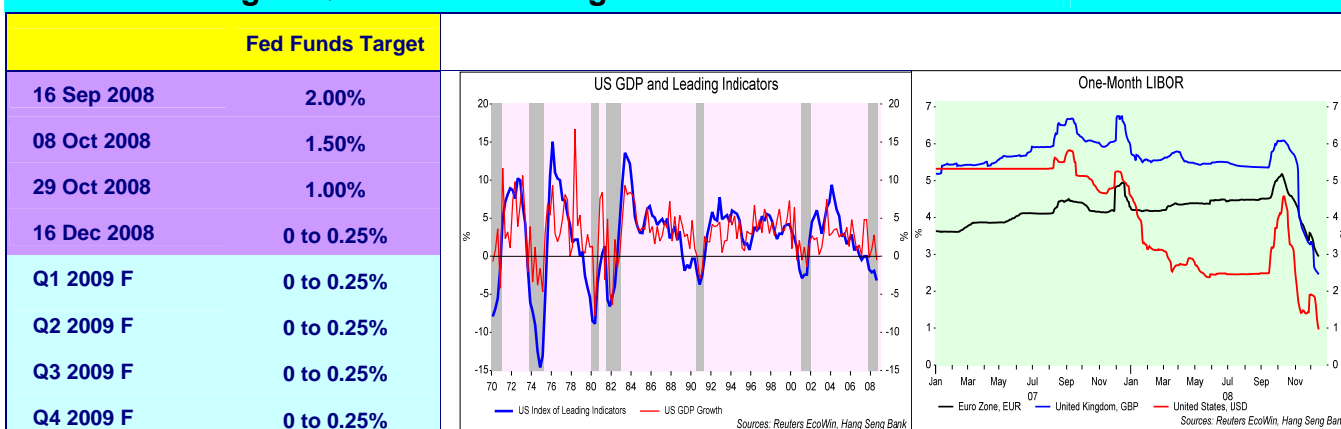


The Fed Shifting to Quantitative Easing

17 Dec 2008



The Big Picture

- The financial crisis is impacting the US and global economy as financial markets seize up and banks are not willing to lend to customers. The US looks set to be in its longest and deepest recession in the post World War II era.

What Have Been Done?

- The Fed, along with central banks around the globe, has been aggressively cutting interest rates in the past year to revive growth momentum. For its part, the Fed has already lowered its benchmark rate by over five percentage points, the latest being the overnight cut which brings the fed funds target rate to a range of zero to 0.25%, the lowest on record.
- The Fed has also implemented various programmes to extend emergency lending to financial institutions and set up swap lines with other central banks.
- However, credit conditions remain tight as financial institutions are reluctant to lend. The economy also shows no signs of bottoming.

What More Would the Fed do?

- The FOMC statement released after the latest meeting said that the Fed would keep the fed funds rate at exceptionally low levels for some time.
- With the fed funds target rate near zero, the US central bank could no longer rely on interest rates as a monetary policy tool, but has to resort to unconventional ones. In fact, Fed Chairman Ben Bernanke indicated in a December 1 speech that policy makers would need to focus on “the second arrow in the Federal Reserve’s quiver – the provision of liquidity.”
- The FOMC statement seems to have endorsed the Fed Chairman’s views. The Fed statement shows that the Fed is shifting its policy focus to other measures that use the **size and composition** of the central bank’s balance sheet as the main tool of monetary policy, i.e., quantitative easing.
- Quantitative easing moves which have already been announced include:
 - the purchase of agency debt and mortgage-backed securities in large quantities to provide support to the mortgage and housing market;
 - a programme to facilitate the extension of credit to households and small businesses.



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- Other quantitative measures being explicitly mentioned include the Fed purchasing longer-term Treasury securities, with an aim at pushing down long term interest rates.

Implications of the Fed's Shift to Quantitative Easing

- The Fed's previous measures to inject liquidity to ease stress in financial markets have flooded the system with cash, pushing down the actual fed funds target rate to near zero for the past two weeks. As such, the Fed's latest decision to cut rates to zero to 0.25% was merely an acknowledgement of the fact.
- The Fed has been in quantitative easing mode for some time as it has flooded the system with funds and purchased commercial paper and other securities. The Fed's move has already boosted its balance sheet to USD2.26 trillion from USD868 billion in July 2007. In terms of the size of the economy, the Fed's balance sheet rose from the normal level of 6% to 15% currently. At the same time, the Fed is taking on more riskier assets.
- The Fed is following the footsteps of the Bank of Japan. The latter was the only other major central bank in modern times to mix a policy of steep rate reductions with quantitative easing. Japan's central bank kept its main rate at zero from 2001 to 2006 while flooding the banking system with extra cash to encourage lending.
- There is, however, one major difference between the Fed's move and the Japanese-style quantitative easing. While the Bank of Japan flooded the system with cash, the Fed is focusing on assets. As banks are reluctant to lend, the Fed is setting up programmes that will bypass the banks and lend directly to consumers and businesses.
- The Fed is determined to revive growth and there is no limit to how far the Fed could expand its balance sheet. But the Fed's action will of course have long term consequences. If economy activities pick up and money velocity increases, the Fed has to quickly drain the excess liquidity, otherwise money supply and inflation will shoot up. The Fed Chairman is aware of the exit problem, but is prepared to do anything to support financial markets and revive economic activities as quickly as possible.

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