upward pressure on the funds rate.

Mr. Bernanke did not commit to the corridor system—"other approaches are also possible", but he did emphasize that "the authority to pay interest on reserves is likely to be an important component of the future operating framework for monetary policy." Eventually, he anticipates that Fed policy will return to using a funds rate target and a balance sheet with "much lower reserve balances."

**We continue to expect the first rate hike in June and a 1% funds rate at year end.** Recent Fed communiqués remind us of the uncertainty surrounding precise timing, but tightening *throughout* H210 appears likely to us. Of course, the unwinding of policy accommodation will continue to depend on financial market and economic conditions. In coming months, economic data—especially jobs data—have to be fairly unambiguous; speeches by Fed officials have to become more hawkish, and we would expect increased use of reverse repos and term deposits. We see tightening sooner rather than later. The fed funds rate and the balance sheet are still at emergency levels (even if the discount rate now has been ratcheted up slightly), yet the emergency has passed.

## Fed statement

### Federal Reserve Approves Modification to the Terms of its Discount Window Lending programs

The Federal Reserve Board on Thursday announced that in light of continued improvement in financial market conditions it had unanimously approved several modifications to the terms of its discount window lending programs.

Like the closure of a number of extraordinary credit programs earlier this month, these changes are intended as a further normalization of the Federal Reserve's lending facilities. The modifications are not expected to lead to tighter financial conditions for households and businesses and do not signal any change in the outlook for the economy or for monetary policy, which remains about as it was at the January meeting of the Federal Open Market Committee (FOMC). At that meeting, the Committee left its target range for the federal funds rate at 0 to 1/4 percent and said it anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period.

The changes to the discount window facilities include Board approval of requests by the boards of directors of the 12 Federal Reserve Banks to increase the primary credit rate (generally referred to as the discount rate) from 1/2 percent to 3/4 percent. This action is effective on February 19.

In addition, the Board announced that, effective on March 18, the typical maximum maturity for primary credit loans will be shortened to overnight. Primary credit is provided by Reserve Banks on a fully secured basis to depository institutions that are in generally sound condition as a backup source of funds. Finally, the Board announced that it had raised the minimum bid rate for the Term Auction Facility (TAF) by 1/4 percentage point to 1/2 percent. The final TAF auction will be on March 8, 2010.

Easing the terms of primary credit was one of the Federal Reserve's first responses to the financial crisis. On August 17, 2007, the Federal Reserve reduced the spread of the primary credit rate over the FOMC's target for the federal funds rate to 1/2 percentage point, from 1 percentage point, and lengthened the typical maximum maturity from overnight to 30 days. On December 12, 2007, the Federal Reserve created the TAF to further improve the access of depository institutions to term funding. On March 16, 2008, the Federal Reserve lowered the spread of the primary credit rate over the target federal funds rate to 1/4 percentage point and extended the maximum maturity of primary credit loans to 90 days.

Subsequently, in response to improving conditions in wholesale funding markets, on June 25, 2009, the Federal Reserve initiated a gradual reduction in TAF auction sizes. As announced on November 17, 2009, and implemented on January 14, 2010, the Federal Reserve began the process of normalizing the terms on primary credit by reducing the typical maximum maturity to 28 days.

The increase in the discount rate announced Thursday widens the spread between the primary credit rate and the top of the FOMC's 0 to 1/4 percent target range for the federal funds rate to 1/2 percentage point. The increase in the spread and reduction in maximum maturity will encourage depository institutions to rely on private funding markets for short-term credit and to use the Federal Reserve's primary credit facility only as a backup source of funds. The Federal Reserve will assess over time whether further increases in the spread are appropriate in view of experience with the 1/2 percentage point spread.

---

### ■ Analyst Certification

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

## Required Disclosures

This report has been prepared by UBS Securities LLC, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS.

For information on the ways in which UBS manages conflicts and maintains independence of its research product; historical performance information; and certain additional disclosures concerning UBS research recommendations, please visit [www.ubs.com/disclosures](http://www.ubs.com/disclosures). The figures contained in performance charts refer to the past; past performance is not a reliable indicator of future results. Additional information will be made available upon request.

## Global Disclaimer

This report has been prepared by UBS Securities LLC, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS. In certain countries, UBS AG is referred to as UBS SA.

This report is for distribution only under such circumstances as may be permitted by applicable law. Nothing in this report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances or otherwise constitutes a personal recommendation. It is published solely for information purposes, it does not constitute an advertisement and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments in any jurisdiction. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the information contained herein, except with respect to information concerning UBS AG, its subsidiaries and affiliates, nor is it intended to be a complete statement or summary of the securities, markets or developments referred to in the report. UBS does not undertake that investors will obtain profits, nor will it share with investors any investment profits nor accept any liability for any investment losses. Investments involve risks and investors should exercise prudence in making their investment decisions. The report should not be regarded by recipients as a substitute for the exercise of their own judgement. Any opinions expressed in this report are subject to change without notice and may differ or be contrary to opinions expressed by other business areas or groups of UBS as a result of using different assumptions and criteria. Research will initiate, update and cease coverage solely at the discretion of UBS Investment Bank Research Management. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing and interpreting market information. UBS is under no obligation to update or keep current the information contained herein. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, groups or affiliates of UBS. The compensation of the analyst who prepared this report is determined exclusively by research management and senior management (not including investment banking). Analyst compensation is not based on investment banking revenues, however, compensation may relate to the revenues of UBS Investment Bank as a whole, of which investment banking, sales and trading are a part.

The securities described herein may not be eligible for sale in all jurisdictions or to certain categories of investors. Options, derivative products and futures are not suitable for all investors, and trading in these instruments is considered risky. Mortgage and asset-backed securities may involve a high degree of risk and may be highly volatile in response to fluctuations in interest rates and other market conditions. Past performance is not necessarily indicative of future results. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related instrument mentioned in this report. For investment advice, trade execution or other enquiries, clients should contact their local sales representative. Neither UBS nor any of its affiliates, nor any of UBS' or any of its affiliates, directors, employees or agents accepts any liability for any loss or damage arising out of the use of all or any part of this report. For financial instruments admitted to trading on an EU regulated market: UBS AG, its affiliates or subsidiaries (excluding UBS Securities LLC and/or UBS Capital Markets LP) acts as a market maker or liquidity provider (in accordance with the interpretation of these terms in the UK) in the financial instruments of the issuer save that where the activity of liquidity provider is carried out in accordance with the definition given to it by the laws and regulations of any other EU jurisdictions, such information is separately disclosed in this research report. UBS and its affiliates and employees may have long or short positions, trade as principal and buy and sell in instruments or derivatives identified herein.

Any prices stated in this report are for information purposes only and do not represent valuations for individual securities or other instruments. There is no representation that any transaction can or could have been effected at those prices and any prices do not necessarily reflect UBS's internal books and records or theoretical model-based valuations and may be based on certain assumptions. Different assumptions, by UBS or any other source, may yield substantially different results.

**United Kingdom and the rest of Europe:** Except as otherwise specified herein, this material is communicated by UBS Limited, a subsidiary of UBS AG, to persons who are eligible counterparties or professional clients and is only available to such persons. The information contained herein does not apply to, and should not be relied upon by, retail clients. UBS Limited is authorised and regulated by the Financial Services Authority (FSA). UBS research complies with all the FSA requirements and laws concerning disclosures and these are indicated on the research where applicable. **France:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities France SA. UBS Securities France S.A. is regulated by the Autorité des Marchés Financiers (AMF). Where an analyst of UBS Securities France S.A. has contributed to this report, the report is also deemed to have been prepared by UBS Securities France S.A. **Germany:** Prepared by UBS Limited and distributed by UBS Limited and UBS Deutschland AG. UBS Deutschland AG is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). **Spain:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities España SV, SA. UBS Securities España SV, SA is regulated by the Comisión Nacional del Mercado de Valores (CNMV). **Turkey:** Prepared by UBS Menkul Değerler AS on behalf of and distributed by UBS Limited. **Russia:** Prepared and distributed by UBS Securities CJSC. **Switzerland:** Distributed by UBS AG to persons who are institutional investors only. **Italy:** Prepared by UBS Limited and distributed by UBS Limited and UBS Italia Sim S.p.A.. UBS Italia Sim S.p.A. is regulated by the Bank of Italy and by the Commissione Nazionale per le Società e la Borsa (CONSOB). Where an analyst of UBS Italia Sim S.p.A. has contributed to this report, the report is also deemed to have been prepared by UBS Italia Sim S.p.A.. **South Africa:** UBS South Africa (Pty) Limited (Registration No. 1995/011140/07) is a member of the JSE Limited, the South African Futures Exchange and the Bond Exchange of South Africa. UBS South Africa (Pty) Limited is an authorised Financial Services Provider. Details of its postal and physical address and a list of its directors are available on request or may be accessed at <http://www.ubs.co.za>. **United States:** Distributed to US persons by either UBS Securities LLC or by UBS Financial Services Inc., subsidiaries of UBS AG; or by a group, subsidiary or affiliate of UBS AG that is not registered as a US broker-dealer (a "non-US affiliate"), to major US institutional investors only. UBS Securities LLC or UBS Financial Services Inc. accepts responsibility for the content of a report prepared by another non-US affiliate when distributed to US persons by UBS Securities LLC or UBS Financial Services Inc. All transactions by a US person in the securities mentioned in this report must be effected through UBS Securities LLC or UBS Financial Services Inc., and not through a non-US affiliate. **Canada:** Distributed by UBS Securities Canada Inc., a subsidiary of UBS AG and a member of the principal Canadian stock exchanges & CIPF. A statement of its financial condition and a list of its directors and senior officers will be provided upon request. **Hong Kong:** Distributed by UBS Securities Asia Limited. **Singapore:** Distributed by UBS Securities Pte. Ltd or UBS AG, Singapore Branch. **Japan:** Distributed by UBS Securities Japan Ltd to institutional investors only. Where this report has been prepared by UBS Securities Japan Ltd, UBS Securities Japan Ltd is the author, publisher and distributor of the report. **Australia:** Distributed by UBS AG (Holder of Australian Financial Services License No. 231087) and UBS Securities Australia Ltd (Holder of Australian Financial Services License No. 231098) only to 'Wholesale' clients as defined by s761G of the Corporations Act 2001. **New Zealand:** Distributed by UBS New Zealand Ltd. An investment adviser and investment broker disclosure statement is available on request and free of charge by writing to PO Box 45, Auckland, NZ. **Dubai:** The research prepared and distributed by UBS AG Dubai Branch, is intended for Professional Clients only and is not for further distribution within the United Arab Emirates.

The disclosures contained in research reports produced by UBS Limited shall be governed by and construed in accordance with English law.

UBS specifically prohibits the redistribution of this material in whole or in part without the written permission of UBS and UBS accepts no liability whatsoever for the actions of third parties in this respect. © UBS 2010. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.

