TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

FED SHADOW

Monetary Hall of Mirrors

Friday, October 11, 2002

David Gitlitz

If monetary policy is the easiest it's been in 40 years, why isn't the Fed adding liquidity?

Our supposition that **FOMC**-inspired speculation about a potential reduction in the fed funds rate, against the backdrop of an already limp recovery, actually risks fostering a tightening of **the Fed's** liquidity posture is being borne out even more strikingly than we might have expected. The most recent data released by the Fed late yesterday showed that for the week ended Wednesday, the Fed's injections of liquidity through tri-party repurchase agreements sank to new lows -- an average of just $7.4 billion per day, down from nearly $24 billion as recently as early September. In fact, the Fed's New York open market desk went four consecutive days -- from last Friday through Wednesday -- without executing a liquidity-adding operation, the longest such stretch in recent memory.

Welcome to the monetary hall of mirrors known as overnight rate targeting. While ostensibly maintaining the "easiest" policy stance in 40 years, the Fed today is providing less dollar liquidity to the financial system than it did while hiking the funds rate to 6.5% in the tightening exercise that ended nearly two-and-a-half years ago. During that time the U.S. economy was booming, so that even while supplying more liquidity than it is now, the Fed was keeping the currency scarcer relative to demand in accordance with its rate-targeting dictates. Now, what we see is that with borrowing activity already weak, the tilting of expectations toward lower rates means businesses have even more incentive to delay marginal borrowing decisions. That also tends to reduce reserve demand which, feeding through the fed funds market, pulls the overnight rate lower. With no need to "defend" the target against upside pressures, the open market desk adds less liquidity, or might be compelled to actually drain reserves, in order to maintain the overnight rate. On a five-day moving average, even with the Fed remaining out of the market on four of the past five days, the fed funds closing rate is running at 1.70%, five basis points below the current 1.75% target.

All this might scarcely rate mention were the signals being transmitted through the rate-targeting apparatus consistent with broader indications in the market for dollar liquidity. Were the funds rate's softness an indication of softening real dollar demand, the desk's stingy stance would be entirely justified. In the current environment, however, the Fed's posture serves to underscore the stark disconnect between its archaic operating procedures and those factors which most heavily influence supply and demand for the unit of account. Through the Fed's narrow-angle operational lens, funds are trading weak and therefore liquidity is ample. In the real world, though, risk aversion is putting a premium on liquid, risk-less, dollar balances. Over the two months, Money of Zero Maturity (MZM), the Fed's broadest measure of demand for immediately available funds, has grown at an annual rate of better than 7.5%. Meanwhile, the monetary base -- which is essentially the liability side of the Fed's balance sheet -- has grown at only half that rate. For our purposes, though, the most telling indication that the Fed is flirting again with a deflationary shortfall of dollar liquidity is recent movement of the gold price, which has fallen by $10 per ounce -- closing today at $316 -- since the last FOMC meeting on September 24. TM

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com

325M Sharon Park Drive #325
Menlo Park CA 94025
Phone 650 429 2112
Fax 650 429 2112

42 Forest Drive
Parsippany NJ 07054
Phone 973 335 5079
Fax 973 402 5074