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IN THE ARMS OF THE FED: PUSHING HARD TO HELP LIFT THE ECONOMY AND FINANCIAL MARKETS

Last Tuesday, the Fed (Federal Reserve Board) basically did little to deviate from the interest rate holding pattern that has been in place since April. In the following discussion, we will:

- Discuss briefly what happened at last Tuesday's Fed meeting;
- Focus on other actions the Fed has taken to support the economy and financial markets since the previous meeting on June 25; and
- Outline our expectations for the Fed's monetary stance over the remainder of the year and into 2009.



Let's first take a look at the results of last week's meeting. Specifically, the Fed maintained the 2% target on the Fed funds interest rate that has been in place since late April. Consistent with that posture, it continued to stress, as in June, that downside risks to the economy remained and that the risk of rising inflation was still a significant concern. This is not surprising given that overall inflation as measured by the Consumer Price Index (CPI) zoomed to 5% year-over-year in June and real Gross Domestic Product (GDP) growth came in at only a tepid 1.9% annualized rate in the second quarter of 2008, even with massive fiscal stimuli during the quarter. In short, the combination of fundamentally weak economic growth and an increased risk of higher inflation called for neither aggressive easing nor aggressive tightening by the Fed. Moreover, the Fed continued to expect a moderation in inflation this year and next, which is the presumed result of slower economic growth and commodity prices at least stabilizing.

Despite keeping its target interest rate constant, the Fed has recently been quite active in using other tools to bolster the economy and foster better financial market conditions. More precisely, they continue to inject sizable amounts of liquidity into the financial marketplace, using a variety of tools (some of which have been quite innovative) that include:

- Focusing on traditional discount-window operations for depository institutions,
- Creating and extending discount-window-like facilities to non-depository institutions, i.e., investment banks and innovative financing, to help distressed bank and non-bank institutions (such as its facilitation of JPMorgan Chase's acquisition of Bear Stearns), and
- Expanding the kinds of collateral that the Fed will accept when making loans.

As a result, the Fed has basically constructed another arm, besides its traditional one of targeting short-term interest rates, to help in the heavy lifting of implementing monetary policy. Having realized that it had already taken significant steps toward pushing the interest rate arm, the Fed is increasingly relying on its newly-created second arm of liquidity injections to drive the economy and financial markets toward greater stability and growth. And, one of the

nice things about this new arm is that it has the potential of placing liquidity precisely where the Fed thinks it's needed (such as at troubled financial institutions), unlike Fed interest rate movements which affect the economy and financial markets more systemically.

So, what can we expect from the Fed over the remainder of 2008 and into 2009? Basically, we expect more of the same: a Fed funds target interest rate held near 2% and continued liquidity injections to support economic activity and financial markets. This, however, is a baseline expectation — the Fed would likely deviate from it should economic weakness or inflation become more worrisome. Indeed, the Fed at its meeting Tuesday reiterated what it stated on June 25, namely, that it "...will act as needed to promote sustainable economic growth and price stability."

So, the major takeaways from the above discussion are:

- The results of the Fed meeting last Tuesday were very similar to those at the previous meeting on June 25 — with the main focus being the maintenance of its Fed funds target interest rate at 2% and a reiteration of its concerns about the risks of economic weakness and higher inflation. Indeed, with both of those concerns still prominent, it is totally appropriate for the Fed to remain on hold and take some time to assess how the aggressive interest rate ease already put in place (325 basis points since last September) affects the economy and inflation going forward.
- The Fed, now tapped out on using interest rate as a stimulus, has continued to rely more heavily on its newly created policy arm (or instrument) and liquidity injections through multiple channels to push the economy and financial markets towards greater stability and growth.
- Finally, we look for more of the same from the Fed in coming months: steady short-term interest rates and continued liquidity injections.

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