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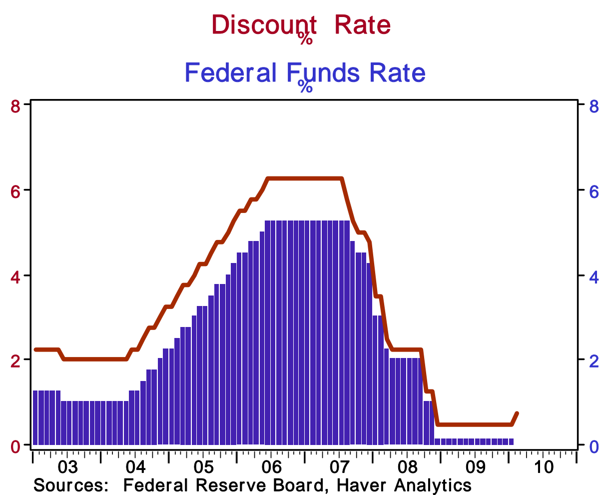
Feb 19, 2010 Economic Commentary

The Fed Tests the Waters

By raising the discount rate to 0.75% from 0.50% yesterday, the Federal Reserve took a big psychological step toward a less loose monetary policy. In addition, the Fed also announced it would shorten the typical maturity for discount window borrowing to overnight from a maximum of 30 days and lift the minimum interest rate on Term Auction Facility (TAF) credit to 0.50% from 0.25%.

These actions, by themselves, will have little to no impact on the economy or financial system. Compared to late 2008, financial institutions have dramatically reduced their discount window borrowing (collateralized loans the Fed makes directly to banks). The same goes for reductions in term auction credit from the Fed.



The Fed went to lengths to make sure markets would understand that lifting the discount rate did not automatically mean the federal funds rate would soon go up too. In congressional testimony delivered last week, Fed Chairman Ben Bernanke said:

> "(B)efore long, we expect to consider a modest increase in the spread between the discount rate and the target federal funds rate. These changes…should be viewed as further normalization of the Federal Reserve's lending facilities, in light of the improving conditions in financial markets; they…should not be interpreted as signaling any change in the outlook for monetary policy, which remains about as it was at the time of the January meeting of the FOMC."

In addition, the Fed made yesterday's announcement outside the framework of the Federal Open Market Committee meetings that occur about every six or seven weeks. Those meetings are the usual forum for the Fed to make changes in monetary policy.

However, before banks started having great difficulty with mortgage loans in 2007, the gap between the discount rate and the federal funds rate was a full percentage point. During the financial panic, this gap fell to a range of 25 to 50 basis points. Now that range is 50 to 75 bps and an anonymous Fed leak this morning suggests the central bank thinks the gap need not expand to the 100 bp that prevailed before the crisis. In turn, the leak suggests the Fed thinks it has fewer adjustments to make before getting to the issue of whether to raise the federal funds rate and by how much.

Every long march begins with a first step. For the time being, the Fed thinks it still will be an "extended period" before making adjustments to the federal funds rate. But it is also projecting that the unemployment rate will finish 2010 at about 9.5%, barely lower than the 9.7% reported for January. By contrast, we believe the jobless rate will have an 8-handle by the end of the year. If the Fed sees the unemployment rate following our projected path, not its own forecast, it should end up surprising itself by lifting the funds rate around mid-year.

Although the Fed is inclined to curtail its special lending facilities *before* raising the federal funds rate, we think the opposite approach is better. As long as the problems associated with mark-to-market accounting lurk in the background, the financial system (particularly the securitization process) may need those facilities, even as the broad economy needs higher short-term rates to curb inflation.

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Text of the Federal Reserve's Statement:

The Federal Reserve Board on Thursday announced that in light of continued improvement in financial market conditions it had unanimously approved several modifications to the terms of its discount window lending programs.

Like the closure of a number of extraordinary credit programs earlier this month, these changes are intended as a further normalization of the Federal Reserve's lending facilities. The modifications are not expected to lead to tighter financial conditions for households and businesses and do not signal any change in the outlook for the economy or for monetary policy, which remains about as it was at the January meeting of the Federal Open Market Committee (FOMC). At that meeting, the Committee left its target range for the federal funds rate at 0 to 1/4 percent and said it anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period.

The changes to the discount window facilities include Board approval of requests by the boards of directors of the 12 Federal Reserve Banks to increase the primary credit rate (generally referred to as the discount rate) from 1/2 percent to 3/4 percent. This action is effective on February 19.

In addition, the Board announced that, effective on March 18, the typical maximum maturity for primary credit loans will be shortened to overnight. Primary credit is provided by Reserve Banks on a fully secured basis to depository institutions that are in generally sound condition as a backup source of funds. Finally, the Board announced that it had raised the minimum bid rate for the Term Auction Facility (TAF) by 1/4 percentage point to 1/2 percent. The final TAF auction will be on March 8, 2010.

Easing the terms of primary credit was one of the Federal Reserve's first responses to the financial crisis. On August 17, 2007, the Federal Reserve reduced the spread of the primary credit rate over the FOMC's target for the federal funds rate to 1/2 percentage point, from 1 percentage point, and lengthened the typical maximum maturity from overnight to 30 days. On December 12, 2007, the Federal Reserve created the TAF to further improve the access of depository institutions to term funding. On March 16, 2008, the Federal Reserve lowered the spread of the primary credit rate over the target federal funds rate to 1/4 percentage point and extended the maximum maturity of primary credit loans to 90 days.

Subsequently, in response to improving conditions in wholesale funding markets, on June 25, 2009, the Federal Reserve initiated a gradual reduction in TAF auction sizes. As announced on November 17, 2009, and implemented on January 14, 2010, the Federal Reserve began the process of normalizing the terms on primary credit by reducing the typical maximum maturity to 28 days.

The increase in the discount rate announced Thursday widens the spread between the primary credit rate and the top of the FOMC's 0 to 1/4 percent target range for the federal funds rate to 1/2 percentage point. The increase in the spread and reduction in maximum maturity will encourage depository institutions to rely on private funding markets for short-term credit and to use the Federal Reserve's primary credit facility only as a backup source of funds. The Federal Reserve will assess over time whether further increases in the spread are appropriate in view of experience with the 1/2 percentage point spread.

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