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THE FED IS IN A HOLDING PATTERN, AT LEAST FOR NOW

Last week the Fed decided not to change the 2% interest rate target it put in place in late April, signaling less concern about the economy's faltering and more concern about rising inflation risks. Below, we review:

- Background leading up to last week's decision;
- Reasons for less concern by the Fed about the economy's slowing further;
- Why the risk of inflation's moving higher got more attention; and
- What the Fed might do over the remainder of 2008.

Let's first look at some background leading up to last week's decision. During the middle of last year, the United States economy was enjoying significant above-trend growth. However, at the very time the economy appeared good, even robust, the seeds of a significant future slowdown were being sown in financial markets.



By late summer, those early, fairly mild tremors arising from that debacle developed into full-scale tremblers, rocking markets and financial institutions around the globe. Financial markets seized up as investors (particularly large financial institutions) were unwilling to realize investment losses and take write-offs against their capital positions. Seeing how quickly this growing distress was infecting financial markets and economies globally, the Fed took actions to try to limit the contagion and mitigate the growing down-side risks. In coordination with other central banks, the Fed first took action to inject sizable amounts of liquidity into the financial markets in an attempt unfreeze the then-frozen markets.

Despite the Fed's actions, the viability of a broad range of structured asset products, bonds or notes backed by loan paper or accounts receivable originated by banks, credit card companies or other providers of credit and often enhanced by credit default swaps or other vehicles, became much more tenuous. So, financial market participants were still very reluctant to buy or sell "distressed" financial instruments (such as CDOs) leaving trading in distressed structured asset products at a standstill. And, with financial markets weakening by the day, the global economy became increasingly ripe for a significant slowdown, even recession. This was quite a change in just a couple of months: from economic buoyancy to talk (not just whispers) of imminent recession!

Having witnessed few results from these massive liquidity injections, the Fed switched gears in September of last year, cutting short-term rates by 50 basis points right out of the box. Why the sudden change in monetary posture, especially after confirming in early August that the 5.25% target in place since mid-2006 was still appropriate? The answer revolves around the perceived steep down-side risks to the global system that could result from a meltdown of the structured asset markets. Through derivatives (particularly swap transactions) the global financial systems were intertwined to a greater extent than ever before, leaving multiple markets vulnerable to the financial stress of one market (such as the U.S. "sub-prime" mortgage market).

The Fed started an aggressive, front-loaded campaign to lower short-term interest rates in an attempt to accomplish

two goals: 1) provide stimulus to the economy as insurance against any adverse fall-out that might result from faltering financial markets; and 2) steepen the slope of the Treasury yield curve to increase net interest margins at banks and other financial institutions to help rebuild capital positions that would take massive hits from large write-offs of investments that had gone sour.

Over the remainder of 2007, the Fed continued to cut rates and make liquidity injections, all in an effort to keep the economy growing and prevent existing financial difficulties from becoming a much larger financial mess globally. In January of this year, when recession looked increasingly likely, the Fed became even more aggressive. In the course of just nine days (in two steps, including a rare inter-meeting move), the Fed lowered its target by a whopping 1.25 percentage points (125 basis points)—a move unseen in decades. By the end of January, the Fed's target reached 3%—a stunning 225 basis points below what it was just four and a half months earlier.

But, the Fed didn't stop there and again lowered interest rates in both March and April 2008, taking even more insurance against financial and economic calamity. Furthermore, it stepped up its efforts to make liquidity available to both financial institutions and markets. The most notable effort was the innovative financing scheme the Fed devised to facilitate the acquisition of liquidity-strapped Bear Stearns by JPMorgan in March (with the deal closing at the end of May).

From mid-April, the financial markets seemed calmer, and the economy started to look a bit better. An improvement in consumer spending was especially evident in May, although this probably reflected a transitory boost from the "tax rebate" stimulus which was then starting to be felt. Meanwhile, during much of the time when the Fed was aggressively lowering rates, the dollar was falling, and commodity (especially food and energy) prices were soaring. In May, the overall Consumer Price Index (CPI) rose 0.6% month-on-month and was up 4.2% over the preceding twelve months. Even the "core" CPI inflation, which excludes food and energy price movements, remained at a higher-than-desired 2.3% year-on-year rate in May with the risk that it could move considerably higher.

As a result of the financial markets' looking somewhat better and the economy appearing firmer, but with inflation still uncomfortably high, the Fed went on hold last week, ending (for now) the easing cycle initiated last September and maintaining the 2% Fed funds target rate established in April.

What's in store for the remainder of the year? The Fed will likely remain on hold for an extended period, taking time to evaluate how the huge monetary stimulus already in place is affecting the economy, financial markets, and inflation. However, the Fed could still ease its policy stance if the economy again appears to be veering towards recession or tighten if inflation becomes uncontained. Therefore, its policy stance going forward will depend heavily on how the economic data shapes up.

The major takeaways of the above discussion are:

- The Fed went on hold at last week's meeting, ending (at least for now) the easing cycle in place since last September and maintaining the 2% Fed funds rate target established at the end of April.
- A lower risk of the economy's weakening further and a greater focus on the risk of inflation's increasing contributed to the Fed's decision to go on hold.
- The Fed will likely remain on hold over much of rest of this year to monitor how the substantial monetary stimulus already in place affects economic growth and inflation. However, the Fed would still likely tighten if inflation gets out of control or ease if the economy veers toward recession.

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