

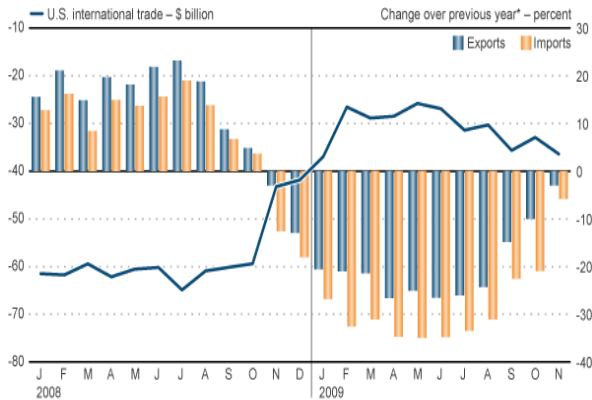
# INSIDE DEBT

PRODUCED BY REUTERS IN PARTNERSHIP WITH ICAP

Tuesday, January 12, 2010

## CHART OF THE DAY

### U.S. trade deficit



The U.S. trade deficit ballooned in November, as the price of imported oil jumped more than \$5 per barrel and revived consumer and manufacturer demand pushed imports to their highest in nearly a year.

## TODAY'S TOP NEWS

- U.S. Fed paid record \$46.1 bln to Treasury in 2009
- U.S. FDIC floats plan to tie bank pay to fee levels
- U.S. trade gap widens in November on import jump
- China surprises with bank reserve hike, markets hit
- U.S. 3-year notes auction met with firm demand
- Obama bank fee could exceed \$100 billion
- U.S. job hiring picks up in November
- Japan bank lending posts first fall in 4 years
- Canada returns to trade deficit, home prices up
- Recovery here after synchronized world recession

## ECON WATCH

FOR WEDNESDAY JANUARY 13

ET	Indicators	Unit	Reuters	Prior
02:45	FR HICP final mm	%	0.2	0.2
02:45	FR HICP final yy	%	0.9	0.5
03:00	DE Annual GDP 2009	%	-4.8	1.3
04:00	IT Industrial output mm SA	%	0.5	0.5
04:00	IT Industrial output yy WDA	%	-9.5	-11.8
04:30	GB Industrial output mm	%	0.3	0.0
04:30	GB Industrial output yy	%	-6.1	-8.4
04:30	GB Manuf output mm	%	0.3	0.0
04:30	GB Manufacturing output yy	%	-5.1	-7.8
14:00	US Federal budget, \$	bln	-92.0	-51.75
14:00	US Fed beige book	-	-	-
18:50	JP Corp goods price m/m	%	0.0	0.1
18:50	JP Corp goods price y/y	%	-3.9	-4.9
18:50	JP Machinery orders	%	0.2	-4.5

## MARKETS TODAY

**TODAY'S TOP STORY:** The Fed paid a record \$46.1 billion to the U.S. Treasury last year as aggressive bond purchases and lending to fight the financial crisis swelled its net income by 46.8 percent.

**For more please click here**

**TREASURIES:** The U.S. Treasury debt market rallied as a Wall Street sell-off revived a safety bid for government debt, allaying some concerns over appetite at this week's government bond auctions.

- 10-yr Treasury prices rose 26/32 to yield 3.72 pct from 3.82 pct.
- 30-yr bonds jumped 51/32, yielding 4.63 pct down from 4.73 pct.
- The gap between two-year and 10-year notes shrank to 281 bps from the record 288 bps on Monday.

**FOREX:** Commodity currencies fell after China said it would tighten banks' reserve requirements, raising concerns that Chinese demand could fall and slow global economic recovery.

- Australian dollar traded 0.99 pct lower at \$0.9203. It touched a two-month high on Monday.
- The New Zealand dollar was last down 0.44 pct at US\$0.7386, while the U.S. dollar rose 0.57 pct against the Canadian dollar to C\$1.0392.
- The euro shed 0.15 pct to \$1.4492. Earlier, it hit the day's low around \$1.4454. Dollar fell 1.23 pct at 91.0 yen.

**CORPORATES:** U.S. corporate bond spreads widened tracking weakness in equities on corporate earnings.

- The CDX.IG-13 index widened by 2 bps to 78 bps.
- The NASDAQ OMX Group Inc launched \$1 bln of senior unsecured notes in a two-part deal.
- Spreads on Alcoa's 6.75 pct bonds due in 2018 widened 25 bps to 250 bps over comparable Treasuries.

**STOCKS:** U.S. stocks slid in a broad selloff as investors pummeled financials on concerns about a potential government levy on banks, while Alcoa Inc's disappointing results stoked unease about the economic recovery.

- Dow fell 0.35 pct to 10,626.81, S&P shed 0.94 pct to 1,136.21 and Nasdaq was down 1.30 pct to 2,282.31.
- BofA was down 3.37 pct to \$16.36, Citigroup dropped 3.03 pct to \$3.52 and JPMorgan fell 2.34 pct to \$43.49.
- Alcoa Inc fell 11.06 pct to \$15.52, their biggest one-day percentage slide since March.
- Shares in KB Home fell 4.03 pct to \$15.72. The Dow Jones home construction index fell 0.83 pct.
- KBW Bank index fell 1.70 pct.

**C & E:** Oil fell by more than \$2 a barrel from 15-month highs after China raised bank reserve requirements to keep the economy from growing too fast, and as cold weather that was supporting U.S. fuel demand began to subside.

- U.S. crude prices fell 2.42 pct to \$80.52 per barrel.
- Gold shed 2.0 pct to \$1,128.05 an ounce.
- Reuters-Jefferies index was down 1.68 pct to 284.52.

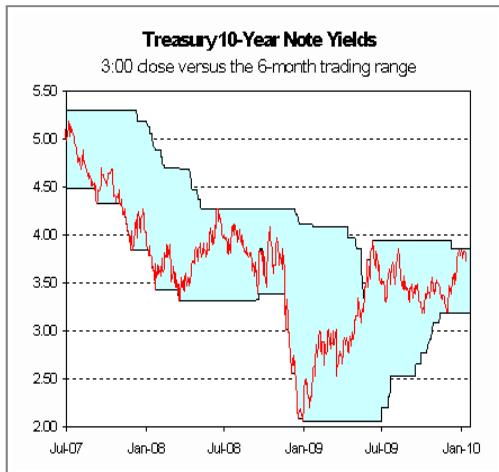
• For MARKET SNAPSHOT click here

• For NEXT UP click here

• For DEEP DIVE click here



MARKET SNAPSHOT as of 3:00 pm EST



**TREASURIES <5> <500>**

	BID	ASK	YIELD	CHANGE
1-Mo Bill	0.015	-0.015	0.015	0.001
3-Mo Bill	0.050	0.040	0.051	0.017
6-Mo Bill	0.135	0.130	0.137	0.005
1-Year	0.298	0.288	0.302	-0.007
2-Year	100.156	100.188	0.920	0.055
3-Year	99.055	99.086	1.457	0.156
5-Year	100.625	100.672	2.491	0.336
7-Year	100.188	100.234	3.220	0.586
10-Year	97.141	97.203	3.724	0.797
30-Year	95.938	96.000	4.627	1.609

**EQUITIES**

	INDEX	CHANGE
DJIA	10615.17	-48.82
NASDAQ	2281.99	-30.47
S&P 500	1135.63	-11.35

**OIL**

	PRICE	CHANGE
NYMEX	80.9	-0.9
BRENT	80.1	-0.9

**EURODOLLAR FUTURES**

	CLOSE	CHANGE
Jan-10	99.750	0.003
Mar-10	99.705	-0.005
Jun-10	99.545	0.015
Sep-10	99.250	0.030

**FUTURES**

	PRICE	CHANGE
CBOT 5 yr	115.34	0.30
CBOT 10 yr	116.63	0.59
CBOT 30 yr	116.47	1.28

**CURRENCIES**

	BID	ASK
Euro	1.4492	1.4494
Sterling	1.6172	1.6176
JP Yen	90.96	90.98
Swiss Franc	1.0180	1.0182
Can Dollar	1.0383	1.0388
Mexico	12.7703	12.7794

**FED FUNDS**

	NYFR <sup>SM</sup> - 10AM
Open	0.1100 1m 0.2189
High	0.1200 3m 0.2544
Low	0.0700

**REPURCHASE AGREEMENTS**

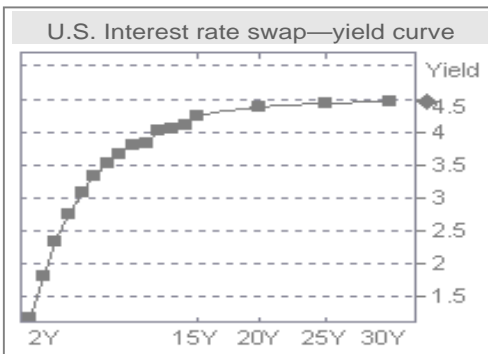
G/C	MORTGAGE REPOS
O/N	0.100 O/N 0.110
2-Week	0.140 2-Week 0.150
1-Month	0.140 1-Month 0.190
3-Month	0.180 3-Month 0.210
AGENCY REPOS	
O/N	0.110 10:00 AM 0.040
2-Week	0.150 3:00 PM 0.043
1-Month	0.150
3-Month	0.190

**IR SWAPS <19901>**

	SPREAD		RATE	
2-Year	25.00	29.00	1.16	1.19
3-Year	35.50	39.50	1.80	1.81
5-Year	26.75	30.75	2.75	2.76
7-Year	11.25	15.25	3.33	3.32
10-Year	8.00	12.00	3.80	3.78
30-Year	-16.25	-12.25	4.46	4.44

**EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)**

	BID	ASK	BID	ASK
O/N	0.110	0.130	-	-
1-Month	0.220	0.300	0.122	0.132
3-Month	0.240	0.450	0.136	0.146
6-Month	0.300	0.650	0.171	0.181
12-Month	0.850	1.250	0.348	0.358



**ACTIVE FANNIE MAE AGENCIES**

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	0.875	12/01/2012	13.5	13	1.05
3-Year	1.75	10/08/2012	4	3.5	1.5
5-Year	2.875	09/02/2015	30	29	2.8
7-Year	5.125	18/10/2016	18	15	3.4
10-Year	-	-	-	-	-
30-Year	6.625	15/11/2030	0	31	-

**ACTIVE FREDDIE MAC AGENCIES**

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	15/12/2011	9.5	8	1.01
3-Year	1.375	09/01/2013	26.5	25.5	1.72
5-Year	2.625	20/11/2014	21	19.5	2.71
7-Year	5.25	15/09/2016	14.5	13.75	3.37
10-Year	3.75	27/03/2019	18	0	3.95
30-Year	6.25	15/07/2032	30.25	29.75	4.93

**Active MBS 15YR**

	CPN	BID	ASK	YIELD
FNMA	5.0	105.1200	105.1400	2.657
FHLMC	5.0	105.1200	105.1400	2.657

**Active MBS 30YR**

	CPN	BID	ASK	YIELD
FNMA	5.5	105.0400	105.0600	3.137
FHLMC	5.5	105.0800	105.1000	3.033
GNMA	5.5	105.1400	105.1600	3.645

**Wrightson ICAP<sup>SM</sup> Chart of the Day**



## TODAY'S TOP NEWS

**U.S. Fed paid record \$46.1 bln to Treasury in 2009**

The Fed paid a record \$46.1 billion to the U.S. Treasury last year as aggressive bond purchases and lending to fight the financial crisis swelled its net income by 46.8 percent.

The Fed's payment represents an increase of \$14.4 billion over its 2008 contribution and was the largest since the U.S. central bank was launched in 1914. Its 2009 net income of \$52.1 billion also was a record.

While the record profits may aid the Fed's case and could ease some pressure on U.S. budget deficits, the central bank still holds billions of dollars' worth of risky assets from bailouts and needs to start unwinding its balance sheet that has risen to more than \$2 trillion as recovery gains steam.

From its total 2009 net income, the Fed paid dividends to member banks of \$1.4 billion and kept \$4.6 billion of earnings as paid-in capital.

The Fed also earned a net \$5.5 billion from limited liability companies created in response to the financial crisis to make loans and take over assets from financial rescues of big institutions such as Bear Stearns and insurer AIG.

**U.S. trade gap widens in November on import jump**

The U.S. trade deficit ballooned in November, as the price of imported oil jumped more than \$5 per barrel and revived consumer and manufacturer demand pushed imports to their highest in nearly a year.

The gap grew 9.7 percent to \$36.4 billion, the biggest deficit since January 2009, as trade continued bouncing back from a sharp fall caused by the global financial crisis, a Commerce Department report showed.

U.S. imports of goods and services jumped 2.6 percent to \$174.6 billion, the highest since December 2008.

The average price for a barrel of imported oil rose to \$72.54, the highest since October 2008, but volume was the lowest in more than 10 years. U.S. exports of goods and services rose by a less-robust 0.9 percent in November to \$138.2 billion, the highest in a year.

Separately, U.S. consumer confidence edged higher in January but remained below levels signaling optimism. IBD and TechnoMetrica Market Intelligence said their Economic Optimism Index climbed to 48.8 in January from 46.8 in December.

**U.S. 3-year notes auction met with firm demand**

The U.S. government sold \$40 billion worth of three-year Treasury notes with comparatively firm demand in the second sale of a total of \$84 billion of auctions this week.

Yields in the auction were near expectations, based on trade in the when-issued market just before the sale, indicating investors did not push to cheapen the market directly ahead of the sale.

Overall demand was strong, with investors submitting bids worth 2.98 times the amount on offer, above the average of 2.72 in the 12 auctions of three-year notes last year.

There was at least one sign of weakness however, with foreign and large institutional investors showing below-average appetite for the debt on offer, based on the indirect bidding category.

Indirect bidding accounted for about 38 percent of the sale, which was below the average of about 56 percent in the three-year auctions since June 2009, when the rules of who is considered an indirect bidder were changed.

The Treasury will sell \$21 billion of reopened 10-year notes on Wednesday and \$13 billion of reopened 30-year bonds on Thursday.

**U.S. FDIC floats plan to tie bank pay to fee levels**

U.S. banks whose compensation plans encourage excessive risk-taking would have to pay more for deposit insurance under a proposal floated by the Federal Deposit Insurance Corp.

The proposal is very preliminary and was contentious even among the members of the FDIC board, which is made up of regulators for different-sized financial firms. The board voted 3-2 to seek public comment on the proposal.

The plan would use the incentive of lower insurance premiums to reward pay structures that tie banker pay to long-term performance and include "clawback" provisions to recoup payments if they were based on performance results that do not hold up over time.

Banks with risky payment schemes, including huge cash components and incentives for short-term results, would have to pay more in insurance fees.

There was significant disagreement on the board about the proposal, and while the tone of the meeting was cordial, there was clearly tension about the merits of the FDIC plan.

**China surprises with bank reserve hike, markets hit**

China took its strongest step towards tightening monetary policy on Tuesday as the world's third-largest economy roars ahead, surprising investors with an increase in banks' required reserves that rocked global financial markets.

The sudden move by the PBOC to boost required reserves came earlier than investors had expected and appeared prompted by concerns that a renewed surge in bank lending was flooding the economy with too much cash, risking overheating and a surge in inflation.

The PBOC said it will increase commercial lenders' RRR by 50 basis points as of Jan 18, making China one of the largest economies to start rolling back the emergency policies used to combat the crisis fallout.

Separately, an investment strategist at China's \$300 billion wealth fund said the world's third-largest economy now had say in the exchange rate of the U.S. dollar, which it expects to rise while the yen should fall further.

The comments by Peng Junming, who works in the asset allocation and strategic research department at China Investment Corp, triggered a rally in the dollar.

**Obama bank fee could exceed \$100 billion**

A fee being considered for banks could raise more than \$100 billion if the Obama administration seeks to recoup the current estimate of financial bailout costs, but exact figures are preliminary.

A financial industry source in Washington told Reuters that many options on how to structure such a fee are being discussed, including basing it on the amount of a financial firm's liabilities.

The source, speaking anonymously because the fee has not officially been proposed, said officials are also discussing exempting automakers and insurer AIG from the fee, even though they are expected to represent a larger proportion of bailout losses. The fee could be included in Obama's budget proposal for fiscal 2011 to help recover some of the taxpayer money used to bail out banks during the financial crisis, a senior administration official.

Talks about the details of such a proposal are fluid. They come as President Barack Obama attempts to take a hard stance against the huge bonuses that many financial firms are poised to pay out so soon after the financial crisis.



## TODAY'S TOP NEWS

**U.S. job hiring picks up in November**

More U.S. business hired people in November, but workers had limited choices as the number of jobs open fell despite an economy inching forward, government data showed.

The rate of hires, measured as a percentage of the total number of people employed, rose to 3.2 percent in November, up from 3.1 percent in October and matching the same pace in July, the U.S. Labor Department said in its monthly JOLTS.

While the rate of jobs opening in November, a measure of demand for labor, ticked lower to 1.8 percent from 1.9 percent the previous month, the pace has been steady at either 1.8 percent or 1.9 percent since March 2009, the department said.

Employees left their jobs in November at a slightly faster pace than in October despite a drop in available positions.

The so-called quits rate rose to 1.5 percent from 1.4 percent in October and to its highest since a matching 1.5 percent in January, 2009. The slight rise in the quits rate comes against a backdrop of a still weak, but improving, labor market.

**Japan bank lending posts first fall in 4 years**

The balance of Japanese bank lending fell from a year earlier in December for the first time in four years as companies remained sceptical about the economic outlook and wary of borrowing to expand their business.

The BOJ introduced a new funding operation last month to help bring down interest rates, but the cash may not spread through the economy if corporate fund demand remains weak.

At the end of December, lending was down 1.0 percent compared with the same time a year earlier. It was the first such fall since January 2006, when it fell 0.01 percent, BOJ data showed. Although few economists expect another recession in the near term, Japan's growth, driven largely by exports, is unlikely to pick up much due to weakness in domestic consumption.

Separately, Japanese Finance Minister Naoto Kan agreed with U.S. Treasury Secretary Timothy Geithner that currency market stability was desirable in his first phone talks with his U.S. counterpart since assuming the post last week, a government source said.

**Canada returns to trade deficit, home prices up**

Canada slipped back into trade deficit in November due to mediocre export growth, while a surge in imports and an extended climb in new home prices attested to the strength of domestic demand.

The surprise trade deficit totaled C\$344 million (\$331 million) as exports grew 1.1 percent from the previous month and imports jumped 3.9 percent, Statistics Canada said. Markets had expected a C\$600 million surplus.

Separately, Statscan said new home prices rose for a fifth straight month in November, up 0.4 percent versus expectations of a 0.3 percent gain, providing fresh evidence that the housing market is leading Canada's recovery.

Exporters themselves are optimistic sales will improve, according to a semi-annual poll done by EDC. EDC's trade confidence index revealed an 8.9-point jump in confidence about future sales in autumn 2009 from spring 2009, the largest rebound in the post-9/11 period.

**Recovery here after synchronized world recession-S&P**

The United States economy has hit bottom and world economies are in a state of recovery after "the biggest synchronized recession in world history," S&P's Chief Economist David Wyss said.

Except for Japan, every major market bottomed out in March, he said, with most stock markets posting 40 percent gains or more.

In the wake of the collapse of Lehman Brothers and government rescue of AIG in September 2008, world economies underwent "the biggest synchronized recession in world history," Wyss said. "We all just took a dive together. We went into it together, we're coming out of it together." Wyss noted that past recoveries had been fueled by "the American consumer's ability to live beyond his means," but that mindset has changed, he said. Wyss also forecast that the U.S. economic recovery will be slow. "We're expecting a half-speed recovery," Wyss said. "But half a recovery is better than none."

## NEXT UP

**U.S. SEC review expected to stir market controversies**

Regulators are set to stir old controversies this week when they meet to release a paper on high-frequency trading and the broader U.S. equity markets, expected to review myriad changes over the last decade.

The U.S. SEC will vote Wednesday on whether to issue the concept release on everything from placing traders' computers next to exchange computers, known as co-location, to the value of anonymous venues known as dark pools.

The SEC said this month the paper would look at "the performance of equity market structure in recent years," and solicit public comment.

The regulator is also expected to ask whether changes are needed to the sweeping Regulation National Market System (Reg NMS), which in 2005 forced exchanges to route orders to the venue with the best price -- a move that connected U.S. markets like never before, and set them apart from other regions.

Traders, analysts, and exchanges said they expected no significant market structure changes, if any, until 2011. Few would comment on record due to the sensitivity over the paper.

**U.S. mortgage originations seen plummeting - MBA**

U.S. residential mortgage originations will plunge 40 percent this year to the lowest level in a decade as home refinancing demand sinks with rising mortgage rates, the industry's main trade group said.

Lenders will underwrite \$1.28 trillion in home loans this year, down from \$2.11 trillion in 2009, the MBA said in its annual forecast. That would be the lowest since \$1.14 trillion in 2000.

New purchase originations are expected to rise slightly to \$776 billion from \$742 billion in 2009. Refinance originations, however, are seen plunging to \$502 billion this year from \$1.372 trillion last year.

Thirty-year home loan rates averaged 5.09 percent in the week ended Jan. 7, down from 5.14 percent a week earlier and up marginally from 5.01 percent a year ago.

The mortgage bankers see 30-year fixed rates rising to 5.8 percent in 2010, 6.2 percent in 2011 and 6.5 percent in 2012.

The mortgage group said it expected the economy to grow 2.7 percent, from fourth quarter to fourth quarter, in 2010, compared to a 0.2 percent expected contraction in 2009.



## DEEP DIVE Commentary and Analysis

**COLUMN-Fed stuck doing the heavy lifting**

By Jim Saft

With employment weak and consumer credit weaker, look for extended official measures to support the U.S. economy.

Recent data show that despite emerging glimmers in manufacturing, de-stocking having reached its limit, and some strong showings globally, the U.S. recovery is far from self-sustaining.

With Congress serving as an effective roadblock to a comprehensively expanding fiscal stimulus, the heavy lifting, if any is to be done, may fall on monetary policy and "off balance sheet" forms of stimulus.

The Christmas eve move to suspend any cap, previously \$400 billion, on the bailouts of Fannie Mae and Freddie Mac is an example of the latter, while more mortgage buying and virtually zero interest rates from the Federal Reserve are probably in store.

"Markets are still thinking of monetary policy strictly as changes in interest rates -- even though the Fed has been conducting successful policy this past year through quantitative easing," St Louis Fed President James Bullard said in Shanghai Monday. "Markets should be focusing on quantitative monetary policy rather than interest-rate policy."

The big question is "how to adjust the asset purchase program without generating inflation and still providing support to the economy while interest rates are near zero," Bullard said. "Interest rates may remain low for quite some time."

A recent run of very poor economic data nicely illustrates the fact that, despite having underwritten the banking system and made progress on reflating asset markets, there really is no simple, elegant, low-cost solution to a balance-sheet recession.

The U.S. economy lost 85,000 jobs in December, leaving just 58.2 percent of the population employed, a figure not seen since the early 1980s. In terms of employment lost since the peak, this recession has been more savage than any in the post- World War II period, and shows signs of being painfully slow to heal. When the annual revisions to the employment data are released next month they may well show a net loss of jobs across not just the year but the entire decade.

There were some brighter spots in the jobs report; employers are using more temporary help, often a first step to adding permanent jobs.

**LESS CONSUMER CREDIT**

Similarly sobering was data on U.S. consumer credit, which fell for a record 10th straight month in November by \$17.5 billion, meaning it is contracting at an annual 8.5 percent annual rate.

Credit card debt fell for a record 14th straight month. The contraction is almost certainly the result both of banks being unwilling to lend and consumers unwilling and unqualified to borrow.

In the end the result is the same; for consumer spending to grow at a reasonable pace incomes and employment are going to have to grow to fund it. That does not seem likely.

The financial markets were quick to draw the conclusion that the Fed is a bit trapped in its current policy mix. Futures contracts are now pricing in only a 20 percent chance that the Fed lifts rates to 0.5 percent by June, down from about a third last week and 78 percent at the end of December.

Of more interest possibly is what the Fed does about mortgages. By the end of March, when its program of buying is complete, it will have bought \$1.25 trillion of them, keeping a lid on rates and supporting the housing market, and through it the banking system.

Boston Fed chief Eric Rosengren said recently that he sees rates rising by as much as 75 basis points in coming months as the effect of official buying ebbs. That timing could be very diffi-

cult for housing, which is benefiting through April from a tax credit for house buyers, but of course the program may not end just yet.

Consumer credit and employment are not indicating a real recovery, nor is there fuel for inflation. It is true too that the effects of government stimulus will recede from the middle of this year, which is likely to further box the Fed into an easy policy mix, and very likely into buying more mortgages. The fight over a further stimulus package would be bloody and the political costs perhaps too high.

The stock market concluded that the prospect of more easy policy is good news for it, and perhaps it is right, though the logic holds up better perhaps for emerging markets than for the United States.

(At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund.)

**FED FOCUS-Fed turning to new tool to pilot rates**

By Mark Felsenthal

The U.S. Federal Reserve looks set to end its reliance on the federal funds rate, long its primary monetary policy tool, when the time comes to tap the brakes as the economy recovers.

Set to take its place is the interest rate the Fed pays on excess bank reserves, a tool the central bank has more control over, particularly in the current financial environment.

With the financial system awash in cash, the central bank could find it more difficult than usual to control the federal funds rate. That puts interest on excess reserves -- a tool it can influence directly -- front and center.

"In a situation where the Fed does not or cannot or is unwilling to bring down the level of excess reserves, the Fed will not be able to target the fed funds rate directly with monetary policy," said Carnegie Mellon University professor Marvin Goodfriend, a former Richmond Federal Reserve Bank economist.

"Most likely the Fed will look to the interest paid on excess reserves as the indicator of the stance of interest rate policy," he said.

The Fed has pumped more than \$1 trillion into the economy since mid-2007, more than satisfying the banking system's appetite for reserves.

Banks hold reserves in excess of requirements on deposit with the Fed, with another bank or in their own possession.

Because of this, trading has fallen off in the federal funds market, where supply is now dominated by mortgage enterprises Fannie Mae and Freddie Mac, who unlike banks, can not earn interest on balances at the Fed.

If the Fed continued to focus on the federal funds rate, it could have a hard time hitting its target because Fannie Mae and Freddie Mac would continue to accept lower rates on their excess. While the Fed is currently paying 0.25 percent interest on excess reserves, the federal funds have been trading around 0.10 percent.

In addition, the thinning of the market and the fact that the market fails to capture some bank-to-bank lending undercuts the federal funds rate use as a borrowing cost benchmark.

In normal times, the federal funds rate would more fully capture firms' costs of overnight borrowing, making it a good foundation from which to calibrate other interest rates.

"Now, in an environment of interest on reserves, where very few transactions are being conducted in the fed funds market, it becomes questionable whether that is still the case," said Michael Feroli, a former Fed economist now with JPMorgan Chase in New York.



## DEEP DIVE Commentary and Analysis

These factors have conspired to make the federal funds rate less of a good indicator of financial conditions in the eyes of Fed officials, who are likely to abandon it, at least temporarily, in favor of tools it can influence more directly.  
The new benchmark would be the interest on excess reserves --

or IOER.

When the central bank begins to exit from its extraordinary monetary easing, expect the statements following its policy meetings to refer to the IOER rate, possibly alongside reserve-draining actions, or targets for reserves.

INSIDE DEBT is produced by Reuters in partnership with ICAP.

(Compiled by Anil Kumar and Pronita Naidu in Bangalore)

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