

What More Could the Fed Do?

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A slowing recovery and falling inflation have analysts questioning the need for more stimulus to reduce unemployment and prevent deflation. That's a big shift from a few months ago when the debate centred on when and how to tighten policy. Even a self-described inflation hawk, St. Louis Fed President Bullard, has warned that the country risks becoming "enmeshed in a Japanese-style deflationary outcome". With fiscal policy largely corralled by ballooning debts and congressional partisanship, the onus is clearly on the Fed to do more if necessary. Although we don't expect a shift in policy at the August 10 meeting, the risks are likely to increase in coming months.

The Fed has already taken unprecedented action in the past three years to support the economy. It has reduced short-term rates five percentage points to virtually zero, and

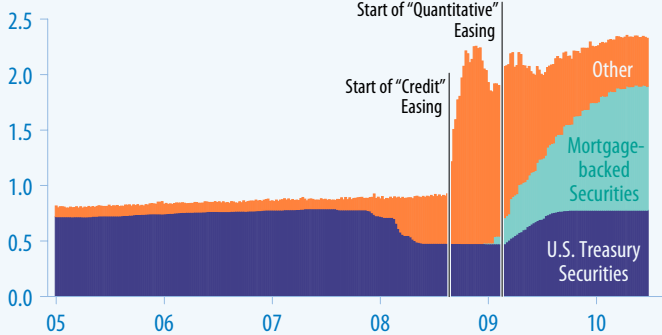
bought \$1.75 trillion in long-dated securities to further reduce long-term interest rates (Chart 1). The asset purchases began in early 2009 and ended in March 2010, and research at the New York Fed suggests they may have reduced 10-year Treasury yields by as much as 50 basis points, and mortgage rates by even more. Credit easing and asset purchases have created over \$1 trillion in excess bank reserves, compared with about \$10 billion in normal times (Chart 2, left panel). Although the excess reserves are largely sitting idle in bank accounts at the Fed, there's a lot of potential monetary fuel to ignite business and personal credit growth once the lending taps reopen.

Up front, we don't believe the Fed will ease further, though it probably should. Given an outlook for sustained growth of 2% or higher, unemployment will likely decline (albeit slowly) and inflation should stay positive (barely). In his recent congressional testimony, Chairman Bernanke downplayed the need for more stimulus. In addition, the June policy meeting minutes said the committee would "consider whether further policy stimulus might become appropriate if the outlook were to worsen appreciably." The qualifier "appreciably" implies a fairly high bar for new stimulus. Moreover, although they are a vanishing breed these days, a few *uber*-hawks on the Federal Open Market Committee might strongly resist new stimulus measures until they see the whites of deflation's eyes, although they will face stiff resistance from likely incoming vice-chair Janet Yellen.

CHART 1
START THE PRESSES

Federal Reserve (\$ trlns)

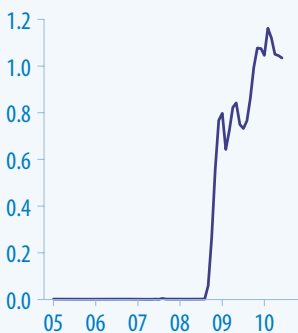
Assets



Source: Federal Reserve

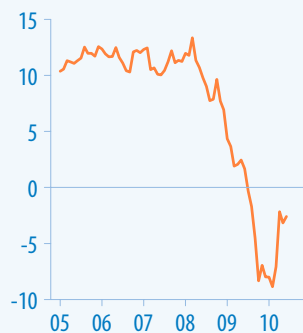
CHART 2
NO VELOCITY

Bank Excess Reserves
(\$ trlns)



Source: Federal Reserve

Commercial Bank Credit
(y/y % chng)



Still, Bernanke, a student of the Great Depression, remains alert to deflation risks, and is “*prepared to take further policy actions*” if conditions warrant. A sustained slowing in GDP growth to below 2½% would likely raise the unemployment rate, warranting more action. With the economic risks skewed to the downside—given the fragile housing market, ongoing financial deleveraging, and waning fiscal support—the odds of further stimulus might be close to 40%.

In the Q&A session of his congressional testimony, the Chairman outlined several options to provide more monetary juice. In essence, the Fed could:

- **Commit to low rates for a longer and more explicit time period than suggested by the vague “extended period” phrase** (which has been in place since March 2009). The announcement would reduce medium- and longer-term interest rates, given subdued inflation expectations. Whether lower rates would meaningfully stimulate demand is another question. On the contrary, Bullard fears the Fed’s low-rate pledge might be counter-productive, since borrowers have less incentive to act when rates are expected to remain low for a long time.
- **Reduce the rate it pays on bank deposits held at the Fed from 0.25% to zero.** This might encourage banks to lend excess reserves to businesses and households. However, if credit demand remains weak and credit standards tight, eliminating the rate on bank reserves probably wouldn’t revive lending (*Chart 2, right panel*). In fact, by pressuring the fed funds rate towards zero, it could disrupt the orderly functioning of money markets. Banks would have no incentive to lend excess reserves to other banks in the overnight market, and money market mutual funds wouldn’t earn enough interest to cover fees, forcing some out of business.
- **Reinvest the proceeds of maturing mortgages and bonds to prevent the Fed’s \$2.3 trillion balance sheet from shrinking.** This option would pump about \$200 billion into the economy by 2011, pocket change really, though it would at least prevent a de facto tightening in policy and signal the Fed’s readiness to do more if necessary. The Wall Street Journal said this option is up for consideration at the August 10 meeting.
- **Buy more Treasuries and mortgage-backed securities.** The Fed would likely lean towards the former purchase given its long-term goal of holding Treasuries rather than mortgages (it currently holds more of the latter: \$1.12 trillion in MBS versus \$0.78 trillion in Treasuries). Buying MBS (or Treasuries) would reduce mortgage rates further below recent record lows, potentially spurring a new wave of re-financings and supporting the still-weak housing market. The Fed could also purchase other types of assets, like municipal bonds, but this might complicate the unwinding process.

CHART 3
SHOW ME THE MONEY

United States (y/y % chng)

M2 Money Supply



If all else fails in achieving a self-sustained recovery that drives down unemployment, the Fed can mint new money and issue cheques to households. This is the ultimate deflation buster, since it virtually guarantees that too much money will chase too few goods, a sure-fire recipe to cook up inflation. To discourage saving, the Fed could include a “gift certificate” proviso that compels consumers to spend the cheques on goods and services (instead of financial assets) before an expiry date. With money growth slowing dramatically, this might be an option the Fed would seriously consider if disinflationary expectations take root (*Chart 3*).

A less dramatic stimulus option, though one that is unlikely to emerge given the government’s aversion to foreign exchange intervention, is to buy major currencies

with the intention of weakening the U.S. dollar (as adopted in Switzerland). This would slow U.S. imports, which have shaved a hefty 2.2 percentage points from GDP growth in the past year (limiting the economy’s expansion to 3.2%). However, the long-run efficacy of foreign exchange intervention is questionable.

With interest rates already so low, the economic payoff from additional quantitative easing is unlikely to equal that of earlier measures, and would come with its own set of risks. While the Fed can always cure deflation by printing more money, forestalling a recession is a harder trick to pull off. The deleveraging headwinds might simply be too strong for monetary stimulus to gain much traction. Tight credit standards, mounting foreclosures and the psychological scar of falling home prices will continue to hamper the housing recovery for some time, regardless of how low mortgage rates go.

The main drawback of providing fresh stimulus is that it risks sowing the seeds of future inflation, which could lead to aggressive rate hikes and another recession down the road. Purchasing more Treasury bonds risks fanning debt monetization fears and destabilizing credit markets. The Fed doesn’t have a lot of practice with unconventional policy measures, and unwinding the stimulus could prove problematic. But that’s a battle it will need to fight some other day, after it wins the current war on unemployment.

Bottom line: The Fed still has a few arrows left in its policy quiver, and will not hesitate to use them if the recovery stalls. **Although we don’t expect more quantitative easing, the fact that it is even an option suggests the federal funds rate will remain low for some time, likely until August 2011.** If more stimulus is implemented, look for bond, gold and commodity prices to rally, and the dollar to weaken, as was the case following the initial round of quantitative easing. However, equities may not rally much this time, given concerns that most of the stimulus arrows are merely bouncing off the deleveraging dragon.

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