Trend Macrolytics, LLC
Donald Luskin,
Chief Investment Officer
Thomas Demas,
Managing Director

TRENDMACRO LIVE!

On the Fed's Discount Rate Hike

Thursday, February 18, 2010
Donald Luskin

Why couldn't renormalizing the discount rate wait until the next FOMC meeting?

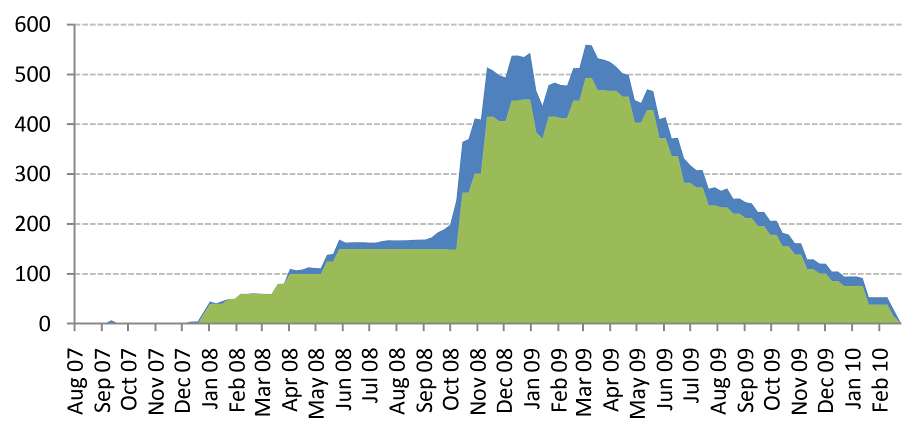
The Fed's move to increase the discount rate from 50 bp to 75 bp, and to make a similar hike in the minimum bid in TAF auctions, shouldn't be seen as a move toward tightening monetary policy. Indeed the Fed was explicit about that in its announcement after the close today, reiterating its pledge of "exceptionally low levels of the federal funds rate for an extended period." In a speech shortly after the announcement, Fed governor Elizabeth Duke said the hikes "do not signal any change in the outlook for monetary policy." They should be seen not as rate hikes at all, but as a widening -- and only a small, incremental one -- of the spread between the funds rate at which healthy banks *can* borrow, and the discount rate at which unhealthy banks *must* borrow. Like the closing of various other emergency credit facilities already announced or completed, this represents only a continued move toward normalization of the Fed's role as lender of last resort as the credit crisis of 2007-2009 recedes in memory. From a combined high of $559 billion in March 2009 at the worst of the crisis, today there are only $14 billion in discount window loans and $15 billion in TAF loans outstanding (please see the chart below).

Update to strategic view

FED FUNDS: The announcement Thursday of a hike in the discount rate is disturbingly bizarre in its timing. But we don't see it as a foreshock of coming funds rate hikes. The mired labor market and quiescent reported inflation still combine to keep the Fed on hold indefinitely.

[Strategy Dashboard home]

Credit outstanding: — discount window and — Term Auction Facility
USD billions



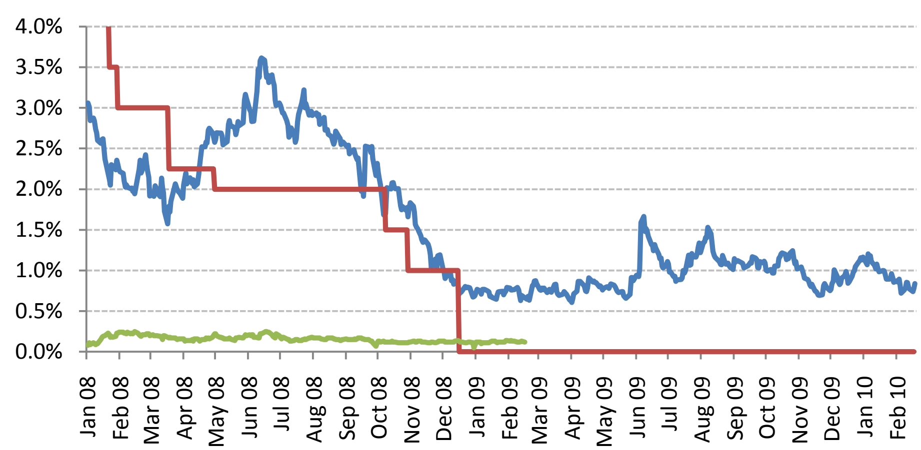
Source: Federal Reserve

In the credit crisis, a surprise *lowering* of the discount rate was the Fed's very first move, announced on August 17, 2007. At that time there was no corresponding cut in the funds rate, and indeed that was the whole point. Under what became known as the "Bernanke doctrine," the discount rate was to be used in response to banking crises, while the funds rate was for macro-economic fine-tuning. As the Fed's August discount rate move failed to stem the crisis and it became clear that the overall economy was at risk, the funds rate was lowered at the next FOMC meeting just one month later. But we don't see it playing out in reverse now, with today's announcement necessarily a foreshock of funds rate hikes soon to come. One indicator of this was the reaction of the fed funds futures markets, where implied expectations for the rate one year ahead increased only a couple of bp following the news (please see the chart below).

But other liquidity-sensitive markets weren't so casual about it. The dollar rallied and gold fell, both sharply. Why? Perhaps because markets are left wondering what was so urgent about it that it couldn't wait for implementation until the next scheduled FOMC meeting less than a month away. But it wasn't entirely a bolt from the blue. It was mentioned as a discussion point in the minutes of the January FOMC meeting released Tuesday. And in Ben Bernanke's House Financial Services Committee testimony on the Fed's exit strategy last week he said, "before long, we expect to consider a modest increase in the spread between the discount rate and the target federal funds rate." But still, what's the rush? It's easy to see why the August 2007 discount rate *cut* was implemented inter-meeting -- that really was an emergency. But why treat a *hike* the same way?

One possibility is that the emergency *this* time is institutional, not economic. If one were inclined toward conspiracy theories, one could imagine the move was forced by the presidents of the regional Feds who, by and large, are more hawkish than Bernanke and the Board of Governors. As a matter of formal procedure, changes in the discount rate

Fed funds rate: — year-ahead futures-implied, — ex-post effective and — ex-ante target



Source: Federal Reserve, Chicago Board of Trade, TrendMacro calculations

Contact TrendMacro

On the web at
www.trendmacro.com

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

[About us]

are *always* recorded as being in response to requests from the regions. Today's announcement noted that all 12 filed such requests. By contrast, the August 2007 cut was requested by only two, New York and San Francisco. Does this really mean that all 12 regional presidents got together *en bloc* and forced this on Bernanke? We think that's unlikely. If it were the case, we'd be reading an announcement of Ben Bernanke's resignation, not a hike in the discount rate. No, the simpler explanation, which is usually the right one, is that there was *no* palace rebellion that precipitated this move. The unanimity of the regional Feds was more likely an attempt, which arguably may have backfired a bit, to show that this was an unremarkable and uncontroversial move embraced by the entire institution. It's typical for uncontroversial discount rate moves to be recorded as having been requested by most if not all of the regionals.

We'll see. But for now, we remain convinced that the continued agonies of the labor market give the Fed strong incentive to keep the funds rate at or near zero indefinitely. While the economic projections in Wednesday's minutes of the January FOMC meeting showed members slightly upgrading their growth forecasts, the central tendency of their unemployment rate forecasts slightly worsened. Their forecasts for core inflation upticked slightly, but the upper end of the central tendency is still well below a level that would be considered alarming. Without the threat of inflation acting as a side-constraint, the Fed has little reason *not* to pamper the labor market in an election year with the continuation of the "extended period" of a near-zero funds rate.

Bottom line

The announcement Thursday of a hike in the discount rate is disturbingly bizarre in its timing. But we don't see it as a foreshock of coming funds rate hikes. The mired labor market and quiescent reported inflation still combine to keep the Fed on hold indefinitely.