

## US: As the Fed Ventures Deeper, Communication Hurdles are Raised

- The Committee's policy announcement at the conclusion of the December 15-16 meeting surprised on three fronts: 1) The reduction in both the target fed funds rate and discount rate was larger than expected; 2) Instead of the usual level announcement for the target funds rate, the interest rate policy has shifted to targeting a specific range for the fed funds rate, between 0% and 0.25% (the rate on excess and required reserves was set at 0.25%); 3) Aside from the unanimous policy vote by the Committee, the six discount rate requests for the 75bps cut by the Reserve Banks were also slightly above average.
- The December post-meeting statement highlights the policymakers' dour assessments of the economy, which are generally in-line with the information implied from the incoming economic data. Specifically, the Committee acknowledges that the "outlook for economic activity has weakened further", and that "inflationary pressures have diminished appreciably". While it maintains its expectations for "inflation to moderate further in coming quarters", the Committee also raises the prospect that the disinflation process might be more severe, perhaps below what is deemed as price stability.
- Even though the Committee expects "weak economic conditions...to warrant exceptionally low levels of the federal funds rate for some time", it leaves ample leeway for the interpretation of the extent of future policy accommodation (i.e., how loose is monetary policy?). Clearly, with the depressed fed funds rate (both the target and effective rate) at this juncture, the future policy conduct would likely be viewed mainly in terms of the extent of swelling in and the changing makeup of the Fed's balance sheet in the near-term. (The asset level on the Fed's balance sheet, which currently stands at greater than \$2.2 trillion, has increased by more than \$1.36 trillion since the end of 2007.)
- Going forward, it is necessary for policymakers to shed more light on at least three fronts: 1) How to interpret the prevailing policy stance? (i.e., using price or quantity of reserves); 2) Aside from the announced policy alternatives, what is the extent of "all available tools"? (i.e., a list of primary and secondary policy options); 3) It is also important to provide some guidance on future policy strategies (i.e., conditional and exit strategies) when conducting alternative policies in a low interest rate environment.
- In my December 2 publication, "Understanding Fed Policy Constraints and Alternatives", I underscore that "the crucial element in accomplishing the intended effects via alternative policies is the ability of policymakers to successfully steer expectations (i.e., both with respect to future interest rate and inflation expectations) amid unusual times". In reality, as Fed policy ventures deeper into uncharted territory, policy communication hurdles are inevitably raised. The lack of communication and the inability to communicate effectively by policymakers could potentially lead to policy-related confusions and speculations, which would further elevate the costs of pursuing alternative policies.
- The outcome of the two-day policy deliberation seems to suggest that policymakers view the funds rate target range of 0% to 0.25% as appropriate in balancing the relevant costs and benefits at this time. As such, I expect the Fed to maintain this policy backdrop for the rest of 2009. Still, the positive effects of conventional and unconventional monetary policy actions per se are simply insufficient to offset the current economic recession, and address the financial market turmoil. Obviously, the much anticipated fiscal stimulus package--together with initiatives from the Treasury and FDIC--under President-elect Obama plays an important role in stabilizing the economy and normalizing market conditions.

A copy of the December 15-16 statement can be obtained from the following link: <http://www.federalreserve.gov/newsevents/press/monetary/20081216b.htm>

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