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TRENDMACRO LIVE!

On TAF and Jobs

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Donald Luskin

Update to strategic view

FED FUNDS: This morning's announcement of an increase in the TAF program was a smart approach to credit market stresses, and a gesture of courage from the Fed, in the face of rumors of an intermeeting funds rate cut. But after a soft jobs report, a 75 bp cut at the March 18 FOMC meeting is a given.

[see Investment Strategy Dashboard]

For a market abuzz with rumors that the Fed would make an intermeeting cut in the funds rate this morning, the announcement that it would instead expand its Term Auction Facility was a disappointment. Especially coming as it did minutes before a jobs report showing further deterioration in the labor market, the Fed's decision could sensibly be interpreted as reticence to cut the funds rate as aggressively as the market expects, perhaps motivated by increasing evidence of inflation risks from commodity and forex markets.

Disappointment aside, the expansion of TAF is, in our view, the correct thing for the Fed to do in response to the worsening seizing-up in credit markets, and will probably help materially. In fact, with the benefit of hindsight, it's what the Fed should have done at the onset of the crisis last August, rather than lowering the discount rate. Then the Fed's approach was guided by the "Bernanke doctrine," borrowed from 19th century economist Walter Bagehot, that a central bank should respond to banking crises with discount lending at a penalty rate, while using the funds rate as an instrument for macroeconomic finetuning. As Bernanke has since admitted, the stigma of the discount window and its penalty rate inhibited banks from using it last summer, so the crisis worsened and the Fed soon responded by cutting the funds rate, against the advice of the "Bernanke doctrine." If only the Fed has used TAF from the beginning of the credit crisis -- as it successfully did with its similar Standby Financing Facility auctions in late 1999 to ease year-end funding pressures associated with the coming Y2K rollover -- more liquidity would have been injected into the banking system earlier, fewer cuts in the funds rate would have been necessary (indeed, perhaps none), inflation pressures would not be mounting as they are, and the Fed would have lost less credibility than it has by so obviously letting its policies be set by market expectations.

The Fed did the right thing this morning, and showed some courage -- responding to the stresses in credit markets without caving in to rumors of an emergency rate cut. But we doubt that will translate into any extreme boldness at the upcoming March 18 FOMC meeting. Before the TAF announcement this morning, futures markets were fully priced for a 100 bp cut at that meeting. Now, in light of the TAF announcement, and despite the jobs report, expectations have retreated from that extreme level, but are still more than fully priced for a 75 bp cut. With the meeting now less than two weeks away, we have to regard a 75 bp cut as a given.

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