Payden&Rygel

# Payden & Rygel Economic**Research**

August 5, 2008

## Fed to Wait for Dust to Settle

Contact:
Thomas D. Higgins, PhD
Chief Economist
**ph:** 213 830-4302
**email:** thiggins@payden-rygel.com

### Highlights

- The Federal Reserve left its benchmark federal funds rate unchanged at 2% at the conclusion of today's policy meeting.
- The vote was 10-1 in favor of holding rates steady with Richard Fisher of the Dallas Fed voting for an interest rate hike for the second meeting in a row.
- The Fed issued a more neutral statement than it had in June suggesting that the upside risks to inflation were roughly balanced with the downside risks to economic growth.

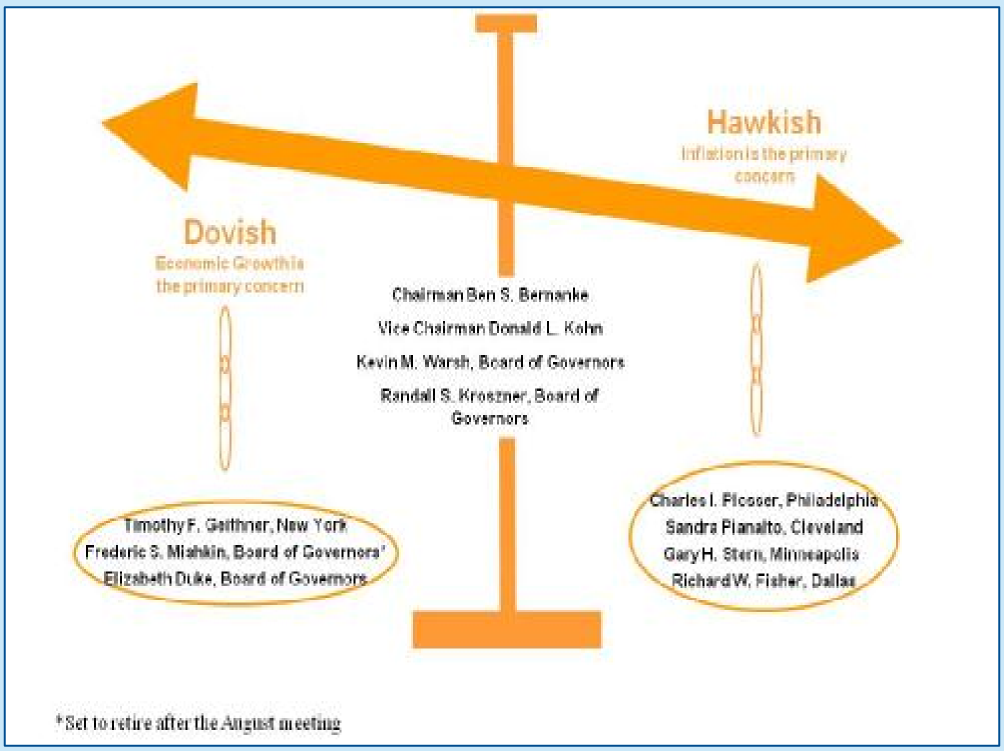
The Federal Reserve left its benchmark federal funds rate unchanged at 2% at the conclusion of today's policy meeting. The vote was 10-1 in favor of holding rates steady with Richard Fisher of the Dallas Fed voting for an interest rate hike for the second meeting in a row. However, contrary to market expectations, none of the other members of the Federal Open Market Committee (FOMC) joined Mr. Fisher in his dissent.

Instead, the tone of today's policy statement was slightly more dovish than the one issued after the Fed's June 25th meeting in which the central bank seemed to be leaning toward a *tightening* bias. Specifically, Fed officials omitted the sentence from the June policy statement that said the downside risks to growth had "diminished somewhat." In its place was a more neutral statement suggesting that the downside risks to growth are roughly balanced with the upside risks to inflation. We continue to believe that the fragility of the US financial system and economy will keep the Federal Reserve sidelined until the middle of next year. Put simply, the Fed doesn't want to make a bad situation worse by raising interest rates.

Stocks extended an already impressive rally on the Fed's decision to leave interest rates unchanged. The S&P 500 stock price index was up 1.4% after the 2:15pm announcement. By contrast, Treasury yields were little changed with two-year yields essentially flat at 2.55%.

### Restacking the Deck

The newest member of the Fed's Board of Governors, Elizabeth Duke, who was sworn in by Fed Chairman Ben Bernanke just a few hours ahead of today's policy meeting, voted with the majority to leave rates unchanged. Ms. Duke was nominated to a seat vacated by the resignation of Susan Schmidt Bies on March 30, 2007, and her term expires January 31, 2012. Her background in community banking may give her special insight into some of the difficulties small lenders face in the current environment. Although it will take time (and more FOMC votes) to get a clear idea as to whether she is a hawk or dove, my inclination is that she is more likely to fall in the dovish camp.



Contact:
Thomas D. Higgins, PhD
Chief Economist
**ph:** 213 830-4302
**email:** thiggins@payden-rygel.com

- The balance of power at the Fed remains tilted toward the more hawkish Regional Fed Presidents.
- We continue to believe that the fragility of the US financial system and economy will keep the Federal Reserve sidelined until the middle of next year.

Even with Ms. Duke's appointment, the FOMC remains short-staffed. Under normal circumstances, the committee consists of twelve members –the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining eleven Reserve Bank presidents, who serve one-year terms on a rotating basis. At the moment there are six members of the Board of Governors and one of them, Frederic Mishkin, is poised to retire after today's policy meeting. That means there are currently two vacancies at the Fed.

### All Bark, No Bite

This has tilted the balance of power at the Fed away from the Board of Governors and toward the regional Fed Presidents for the time being. Dallas Fed President Richard Fisher has been the only one to openly vote for an interest rate hike, but other Fed Presidents, including Charles Plosser of Philadelphia and Gary Stern of Minneapolis have stepped up their hawkish rhetoric in recent speeches.

Although Regional Fed's have had input into the central bank's interest rate decisions, they had no say in the decision by the Board of Governors to extend the discount window to non-bank primary dealers under the Primary Dealer Credit Facility (PDCF). Some of the Regional Bank Presidents have expressed concern that the PDCF may have created a moral hazard in the financial system since non-bank broker dealers are not regulated by the Fed. With no power to revoke the PDCF, the Regional Fed Presidents may be exercising their only other option which is to pressure the FOMC to raise short-term interest rates.

When all is said and done, however, I do not believe any of the Regional Fed Presidents, would actually advocate interest rate hikes in the current environment even if they had the power to implement them without consulting their colleagues on the Board of Governors. Talk is cheap and perhaps it even helps the central bank to build credibility with those who believe inflation is a real risk despite the deflation that is underway in the housing market. That said, raising interest rates at this stage would aggravate an already difficult situation.