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Commentary

Market Opinions and Topics of Interest

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Why The Fed Might Be Changing The Way It Conducts Monetary Policy

Change is often something not thought out. Circumstances force it upon you. So what often starts out as temporary has a way of becoming permanent.

When it comes to the form of conducting monetary policy, change is the only constant. History shows us that every 10 to 15 years the Fed changes the way it operates. In the 1970s, it targeted reserve requirements. In the 1980s, it focused on money supply. Only since 1994 has it been officially setting the federal funds "target" rate. The target rate literally did not exist before 1994 (all measures of the target rate before 1994 are reverse engineered). So, if nothing else, the calendar suggests time for a change may be near.

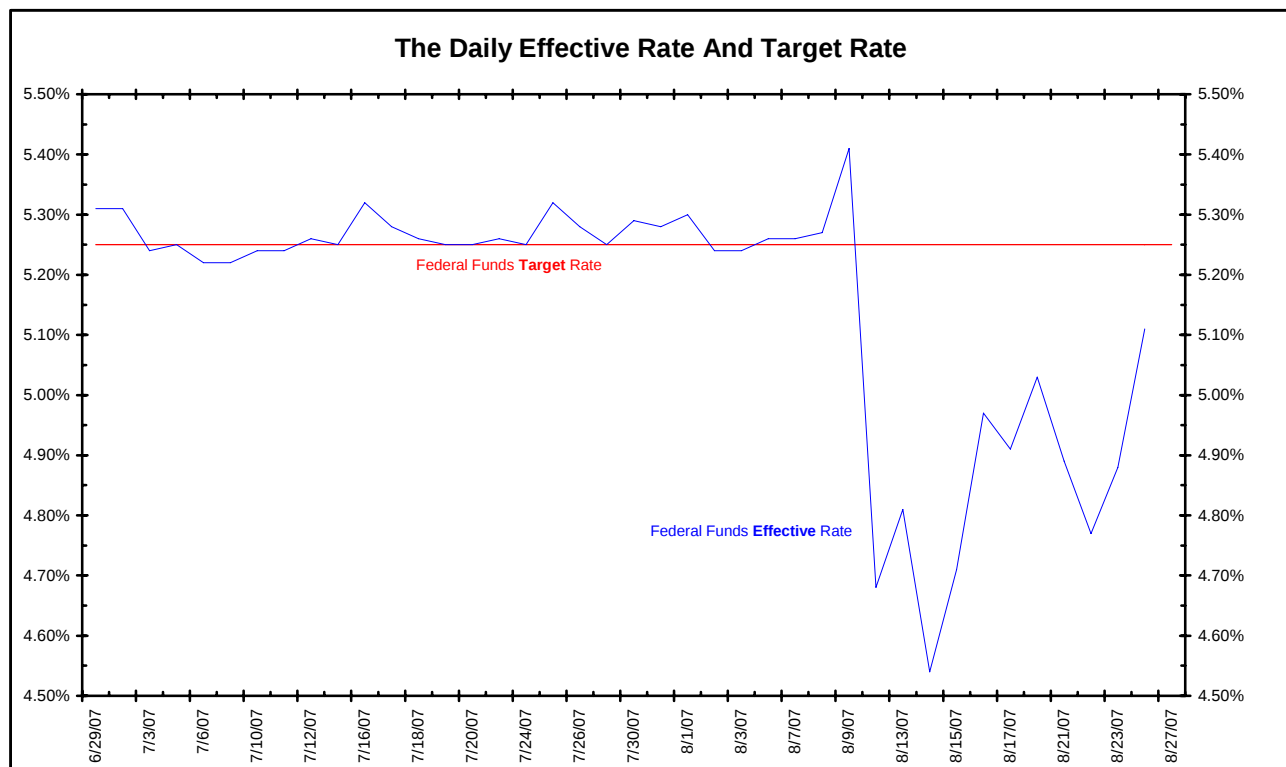
Target vs. Effective

As we detailed on [August 13](#), the effective rate is different from the target rate"

[E]ach day banks buy or sell overnight loans in the federal funds market. Transaction data is compiled by the Federal Reserve and each day it publishes an "effective rate" for that day's activity.

Normally it is not worth mentioning the distinction between these two rates as their difference is often less than 0.02%.

Now, however, they are not the same thing. As the next chart shows, the Fed has **not** been holding the effective rate on the target rate in recent weeks. The effective rate has averaged less than 5% since August 10. **So, did the Fed ease on August 10?**



We believe this to be the case, and the discount rate cut on August 17 was a confirmation that the Fed did indeed cut rates the week before.

How unusual is this divergence between the target and effective federal funds rates?

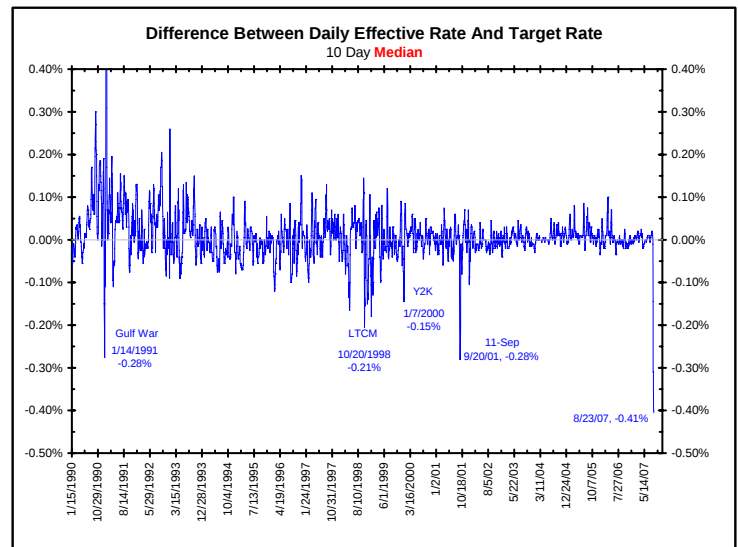
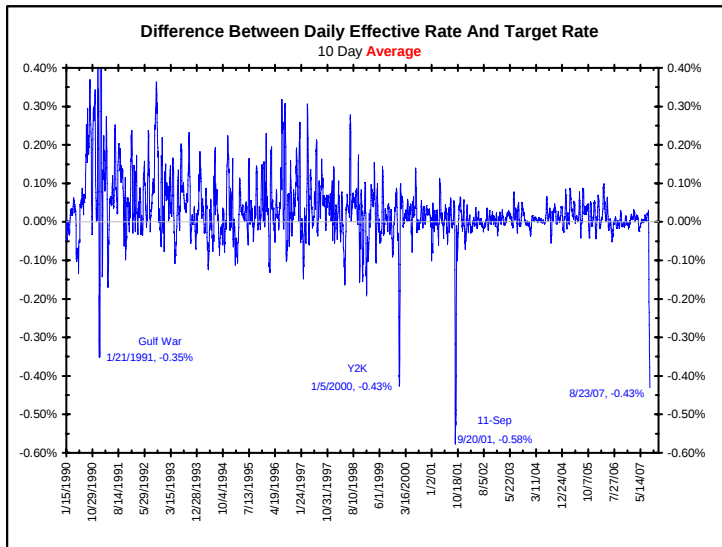
Both charts below plot the difference between the target rate and the effective rate. The chart to the left is the 10-day **average** while the chart to the right is the 10-day **median**.

The median difference is more interesting to us. Median data measures the middle value of a range,

so it better measures the consistency of a divergence.

The median chart shows the largest divergence between the target rate and the effective rate ever. While the 10-day average still shows large divergences (Sept-11 and Y2K), this is due to a few days of massively large divergences. 10 days after those events, the divergence was already correcting. This time, however, is different.

So, the chart below tells us the effective federal funds rate has broken from the target rate to a degree and consistency never seen before.



Until this divergence corrects, the target rate is a meaningless measure. It has become equivalent to the “prime rate” which is supposed to be the interest rate banks extend to their best credits. However, there are other better rates banks will offer their best borrowers; all you have to do is ask.

The Cost of Funding

As we noted in the lead of this piece, change is not something that is planned, it is forced by circumstances. Circumstances have changed.

Long before helicopters, Ben Bernanke was famous for his study of the great depression. He authored books about the subject in the 1980s.

In June Bernanke gave [a speech](#) at the Atlanta Fed titled *The Financial Accelerator and the Credit Channel*, he said:

Loan sales and similar activities are, in essence, another form of nondeposit financing, and the effective cost of this form of funding to the bank will generally depend on its perceived financial strength and resources (which may affect recourse and reinsurance arrangements with the loan purchasers, for example). . . . Like banks,

nonbank lenders have to raise funds in order to lend, and the cost at which they raise those funds will depend on their financial condition--their net worth, their leverage, and their liquidity, for example. Thus, nonbank lenders also face an external finance premium that presumably can be influenced by economic developments or monetary policy. The level of the premium they pay will in turn affect the rates that they can offer borrowers. Thus, the ideas underlying the bank-lending channel might reasonably extend to all private providers of credit.

Let us restate; the ability to sell loans (i.e., CDOs) affects the cost of borrowing for a lending institution. If the market for mortgages or CDOs dries up and they cannot be sold, the cost of funding to those institutions goes up. If the cost of funding goes up, the cost of loans to customers (the real economy) goes up. Simple enough.

This is what the Fed is trying to alleviate. So when economists call for a blanket cut in the target funds rate, the Fed does not see that as the problem. **In the eyes of the Federal Reserve, the problem is not that the target rate is too high. They see the**

problem as a lending institution funding problem.

Why This May Last

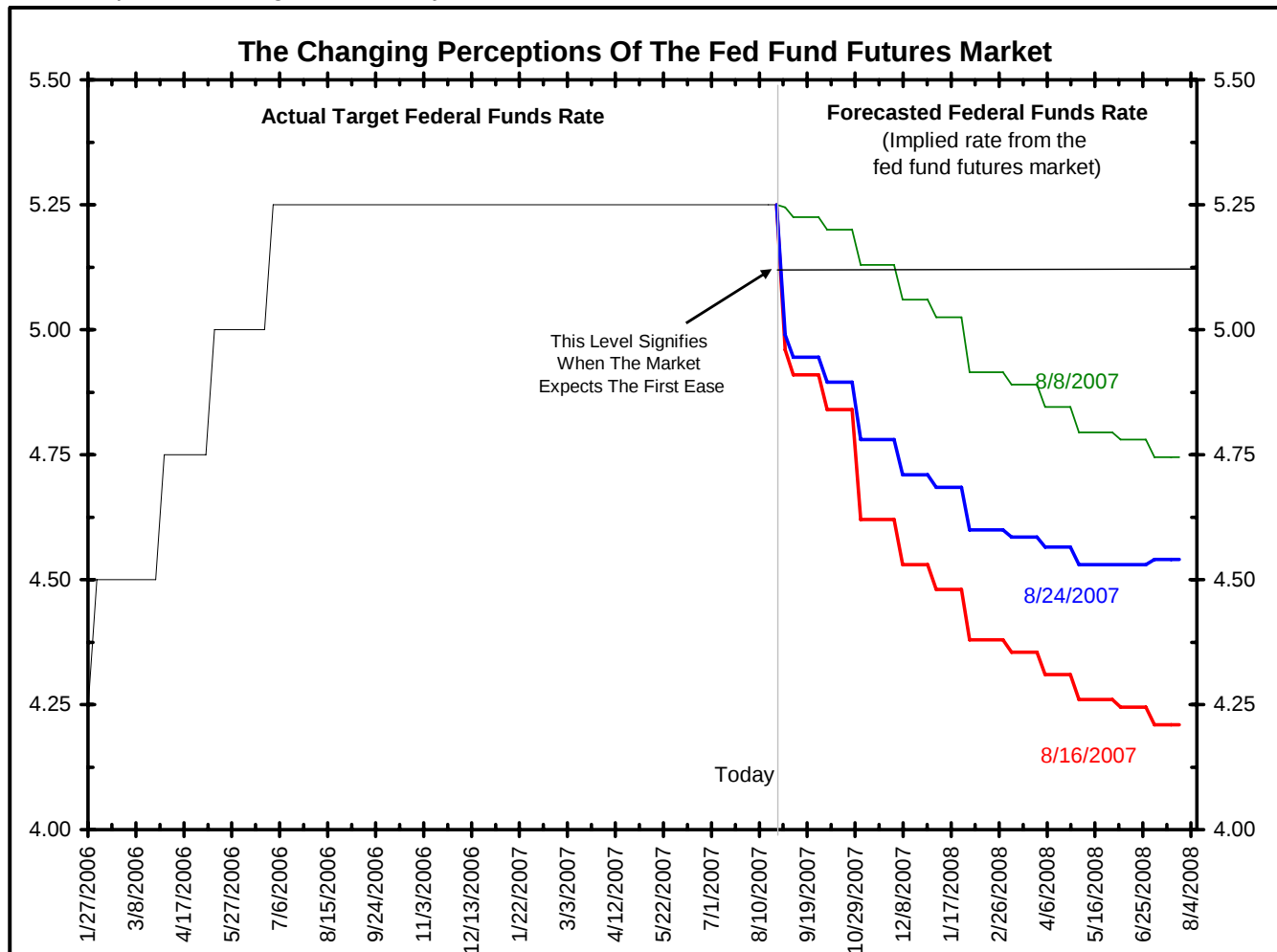
The first way the Fed is combating this problem is described above; the effective federal funds rate is being allowed to trade well under the target rate. How long will this last? The federal funds futures contract gives us an insight into the market's thinking.

Recall that the federal funds futures contract is the monthly average of all the daily effective rates. As we noted above, until August 10, there was not a reason to distinguish between this and the target rate as the open market desk of the New York Federal Reserve worked to keep these two rates close together. Now they are allowed to diverge.

The green line in the chart below shows what the market expected on August 8, the day after the last

FOMC meeting. No cut in the target rate was expected until the December 11 FOMC meeting. **We believe this was the last day this contract was forecasting the target rate. Starting the next day and accelerating on August 10 (more below), this market switched to forecasting the effective rate.**

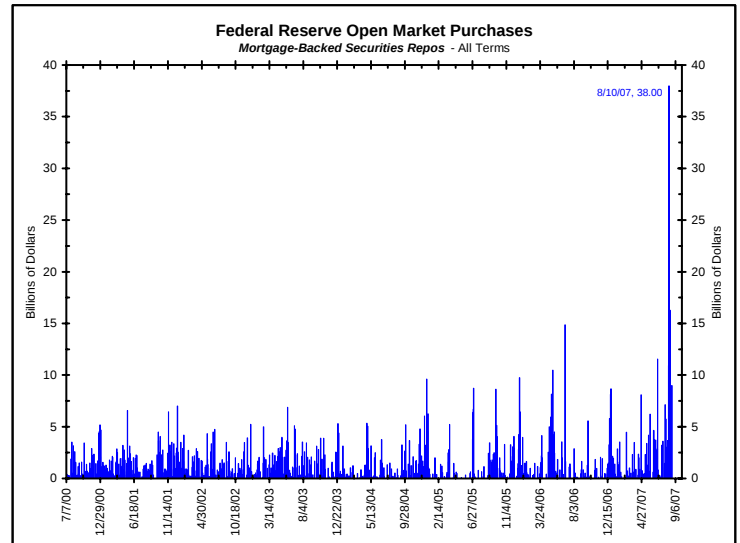
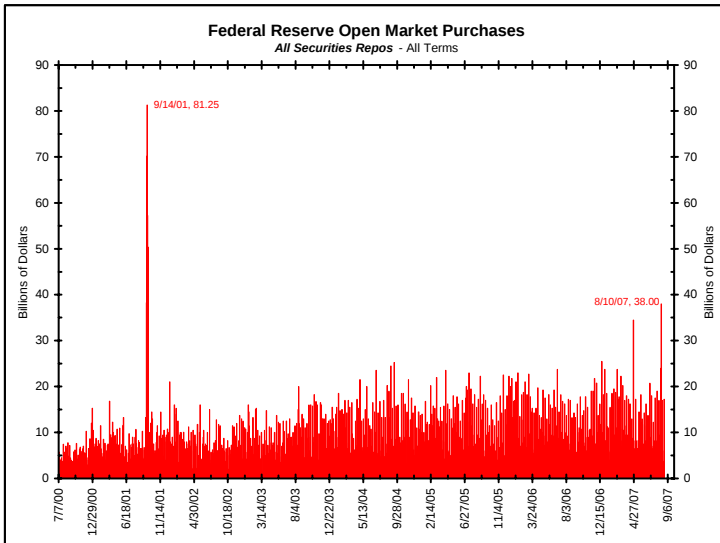
The red and blue lines below show a dramatic change that occurred in the coming days. The federal funds futures contracts were pricing in what initially looked like an intra-meeting cut in the target rate and many were indeed calling for this to happen. **Instead, we believe this market is telling us that the divergence between the effective funds rate and the target rate will last for months. If it does last months, the FOMC may not be able to resume as it did prior to August 8.**



What Happened on August 10?

The morning of August 10 at 8:25AM ET the Fed did something we have not seen. They stepped into the market on three separate occasions throughout the day and executed \$38 billion of same day repos for **only** mortgage-backed securities (MBS). As the chart to the left shows (red bars), \$38 billion is the

largest amount of liquidity added to the banking system in any one day since the immediate aftermath of September 11, 2001. As the chart to the right shows (blue bars), \$38 billion in MBS repos is by far the most MBS executed in any single day.

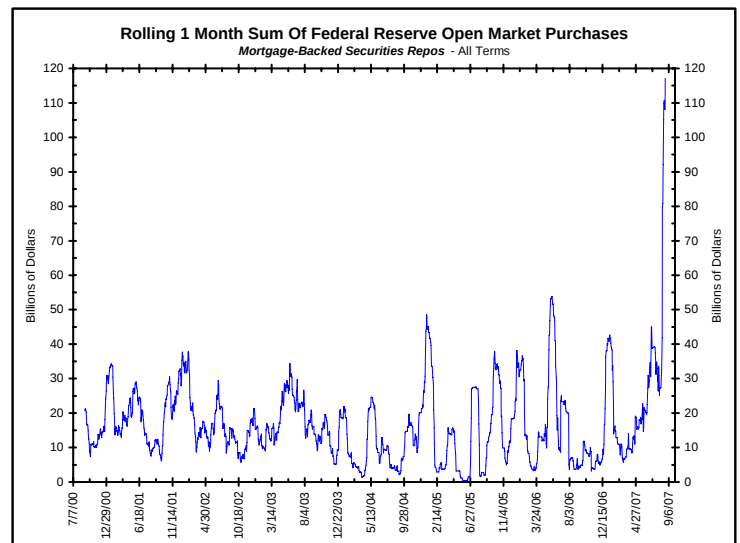
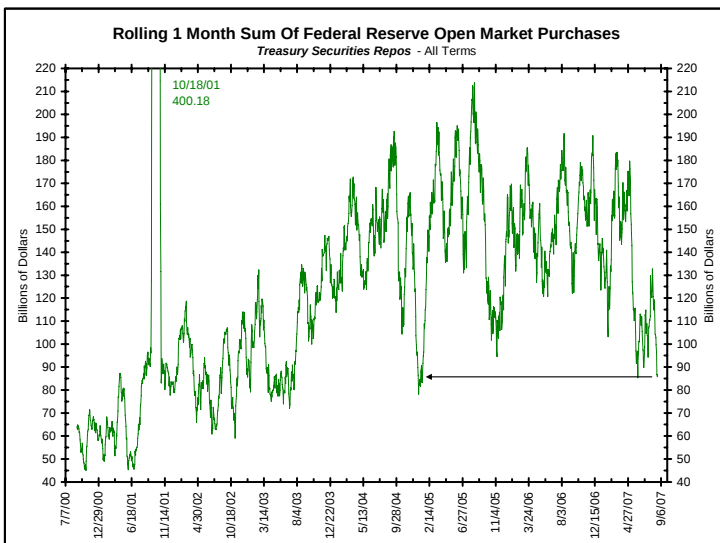


Recall what Bernanke [said](#) on June 15 in Atlanta; when the cost of funding for lending institutions goes up, the cost of funding to the real economy goes up. **So, on August 10, the Fed aggressively started a campaign to lower the cost of funding to lending institutions. In other words, they eased.**

But in Bernanke's thinking, the Fed wants to alleviate this funding crisis and not spur inflation fears a blanket cut in the target rate would do. So, they are careful to pinpoint their activity on the exact problem in the financial markets and no more.

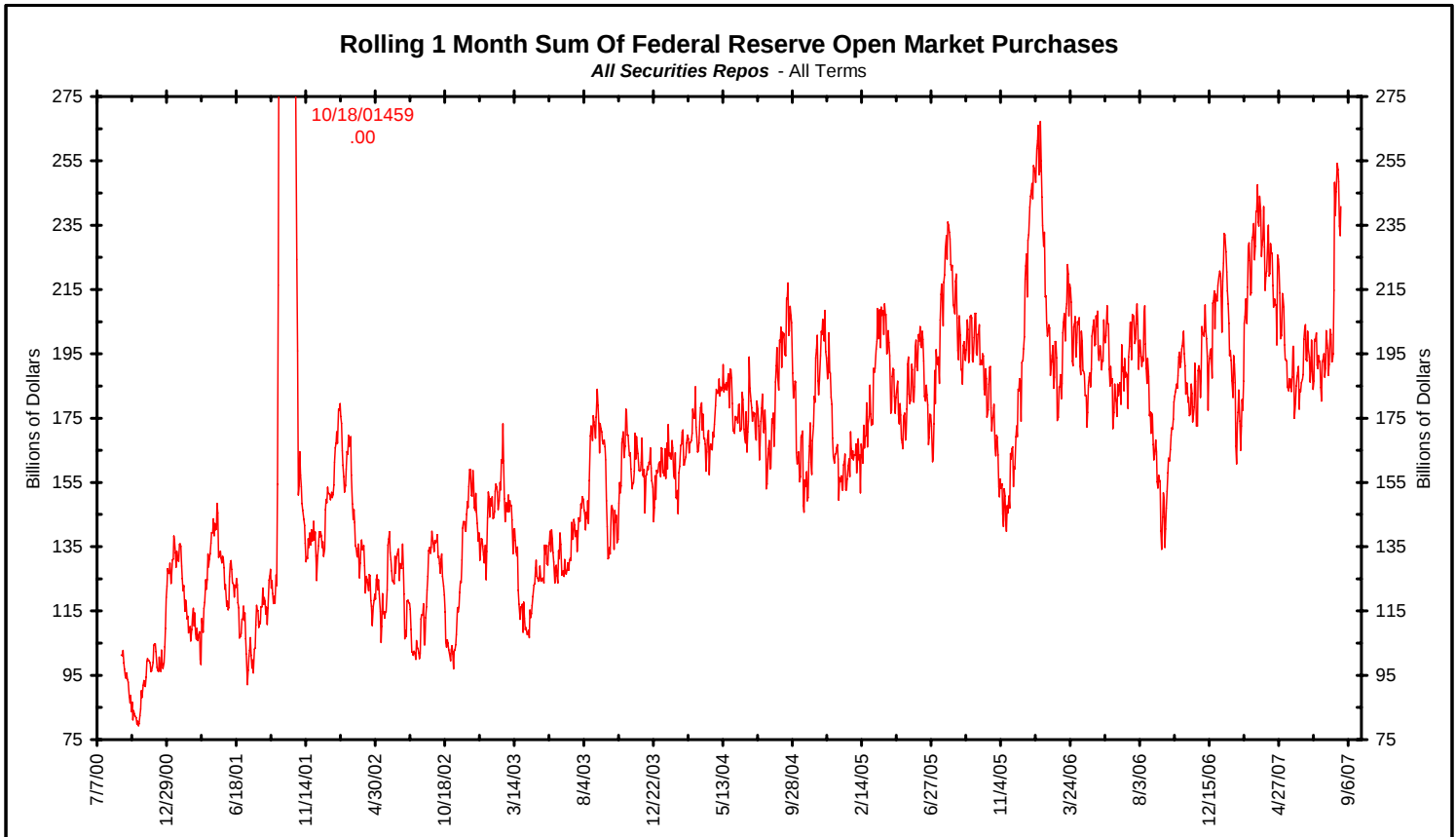
The problem is a lack of liquidity in MBS. So, the Fed is willing to offer the market that liquidity by letting the market repo MBS for cash with the Fed.

However, the Federal Reserve has also been careful to "sterilize" this intervention. The chart to the left (green line) shows a rolling one-month sum of repos done with Treasury securities as collateral. Currently this amount is at a 2+ year low. At the same time repos done with MBS as collateral (right chart, blue line) have rocketed to new highs. Note the differing scales between these two charts.



The reduction in Treasury repos and the record MBS repo activity have largely offset each other ("sterilized" in Fed speak). The amount of all repos done with all securities as collateral by the Federal Reserve has risen, but only to the top of its recent range (chart below, red line).

Restated, the Federal Reserve has identified the problem as a liquidity crisis within the MBS sector and is willing to provide liquidity to the financial system. Institutions can repo their MBS collateral for cash with the Federal Reserve, but the overall liquidity in the financial system has been kept relatively constant.



Bending The Rules

Late Friday (August 24) on the Fed's website two letters to [Citibank](#) and [Bank of America](#) (B of A) were posted. The letters were written on August 20 and granted an exemption from section 23A of the Federal Reserve Act and board regulation W. As [Fortune](#) Magazine explained this weekend:

The Aug. 20 letters from the Fed to Citigroup and Bank of America state that the Fed, which regulates large parts of the U.S. financial system, has agreed to exempt both banks from rules that effectively limit the amount of lending that their federally-insured banks can do with their brokerage affiliates. The exemption, which is temporary, means, for example, that Citigroup's Citibank entity can substantially increase funding to Citigroup Global Markets, its brokerage subsidiary. Citigroup and Bank of America requested the exemptions, according to the letters, to provide liquidity to those holding mortgage

loans, mortgage-backed securities, and other securities

In addition to the discount rate cut, the Fed [announced](#) last week that they are extending the terms of discount window borrowing from overnight to as long as 30 days. They also re-iterated that the list of [acceptable collateral](#) includes mortgages and home loans and said there is no stigma in borrowing at the discount window.

These moves are consistent with the divergence in the effective funds rate and the sterilized MBS repo surge. The Federal Reserve has identified the problem as a lack of liquidity in the MBS sector (nobody wants to buy them), so they are bending the rules to allow those that are stuck with these illiquid securities to use them as collateral in a loan.

Conclusion

The Federal Reserve has gone to extraordinary lengths to alleviate this crisis. They have pinpointed their activities at what they perceive as the problem rather than throwing money at everything – which is what a target rate cut does. This is all they can do. They cannot restore confidence to the financial system, but they can provide facilities (collateralized loans) to buy time until confidence returns. Sometimes time is all that is needed.

This is a far better approach than what the Greenspan FOMC did. Recall that when they cut the target rate to the emergency level of 1.00% through 2003 when no emergency was evident, many fretted (including us) that they were solving one problem and creating others by throwing cheap money at everyone in hopes of getting it to those who really needed it. The problem is that when the Fed offers everyone cheap money, people usually take it and find something to do with it after the fact. Economists call this malinvestment.

Four years later a strong case can be made that the current problem with the mortgage/subprime/asset-backed sectors are a by-product of the cheap money period under Greenspan and the malinvestment it created.

Our immediate concern, however, is these current efforts will last months, and the effective rate will diverge from the target rate for a long time. If so, it is only a matter of time before everyone forgets about the obsession of the quarter-point pre-

announced moves in the target rate and start focusing on other measures of Fed policy. It is too early to tell what those measures will be, but this is how other changes in the conduct of Fed policy have started – a temporary move that soon becomes permanent.

For example, the FOMC statement did not even exist until February 3, 1994. The Fed tightened for the first time since 1989 and the market was not sure the act in fact drained liquidity as there was no announcement or target rate change, merely interpretations of open market operations. Larry Kudlow, then the chief economist at Bear Stearns, quipped that their Fed watcher was in college when the Fed last tightened, so he was unfamiliar with what a tightening looked like. Greenspan, understanding this confusion could be found in many quarters on Wall Street, released a statement the next day clearing up what the Fed's intention was with its open market operations of the day before and that they did tighten. Thus was born the FOMC statement. We are sure that when Greenspan made that first announcement, he had no idea he was creating a new institution.

Until the current Federal Reserve scheme is understood, and we largely believe it is not, we have a serious loss of transparency with respect to Fed policy. For the moment the market is not concerned about missing transparency as the Fed is busy supplying liquidity, or easing. But as this drags on, there will be a day the market does worry it has no transparency with respect to Fed policy.

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