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FED SHADOW

Fed Liquidity Runneth Over

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A new conundrum: the Fed is injecting record liquidity, yet the funds rate is trading below target.

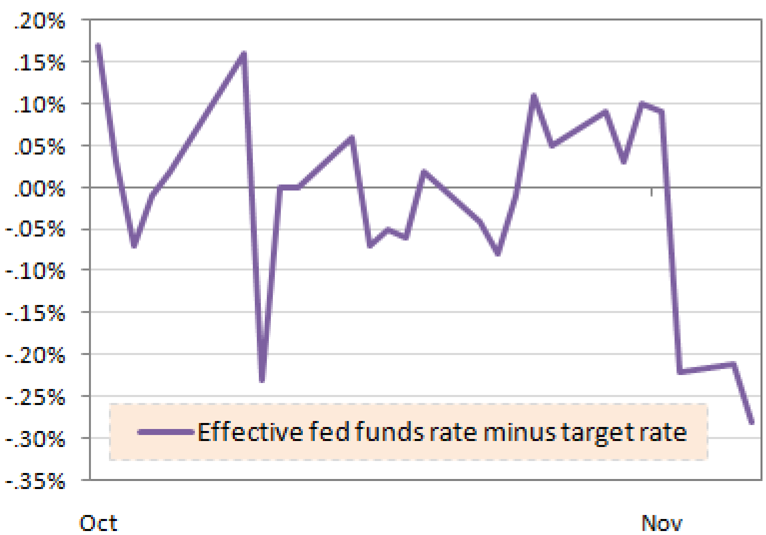
Update to strategic view

FED FUNDS: The Fed's massive liquidity injections in the face of fed funds trading below target suggests operations aimed at heading off risk in the banking system, and makes another rate cut at the December FOMC meeting much more likely.

[see Investment Strategy Dashboard]

If the Fed intended to send the message with its post-FOMC statement last week that it was leaning against additional easing steps (see "Hawk on the Outside, Dove on the Inside" November 1, 2007), it is taking a very unusual approach to conveying that intention to the market. Since the meeting a week ago, the Fed has been injecting larger sums of liquidity than it has at any time since the onset of financial market turbulence in August, and has been tolerating a funds rate trading well below the new 4.5% target.

On the morning of November 1, the day after the FOMC meeting, the New York Fed's open market desk executed three separate repo transactions totaling $41 billion. At the height of the credit market crisis in August, its largest one-day liquidity injection was $35 billion. At that time, safe haven demand was driving the funds rate *above* the 5.25% target, so the additional liquidity could be seen as a response to the *above*-target rate. Currently, though, the funds rate is trading *below* the 4.5% target. On each day since the meeting last week, the Fed entered the market with funds *below* target, and with the exception of last Thursday, the effective rate for the day finished even lower -- below 4.3% since Friday. The desk is maintaining its highly generous provision of reserves to the system, as the daily injection is now running at $48 billion. In the two prior weeks, daily operations generally ranged from $5 billion to $15 billion.



Since last week's meeting, the

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price of gold has jumped from $781 to above $835, the euro has rallied from just above $1.44 to just below $1.47, and the trade-weighted dollar index has fallen from 76.5 to below 75.5. The weak dollar trend began long before last week's FOMC meeting and is being sustained by expectations that the credit market turmoil will compel the Fed to indefinitely remain in an easy money stance. But the open spigot approach to reserve injections since the FOMC session, apparently all but suspending any adherence to the overnight rate target, has to be viewed as an important factor currently exacerbating the excess supply of dollar liquidity relative to demand.

The Fed's open market operations of the past week raise several questions for which ready answers are not yet available. Having begun the day following the most recent most FOMC meeting, the desk's boost to liquidity and tolerance of a below-target rate was almost assuredly a conscious decision of the committee. We don't entirely rule out the possibility that there are entirely technical explanations for this extraordinary shift in operations. But if technical pressures were responsible for the upping of reserve provisions, they would likely have been associated with the funds rate running *above* target, not *below*.

Most likely, there is some policy reason underlying the operational shift. Despite the outward profile it presented showing some confidence that downside economic risks and financial market strains were easing, the Fed may perceive exogenous pressures on the system that it believes require this response. If so, that would not tend to enhance the credibility of Fed chairman Ben Bernanke. He came in to office last year professing his intention to improve the transparency of Fed policymaking, but that would seem to run counter to publicly expressing assurance about the environment but secretly moving to adapt to some undisclosed risk. At the same time, though, it could well be that the Fed is significantly overcompensating for the perceived risk. Such an intensified risk environment would not normally be associated with the funds rate trading *below* target. If the risk was being transmitted through the financial system, it would likely show up in a heightened demand for funds, which would have the funds rate trading above target. Bernanke may be asked to shed some light on these questions tomorrow when he appears before the Joint Economic Committee.

BOTTOM LINE: The consequences of an extended decline in the dollar are becoming increasingly difficult to escape, with the falling currency front and center in explanations for today's stock market sell-off. But largely unnoted, the recent acceleration of the dollar's decline is traceable to an operational shift toward greater liquidity provision following last week's FOMC meeting. These highly generous liquidity operations have also coincided with the funds rate trading well below target, which may help explain why interest rate futures markets are now pricing for a significantly better than even chance of another rate cut next month despite the Fed's attempt to shape public perceptions that it is disinclined to sanction another cut.