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Flash Notes

The Upcoming April 29-30 Fed Meeting: A "Dull" Outcome?

- One of the general, yet essential, themes surrounding some of the incoming Fed rhetoric since the March 18 meeting is the importance of "normal" market functioning in promoting the effectiveness of Fed interest rate cuts. This suggests that insofar as credit markets exhibit abnormalities, the overall focus on Fed policy, at least for now, is likely to shift away from the conventional policy tool of targeting the fed funds rate towards liquidity provision programs and other less conventional policy measures. The notion of deemphasizing conventional monetary policy (in favor of less conventional policy measures), in my judgment, is a more important factor than the inflation-sensitivity argument in curtailing the downward adjustment in the target funds rate at this juncture.

- Since the prior Fed meeting in March, the degree of improvement in financial market conditions remains uneven, perhaps with some lingering degree of hesitancy. Indeed, term Libor rates are still elevated and both the TED and LIBOR/OIS spreads either remain wide or have widened further. The proxies for counterparty risk and implied default risk have barely eased from their ominous levels. While there is some evidence that liquidity risk has moderated some, the results from the Fed's recent Term Auction Facility imply that liquidity-related concerns remain.

- One approach to deemphasize conventional interest rate adjustments for now (or until market conditions normalize), without delivering a negative shock to financial markets, is for the Committee to communicate a 25bps reduction in the target funds rate to 2.00% at next week's meeting on April 29-30. Since a 25bps cut is more-or-less in-line with market sentiment, this policy move would probably accentuate the accompanying statement.

- The tone of the April post-meeting statement would continue to highlight concerns about growth and inflation, essentially maintaining key phrases that "downside risks to growth remain" and that at the same time "it will be necessary to continue to monitor inflation developments carefully". But aside from the usual current assessment updates on economic activity and inflation since the prior meeting, the accompanying statement this time around might be deliberately uninteresting. In part, this should convey the impression that the incoming data on the economy have not changed the near-term outlook materially, and that it is crucial to allow more time for markets to acclimatize and prior Fed actions to seep in.

- Despite the revision to our Fed policy call next week (to a 25bps cut from 50bps reduction previously), our initial 2008 full-year forecast trajectory, which was for the target fed funds rate to be on-hold following the April easing (now forecasted to be at 2.00%), remains the same. But we continue to expect the Fed to maintain their accommodative posture via the ongoing liquidity-provision programs. Also, the prospect of introducing alternative policy tools would probably increase over time if market conditions remain stubbornly abnormal.

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