

Reaction to Fed Policies: Sharp Inflation or Price Stability?

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The massive size of the Federal Reserve’s programs designed to stabilize the capital markets has fueled speculation that there could be an ensuing surge in inflation. While gradual price increases may be inevitable as the economic recovery gains traction, the central bank possesses the conviction and the tools to achieve its mandate of maintaining price stability.

LORD ABBETT, November 2009—If there were a law of physics that applied to the events of the financial crisis, it could be that “for every action, there is an equal and opposite reaction.” Newton’s law describes how the severity of the financial crisis prompted an unprecedented monetary policy response, which could precede either an aggressive unwinding process by the Federal Reserve or an eventual spike in inflation.

Given the trillions of dollars that the Fed has printed as part of its liquidity programs, the anticipation for an “equal and opposite reaction” appears to be the basis for those who are expecting a surge in inflation. The central bank remains an integral part of the equation, however, and it has increasingly demonstrated the influence it could wield on the direction of future prices.

The Fed may, therefore, have more control over inflation than some investors fear, based on the design and termination of the programs, the array of tools at its disposal, and the muted expectations for an economic recovery.

THE ROLL-OFF EFFECT

Fluctuations in the supply of money are important factors for those measuring the prospects for future inflation, and, historically, the faster the growth in supply, the greater the chances for a sharp increase in prices.

As one would expect, the M2 measure of money supply accelerated during the financial crisis, up 8.7% between August 2008 and its recent peak in June 2009. The rate of increase appears to be limited, however. The size of the money supply appears to have stabilized. Over the past six months, M2 has grown by only 0.8%, and since its June peak it has contracted

by nearly 1% as of August 2009 (see Chart 1). The picture is similar with the narrower M1 gauge of money supply.¹

The recent ballooning in the size of the Fed’s balance sheet also may be considered a proxy for the huge amount of liquidity that has been made available. Its growth pattern mirrors that of the money supply. The Fed’s alphabet soup of programs (TALF, TSLF, TAF, etc.) helped expand the amount of assets held on its balance sheet, which more than doubled in size from September 2008 to January 2009.

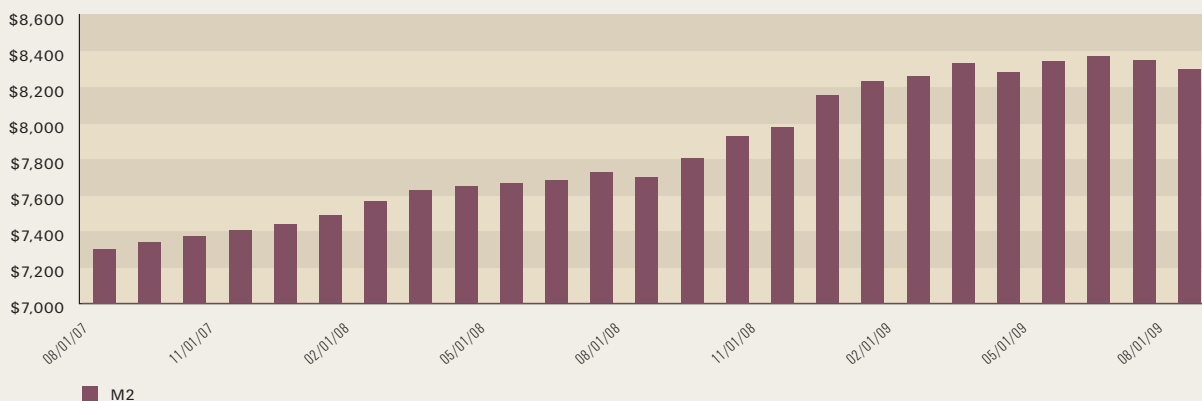
Since then, however, some programs have already been scaled back, or are no longer needed, and that trend has reduced the balance-sheet assets from \$2.27 trillion at the start of the year to \$2.14 trillion as of September 30, 2009.² Such a decline is not a declaration of victory in the liquidity management process but is more indicative that the directional shift is already under way.

Further analysis of the Fed’s balance sheet reveals that it may not take a major catalyst to initiate a significant contraction, since about a quarter of the assets that it is holding have short-term maturities. For example, of the \$2.04 trillion in term auction loans, securities, and other loans on the Fed’s balance sheet (as of September 30, 2009), about 20% had maturities within 90 days and 24% had maturities of less than one year.³ As more of these assets roll off its books, the contraction of the Fed’s balance sheet should accelerate.

While potential borrowers could return for more of these short-term loans, the Fed has also been gradually reducing the size of these programs as conditions in the credit markets have improved (see Chart 2). For example, at the height of its Term Auction Facility in early February 2009, the Fed granted

Chart 1. Expansion of Money Supply During Crisis

M2 (\$ in billions)



Source: Federal Reserve.

This chart is for illustrative purposes only and does not represent the performance of any Lord Abbett fund or product, or any investment.

\$142.4 billion (out of \$150 billion available) in 28-day loans to depository institutions. The Fed subsequently reduced the size of the 28-day auctions to \$75 billion, and only \$55.8 billion in loans were distributed at the auction on September 21.⁴ The total amount of outstanding loans on the Fed’s balance sheet, including credit extended through the Term Auction Facility, totaled \$288 billion as of September 30, down from \$556 billion in mid-February 2009.

Other programs that have recently seen little use by participants—and could potentially be discontinued with minimal market disruption—include those involving primary dealers, commercial paper, asset-backed commercial paper, and securities lending. The Fed stated in June that these programs are set to expire, unless further extensions are made, on February 1, 2010.⁵

The Term Asset-Backed Securities Lending Facility (TALF), which is designed to support the asset-backed securities market, has a staggered completion date of March 31, 2010, for asset-backed securities and June 30, 2010, for commercial mortgage-backed securities. Recent declines in participation suggest little need for the continuation of the asset-backed program, and its loans of one to three years will gradually mature, further reducing the need for Fed-provided liquidity.

“CREDIT EASING” ADDS LONG-TERM ASSETS

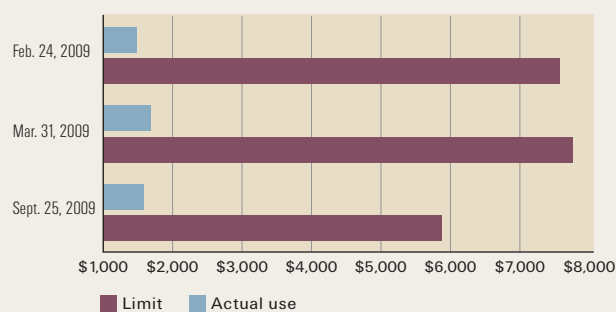
Some of the central bank’s more controversial programs have involved the buying of long-term assets, which make up nearly three-quarters of the holdings on its balance sheet. By purchasing the debt of government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, mortgage-backed securities (MBS) guaranteed by the GSEs, and U.S. Treasuries,

the Federal Reserve—rather than market forces—has been a significant factor in keeping several key interest rates near historically low levels.

Interest rates on long-term Treasury securities could have been higher and more volatile were it not for the Fed’s program to buy up to \$300 billion of longer-dated U.S. Treasuries. That initiative, however, is dwarfed by the Fed’s \$1.25 trillion agency MBS program, which is designed to improve the availability of mortgages and support the ailing housing market. A third program provided similar support

Chart 2. Limits and Actual Use of Fed Programs

(\$ in billions)



Source: Bloomberg Financial Markets.

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to the agency bond market through the purchase of \$200 billion of direct GSE debt.

As it implemented these aforementioned programs, which Fed chairman Ben Bernanke has deemed to be part of a “credit easing” initiative, about 41% of the Fed’s balance sheet eventually consisted of assets with maturities of 10 years or longer (as of late September 2009).⁶ All of these initiatives are approaching their completion, however. The Treasury purchase program ended at the end of October, while the MBS and GSE debt programs are scheduled to be completed by the end of the first quarter of 2010.

PLAN IS IN PLACE

While the purchases of long-term assets have played a significant role in the recent expansion of the Fed’s balance sheet, we also can expect these securities to become part of the central bank’s strategy to absorb excess liquidity once it sees the need to start tightening monetary policy.

Just as the Fed took a multi-pronged approach to dealing with the financial crisis, unwinding the effects of its programs may involve multiple, less-conventional methods that complement the standard adjustments to the fed funds target. “The exit strategy is closely tied to the management of the Federal Reserve balance sheet,” Bernanke wrote in a letter to *The Wall Street Journal*. “When the time comes to tighten monetary policy, we must either eliminate these large reserve balances or, if they remain, neutralize any potential undesired effects on the economy.”⁷

One potential step involves the Fed’s sale of long-term Treasuries, agency bonds, and agency MBS into the open market.⁸ The central bank purchased those securities by creating additional reserves, which then made their way into the open market when it bought the securities. Conversely, the Fed can absorb some of the money that it had previously made available when it sells those assets.

In a second option set forth by Bernanke, the Fed could receive short-term loans from money market funds that may be collateralized by the long-term securities held on its balance sheet. With money market funds holding about \$2.5 trillion in assets, they could conceivably conduct up to \$500 billion of “reverse repurchase” transactions with the central bank.⁹

The Fed’s recently received ability to pay interest on the bank reserves it holds is a third tool that Bernanke and other Fed members have featured in their remarks regarding an exit strategy. If the Fed pays interest on reserves, banks will be enticed to keep their money at the central bank—similar to a risk-free loan that earns interest—rather than lend those reserves out to other banks or throughout the broader economy, which would involve credit risk. By adjusting the interest rate it pays on reserves, the Fed can

influence the banks’ use of those reserves, the resulting changes to the money supply, and, implicitly, the potential rate of inflation.

CREDIBILITY KEY

As the grip of one of the worst recessions in history appears to be weakening, several central bankers worldwide—along with many other market participants—have indicated their expectations for tepid economic growth once expansion resumes. Amid these widespread expectations, the Fed may feel less pressure to provide the fuel for further economic growth, leaving it instead with the flexibility needed to potentially eliminate a sharp uptick in prices.

Amid this flexibility, the “equal and opposite reaction” to the Fed’s unprecedented easing of monetary policy will likely be an aggressive process of absorbing any excess liquidity. In addition to Chairman Bernanke providing the technical details of the Fed’s exit strategy, other key members of the Fed have increased the rhetoric about how forceful the unwinding process could become.

The combination of providing details about its exit strategy while acknowledging the importance of keeping inflation low are key components in maintaining the Fed’s credibility as an institution capable of controlling inflation. These comments also may increase the transparency of the Fed’s policies as it gradually embarks on additional stages of its exit strategy.

“If ‘whatever it takes’ was appropriate to arrest the panic, the refrain might turn out to be equally necessary at a stage during the recovery to ensure the Federal Reserve’s institutional credibility,” wrote Kevin Warsh, a voting member of the Federal Reserve Open Market Committee, in a September 25, 2009, opinion letter to *The Wall Street Journal*.¹⁰

Should the Fed’s credibility in controlling inflation become compromised by its own actions, such an outcome could lead to anticipation about higher inflation rates in the future. If a surge in future prices is expected, current prices may be raised in anticipation of that increase, thus starting a process that could develop into a severe inflationary cycle.

The risks of allowing a reinforcing cycle of inflation to develop are substantial and could threaten the viability of an economic recovery, which is why it is positive that the Fed has already started to withdraw its massive monetary stimulus in a process likely to accelerate from here, yet still allow for a gradual economic recovery.

“My experience tells me that we will need to remove our very accommodative policy sooner rather than later,” said Thomas Hoenig, president of the Kansas City Federal Reserve. “Even if we were to start immediately, much time would pass before incremental increases could be considered tight or even neutral policy.”¹¹

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Mr. Brown, who has more than 30 years of experience in the financial services industry, joined Lord Abbett in 1992 as an Investment Team Leader, and became a Partner in 1996. During his tenure at Lord Abbett, he has been actively involved in the management of various fixed-income and balanced portfolios. He has spent most of the past decade as Director of Fixed Income.

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¹ M2 consists of M1 (currency in the hands of the public, travelers' checks, demand deposits, and other deposits against which checks can be written) as well as retail money market funds, savings accounts, and time deposits of under \$100,000.

² Federal Reserve release H.4.1, September 24, 2009, table 9. TALF stands for Term Asset-Backed Securities Loan Facility; TSLF stands for Term Securities Lending Facility; and TAF stands for Term Auction Facility.

³ Federal Reserve release H.4.1, September 24, 2009, table 2.

⁴ Results of auctions under the Term Auction Facility at www.federalreserve.gov.

⁵ "Federal Reserve Announces Extensions of and Modifications to a Number of Its Liquidity Programs," New York Federal Reserve, June 25, 2009.

⁶ "The Federal Reserve's Balance Sheet: An Update," Federal Reserve Website, October 8, 2009. As defined in the update, credit easing is tied to the asset side of the Fed's balance sheet rather than the liability side. Quantitative easing relates to the liability side and is associated with gradual growth of the balance sheet.

⁷ Ben Bernanke, "The Fed's Exit Strategy," *The Wall Street Journal*, July 21, 2009.

⁸ *Ibid.*

⁹ Krishna Guha and Michael Mackenzie, "Fed Eyes Tie-up With Mutual Funds," *Financial Times*, September 23, 2009.

¹⁰ Kevin Warsh, "The Fed's Job Is Only Half Over," *The Wall Street Journal*, September 25, 2009.

¹¹ Thomas M. Hoenig, "Regulatory Reform and the Economy: We Can Do Better," Kansas City Federal Reserve, October 6, 2009.

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