Exit strategies and the Federal Reserve

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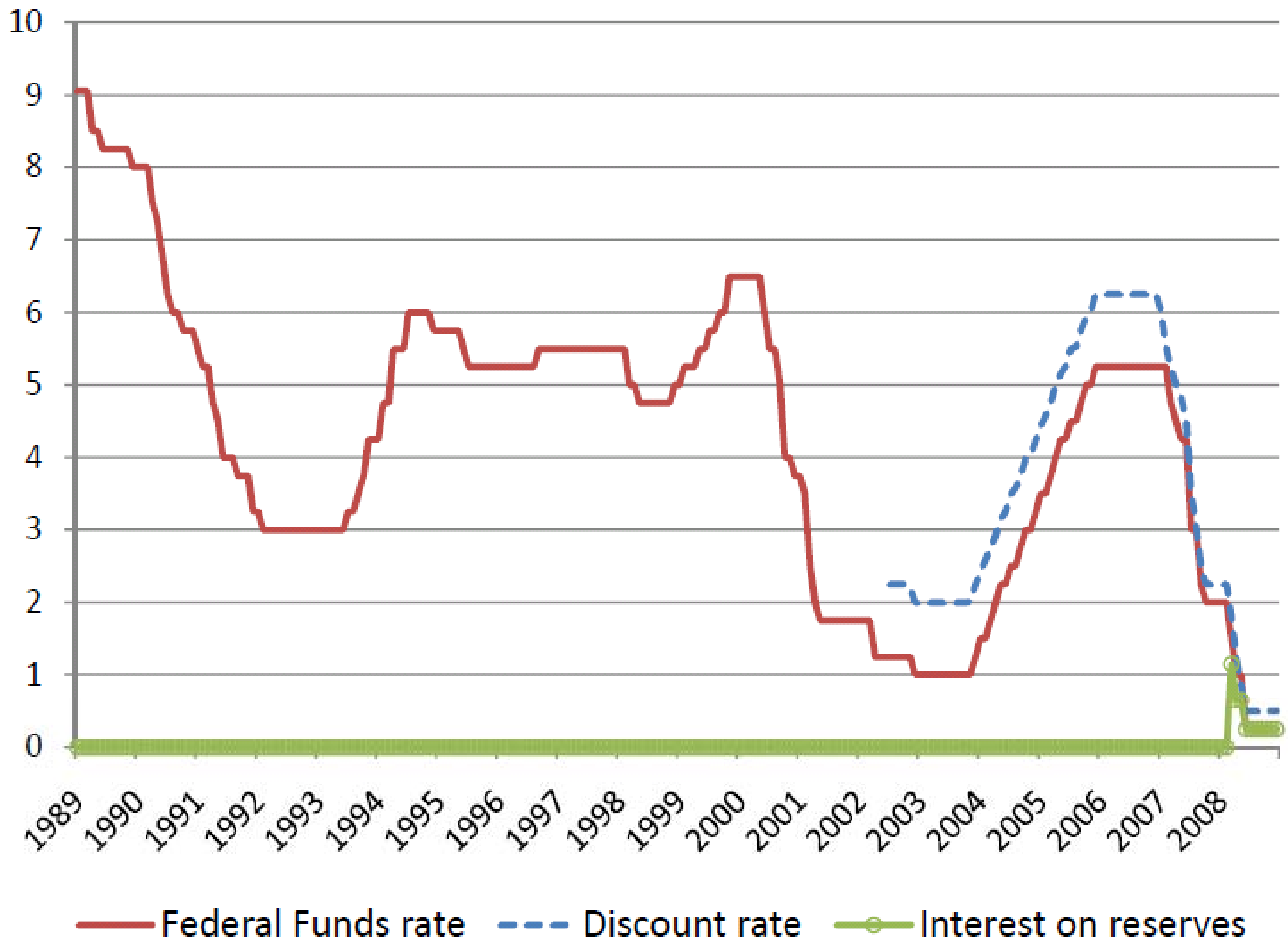
Extraordinary times: interest rates

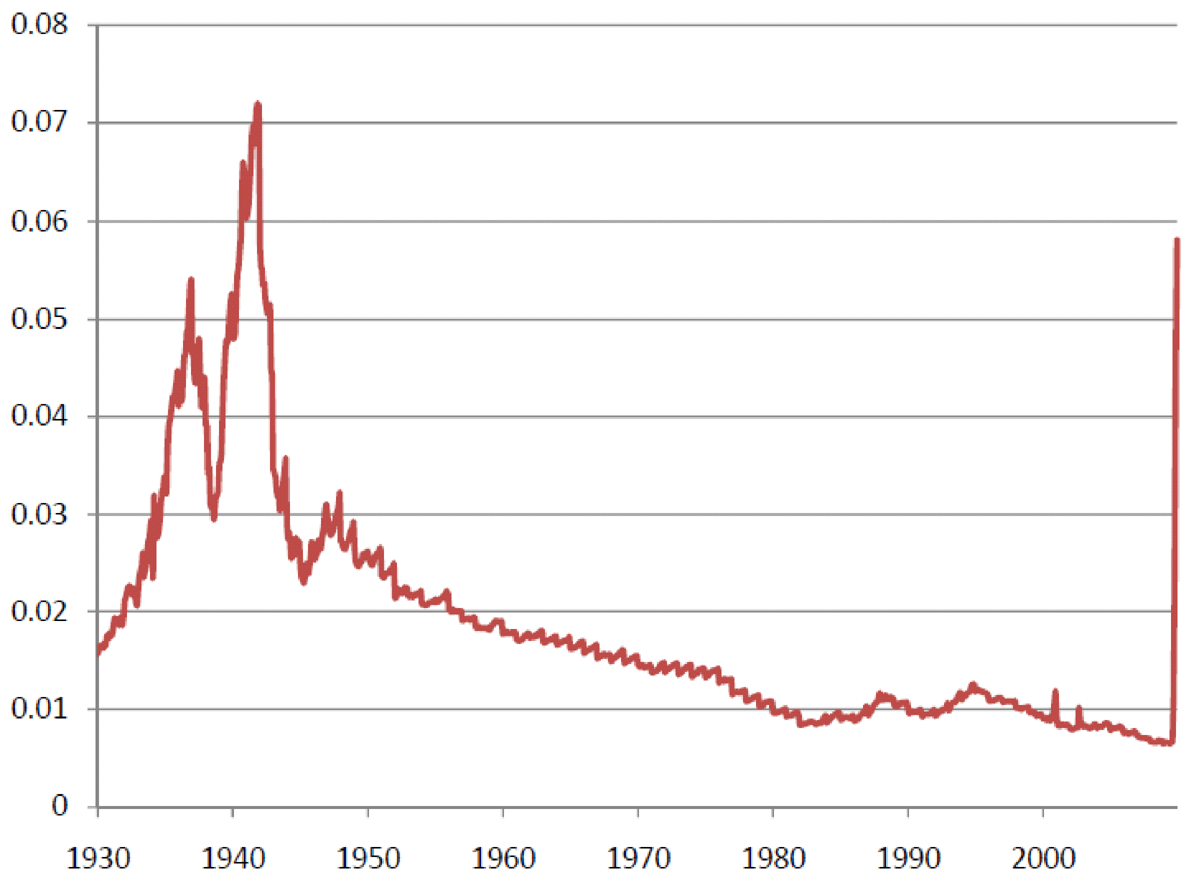
Figure 1. Interest rates controlled by the Federal Reserve, 1989:8-2009:8



Extraordinary times: reserves

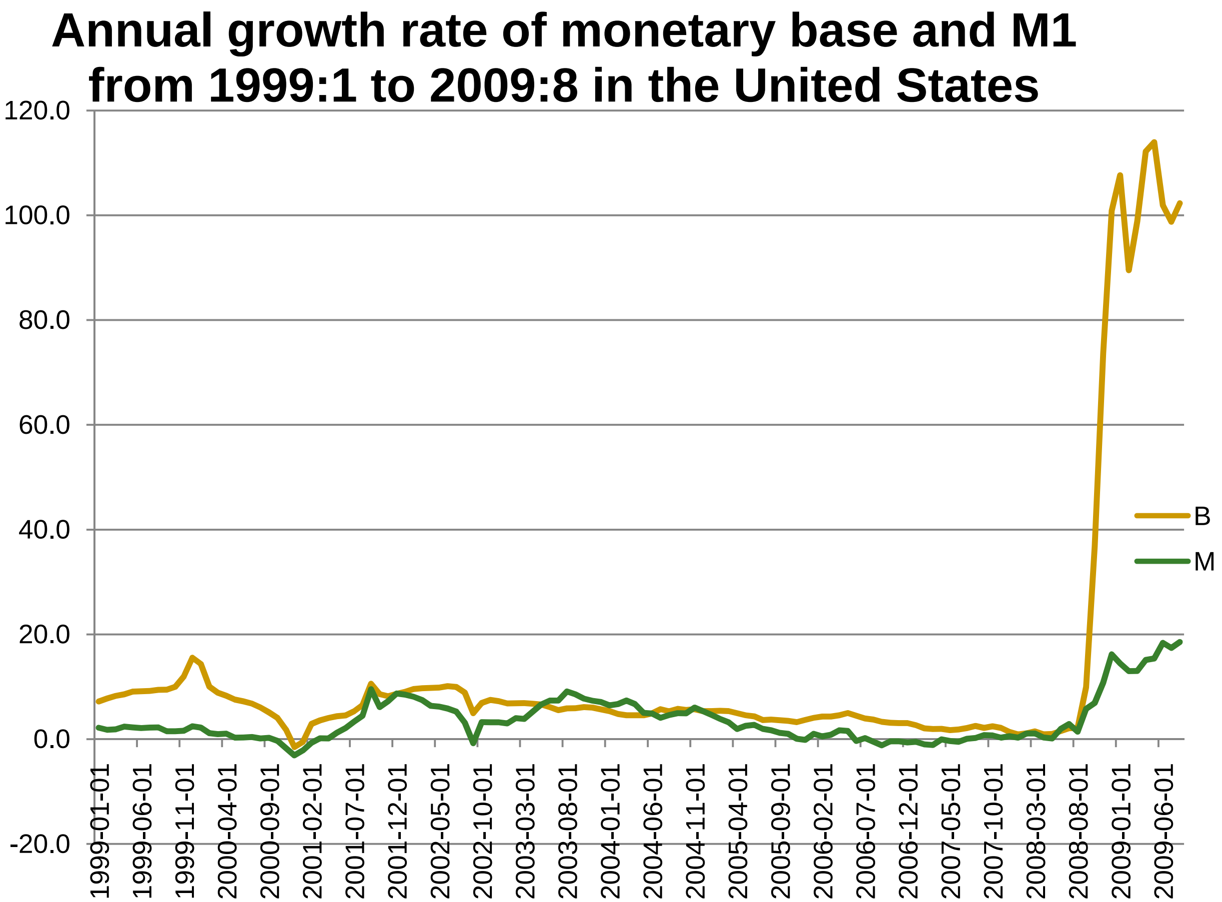
Size of balance sheet: 01/07 ($879bn) vs. 08/09 ($2064bn)

Figure 2. Adjusted reserves divided by annual U.S. GDP, 1929-2009



Extraordinary times: money

Money multiplier has collapsed



Extraordinary times: Fed's credit

Traditionally, Fed almost exclusively buys/sell Treasury securities in exchange for bank reserves. Now:

- TAF – credit auction to banks for 28, 84 days
- TSLF (28d) and PDCF (overnight) – primary dealers
- TALF – lend against collateral provided by ABSs on student, auto, credit card, and SBE loans.
- AMLF and MMIFF – Credit to money market funds.
- CPFF – Credit to firms directly by buying commercial paper as a backstop provider
- Purchase of mortgage-backed securities.
- Maiden Lane – taking in Bear Sterns and AIG assets

Extraordinary times: Fed's assets

Fed's assets January 07

Assets	
Securities held outright	
U.S. Treasury bills	277.2
U.S. Treasury notes and bonds	501.7
Agency Debt	0
Repurchase Agreements	39.8
Direct Loans	1.3
Gold	11.0
Foreign reserves	20.5
Other Assets	27.0
Total Assets	*878.5*

Fed's assets August 09

Assets	
Securities held outright	
U.S. Treasury bills	18.4
U.S. Treasury notes and bonds	717.7
Agency debt	111.8
Repurchase Agreements	0
Direct Loans	106.3
Gold	11.0
Foreign reserves and other assets	76.7
New asset categories	
Term Auction Facility (TAF)	221.1
Commercial Paper FF	53.7
Maiden Lane	61.7
Mortgage-backed securities	609.5
Central Bank liquidity swaps	69.1
Total Assets	*2063.8*

First question: what are the dangers of the current situation?

- Inflation?
  - Monetarist nightmare
  - But (i) inflation today and expectations of it in future are low, (ii) will raise interest rates, (iii) once pay interest on reserves, naïve monetarism out the window.
- Employment?
  - Because of zero-lower bound on nominal interest rates, perhaps real interest rates are too high.
  - But, doing everything it can.
- Political
  - Captured by Congress if need funds.
  - Captured by financial market participants.

Second question: can the Fed get back?

- Monetary base
  - Easy by conventional open-market operations
- Credit programs
  - Let them expire
- Maturity of Treasury securities
  - Sell bonds and buy bills

- Mortgage-backed securities ($610bn)
  - More difficult, as big stakes and political pressure
- Maiden Lane ($62bn)
  - Hope…

Third question: should it go back?

- Credit programs
  - No reason to maintain
  - Dangerous direct interference with financial markets

- Interest rates
  - Eagerness to raise can be dangerous
  - Recession of 1937-38, and Japan’s lost decade

- Monetary base and interest on reserves
  - Should not be reversed
  - Optimal to satiate society with liquidity
  - Accomplished by federal funds rate equal to rate on reserves
  - Reserves and monetary base are whatever market wants