



# Market Analysis, Research & Education

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## The Fed Wages An Unconventional Battle

### *Aggressive Moves Designed to Counter Crisis*

By Dirk Hofschire

During economic downturns, banks and other lenders typically tighten credit standards and cut back on lending, which serves to reinforce economic weakness. To counter-act this pro-cyclical trend, the Federal Reserve (Fed) normally cuts its policy interest rate (the federal funds rate). In typical recessions, banks and other lending institutions normally drop their interest rates as well, which eventually lowers borrowing costs sufficiently to spur new lending and sow the seeds of economic recovery.

During the past year, the Fed slashed its target federal funds rate, but the lower fed funds rate has not resulted in cheaper borrowing costs due to the severe crisis in the credit markets (see November 11 MARE article, "U.S. Credit Market Update: Is the Financial Crisis Abating?"). With its target rate now at a range of 0-to-0.25%, the Fed effectively has run out of room to lower its policy interest rate. However, the target federal funds rate has not been the most important aspect of monetary policy for the past year, and its importance has dwindled during the fall of 2008 when the Fed essentially shifted the bulk of its focus to an unprecedented expansion of unconventional monetary actions.

#### KEY TAKEAWAYS

- With the impact of conventional rate-cutting muted and its policy rate approaching zero, the Federal Reserve has moved on to extraordinary unconventional monetary actions to boost the financial markets and the economy.
- Though the Fed's out-of-the-ordinary activities had already reached an unprecedented level, developments toward the end of 2008 signaled the beginning of an even more aggressive phase.
- For example, the Fed plans to purchase hundreds of billions of dollars of mortgage-backed and other securities, aimed at directly lowering borrowing costs.
- The Fed appears determined to fill the lending void and prevent a deflationary spiral, and it possesses near-unlimited resources.
- While these policies represent a risk of inflation down the road, they currently offer a massive counter-weight to the negative forces affecting the credit markets and economy.

#### Unconventional policy at the forefront

Since the end of 2007, the Fed has taken a number of actions that are "unconventional" in the sense that they go beyond simply lowering its policy interest rate for bank borrowing. At first, the Fed created a number of new lending facilities targeted at injecting liquidity into the financial system. Compared to traditional Fed lending through its discount window, the facilities generally aimed to broaden access (by type and number of borrowers), accept a broader range (lower quality) of asset collateral, and extend loan maturities. With the financial crisis simmering to a new boil in September 2008, the Fed added a series of new programs, lending facilities and extraordinary activities. These included programs to provide support to other short-term lending markets, including money markets and commercial paper. The Fed also was involved in several rescue operations to avert the collapse of large financial institutions, including Bear Stearns, AIG and Citigroup. All of these operations were generally intended to bolster lending institutions in an effort to keep the financial system from collapsing, in addition to filling the void in lending by providing credit more directly to the private sector.

In November, the Fed sent clear signals that it had taken its gloves completely off in its battle against this ongoing crisis, with the announcement of two new programs that represented an even more direct commitment to its unconventional response effort. First, the Fed created the Term Asset-Backed Securities Loan Facility (TALF), which is designed to purchase \$200 billion of asset-backed securities such as auto, student and small business loans. Second, the Fed announced it will purchase \$600 billion of mortgage-backed securities and debt of housing-related government sponsored enterprises. Fed officials have intimated there may be much more to come, including the possibility of purchasing other types of assets, such as long-term Treasury bonds. "The Federal Reserve will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability," the Fed stated in a release on December 16, after slashing its target fed funds rate to a historically low range of 0-to-0.25%.

In effect, the Fed is now flooding the financial system with money in an effort to drive down borrowing rates for homeowners, consumers and businesses. When the Fed buys assets (such as mortgage-backed securities), it pays with cash, in essence bringing securities onto its balance sheet while pumping money out into the economy. The massive increase in Fed loans has made banking reserves swell. In a typical environment, the Fed might offset this money increase with open-market operations to remove excess liquidity. Instead, the Fed currently is allowing banking reserves to expand beyond what is required

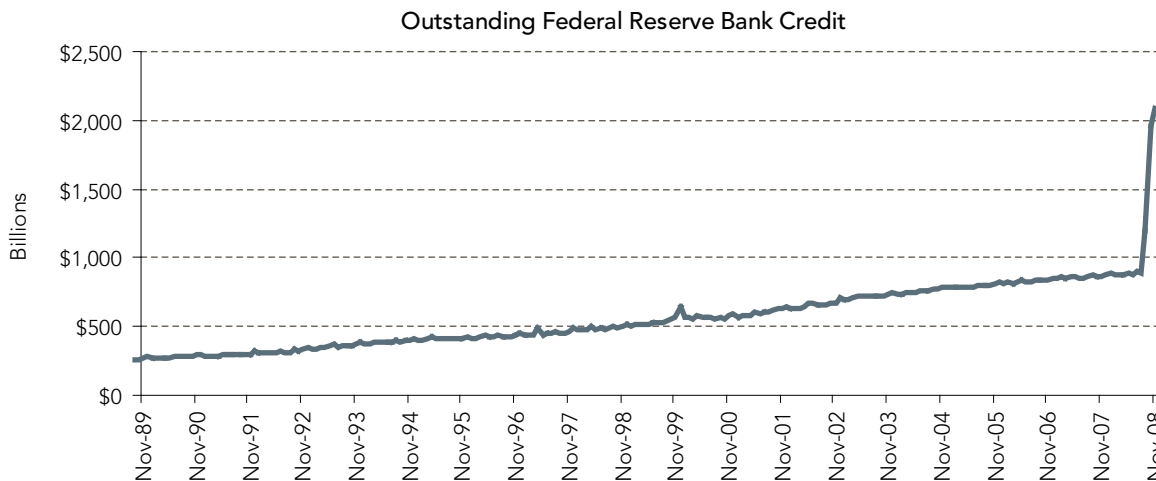
to maintain its policy rate so that it can finance more lending and asset purchases. The impact is illustrated in Exhibit 1, which shows how the Fed doubled the credit it provides to the financial system to more than \$2 trillion in just two months (from the end of September 2008 to the end of November 2008).

Due to these unprecedented actions, the conventional federal funds rate has been relegated to relative unimportance in the Fed's overall monetary policy efforts. In fact, the effective federal funds rate (or the actual rate at which banks lend their federal reserve balances to each other), has been well below the Fed's target since September, which underscores how unconventional policies have become dominant (see Exhibit 2, page 3). Not only is the target federal funds rate not the most important aspect of monetary policy, it has not even been the real-world rate experienced in the federal funds market.

**Objective: Fight prolonged deflation**

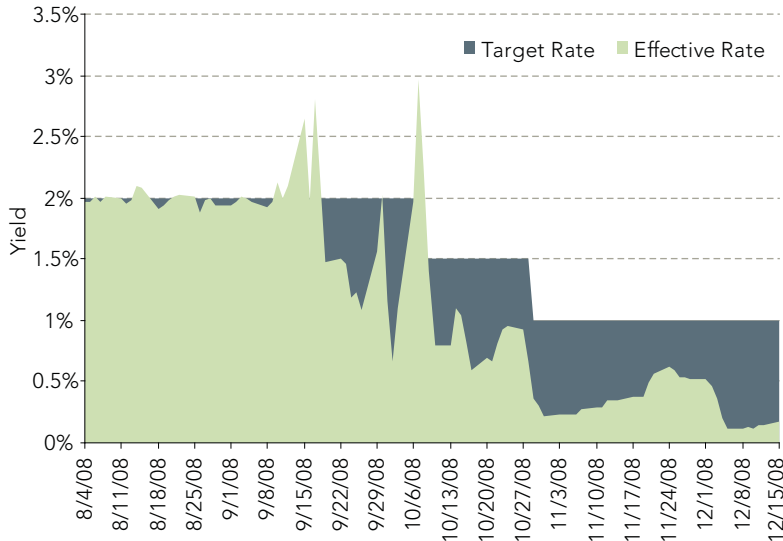
The latest evolution in the Fed's policy response has moved from the unconventional into all-out quantitative easing, meaning the expansion of the money supply beyond what is necessary to achieve a target policy rate. In essence, it means the kitchen sink is now being thrown at the problem. The goal is to counter-act the current vicious cycle of asset deflation (decline in asset value), which has caused a contraction in lending, has led to economic contraction, and appears to be spawning broad-based price deflation. During the U.S. in the 1930s and Japan in the 1990s, this cycle fed upon itself and resulted in

**EXHIBIT 1:**  
The amount of credit the Fed provides to the U.S. financial system has exploded during the past two months.



Source: Federal Reserve Board, Haver Analytics, FMRCo (MARE) as of 11/30/2008.

**EXHIBIT 2: Even before the Fed cut its target rate to near 0% on December 16, the actual (effective) fed funds rate was much lower than the official level.**



Source: Federal Reserve Board, Haver Analytics, FMRCo (MARE) as of 12/12/2008.

broadly deflationary economies that did not respond to conventional interest rate changes. The lessons drawn from those crises by economists such as Fed Chairman Ben Bernanke, is that monetary policy must become extremely aggressive during periods of massive deleveraging and deflationary pressures. So the Fed has expanded its balance sheet to more than \$2 trillion and shows no signs of slowing down, mostly because there are few practical limits on the magnitude of its actions. As Bernanke noted in a speech during a brief deflationary scare in 2002, "...we can take comfort that the logic of the printing press example must assert itself, and sufficient injections of money will ultimately always reverse a deflation."

**Risk: Inflation down the road**

There are, of course, risks to such activities. First, the Fed is increasingly taking credit risk onto its balance sheet. This began in a relatively minor way as the initial lending facilities in early 2008 provided loans that were highly collateralized with high-credit-quality assets. Over time, the credit risk has become much more direct, as the Fed is increasingly on the hook for mortgage-backed and other securities it owns outright, as well as backstopping liabilities for everything from Citigroup's troubled

assets to asset-backed securities purchased by the TALF. In each case, the Fed's exposure is minimized by credit protection funds pledged by the Treasury or other entities, but ultimately whether the Fed makes or loses money on these activities will depend on how much the prices for these securities rise or fall over time. While the Fed has virtually unlimited ability to essentially print money to buy more assets, any losses on asset purchases would result in less money being returned to taxpayers through its regular transfers to the Treasury Department.

Second, and more critical for the economic outlook, is that massive increases in the money supply have the potential to translate into high price inflation in the future. The reason this is not happening now is that the velocity of money—how quickly and often money exchanges hands in the economy—has plummeted. There is more cash in the financial system, but by and large it is being hoarded by banks, not lent out to borrowers. When the credit environment eventually settles down, financial institutions resume lending, and velocity picks up, there will be an abundance of money relative to the amount needed for economic growth. This will make it critical for the Federal Reserve to recognize the eventual stabilization of the markets and to respond quickly by withdrawing excess liquidity, otherwise the surplus money is likely to generate higher inflation.

**Investment implications**

If the Federal Reserve is unable to resuscitate credit markets and reflate the U.S. economy, it will not be for lack of trying. Great Depression scholar Ben Bernanke, lampooned as "Helicopter Ben" after alluding to a hypothetical helicopter drop of money to fight deflation in 2002, is steadily working through his playbook of how to use monetary policy to ensure a gripping period of deflation does not become a decade-long economic catastrophe. The Fed is clearly in uncharted waters, and only time will tell how effective it is in mitigating the credit and inflation risks that have accompanied its unprecedented policy actions. However, the cost of doing nothing in the face of this deflationary economic environment probably justifies such risks. The timing of how long it takes these actions to stem the credit crisis is difficult to determine, as all monetary policy operates with a lag. But investors may do well to note that with its clear determination and few practical restraints on its policy response, the Fed's ultimate success is probably not a question of "if" but "when." ■

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