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# **“The Lack of a Fed Exit Strategy”**

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While the Federal Reserve has all of the necessary tools to tighten monetary policy, it lacks an actual plan that discusses to the timing of and manner in which the tools will be utilized to withdraw its policy accommodation. The Fed has shown its willingness to aggressively ease monetary policy, even before signs of an actual downturn, as it demonstrated in 2001 and 2007. The Fed has also demonstrated that it will maintain an accommodative policy, despite signs of economic improvement or deterioration in inflation, as witnessed in 2003 and 2008. This asymmetric approach to monetary policy has made the domestic and global economies more unstable, as the Fed pursued policies that spawned the housing, debt-market and commodities ‘bubbles’ that burst in 2007 and 2008, and caused a weakening of the dollar, a large increase in inflation and losses in the value of global financial assets. It is this history and the lack of easy options from which to choose to withdraw this unprecedented monetary accommodation that leads us to conclude that the domestic economy will face a substantial increase in inflation.

Chairman Ben Bernanke, in an op-ed piece in the Wall Street Journal entitled “The Fed’s Exit Strategy”, listed the tools available to tighten monetary policy. However, Mr. Bernanke provided no information regarding how or when any decision to tighten policy will be made. Although he clearly stated that, despite an improvement in the flow of credit and a softening of the economic impact from the financial crisis, “...an accommodative monetary policy will likely be warranted for an extended period”, the chairman left the following questions unanswered:

- Why must monetary policy remain accommodative, given the signs of improvement in the economy?
- If such an accommodative policy helped to soften the economic impact of the financial crisis, why should we risk a large increase in inflation with such a high-level of excess reserves, given signs that the economy is improving?
- If the expansion of the Fed’s balance sheet was aimed at restarting the flow of credit, shouldn’t tighter credit-spreads warrant a reduction in the level of bank reserves to lessen the risk of a rise in inflation?
- Why is a \$2 trillion Fed balance sheet adequate, in light of the amount of credit in the system created by the TARP, TGLP, the American Recovery and

Reinvestment Act of 2009, the fiscal-year 2010 budget proposal, FDIC-asset guarantees, loans and preferred investment in Fannie Mae, Freddie Mac and AIG?

-What are the measures of growth and inflation that would warrant a tightening or further easing of monetary policy? Do specific levels of the dollar, crude-oil, gold, the slope of the yield-curve and the Treasury Inflation Protected Securities (TIPS) break-even spreads figure into your decision-making?

-Why is the FOMC confident that its monetary tools will allow the “smooth and timely” withdrawal of policy accommodation?

We worry that the lack of detail provided in Mr. Bernanke’s testimony and op-ed piece recognizes that a withdrawal of monetary accommodation would cause significant damage to financial institutions, consumers and the economy. In an attempt to avoid such a downturn, the Fed will need to indefinitely maintain an accommodative monetary policy. However, such a large amount of system-wide credit will generate a troubling increase in inflation that will eventually contract economic activity.

During the past 22 months, the Fed created a variety of new programs, aimed at providing emergency liquidity to the broader financial system. The programs included the following: the Term Auction Facility (TAF), the Primary Dealer Credit Facility, the Asset-Backed Commercial Paper Money-Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility (CPFF), the Money-Market Investor Funding Facility and foreign central-bank swap-lines. The Fed and the Treasury created the Term Asset-Backed Securities Lending Facility (TALF) and the Public Private Investment Partnership (PPIP), in order to provide inexpensive financing for investors to purchase primary and secondary debt securities. The Troubled Asset Relief Program (TARP) was created to provide temporary capital to financial institutions, in order to stabilize the financial system. In addition to its typical methods of injecting capital into the banking system, the Federal Reserve has committed to purchasing \$1.75 trillion in long-dated U.S. Treasury and agency mortgage-backed and unsecured debt. The FDIC has created the Temporary Liquidity Guarantee Program (TGLP) to allow financial institutions to borrow at government-subsidized rates in the capital markets. The government agency has also agreed to guarantee in excess of \$300 billion in Citigroup’s assets. The Treasury has provided capital for Fannie Mae and Freddie Mac that has allowed them to continue to originate less-stringent below-market mortgages. These and other programs and the conduct of monetary policy have added an unprecedented amount of monetary stimulus to the system. We cannot even foresee that the withdrawal of \$2 trillion in bank reserves by the Fed will prevent a significant rise in inflation.

The amount outstanding under the Fed’s emergency lending programs, the majority of which was comprised of the TAF, CPFF and foreign central-bank swap lines, reached \$1.62 trillion on 12/10/08, and has since fallen to \$670 billion as of the week of 7/15/09. These temporary lines of credit contained onerous terms and have contracted as improved conditions have allowed the banks to borrow more cheaply from the capital markets. While the \$700 billion TARP is operational and has made injections of capital into the

banking system, the TALF and the PPIP have been slow to reach expected capacity of \$1-2 trillion. However, the markets are starting to see some increased demand for the loans, as witnessed by the shopping center giant Developers Diversified Realty Corp. preparing to issue the first commercial mortgage-backed security that is eligible for TALF-financing. Although the Fed has extended only \$35 billion in TALF loans, thus far, we would expect that amount to rise, as conditions continue to improve in the capital markets and as the Fed looks to expand the TALF to alternative assets. Although the TALF is scheduled to expire on December 31<sup>st</sup>, we have the expectation that the program will be extended.

We also expect the PPIP to become more attractive to potential investors, as prices in credit-markets rise and the banks' asset carrying values fall. Second-quarter earnings from the banks highlighted the continued challenge of higher credit-costs. Wells Fargo, Bank of America, Citigroup and others reported large write-offs and loan-loss reserves. Although the banking system has raised \$93 billion in fresh capital in the second quarter, the balance sheets remain exposed to further deterioration in credit costs and will be expected to utilize the PPIP to sell troubled assets. We expect the Fed to keep policy accommodative indefinitely, in an attempt to address the deterioration in the credit-quality and available financing for the consumer and commercial borrowers.

The PPIP and TALF facilities are term-loans with up to five-year maturities. How quickly these facilities can grow, which is a function of the improvement of the market conditions, and approach the original expectations of \$1-2 trillion will contribute to the difficulty and the magnitude of a future tightening in policy. Further improvements in the markets and the economy will increase demand for these loans, the velocity of money and increase the need for a significant tightening of policy.

The Fed announced on March 18th its commitment to purchase as much as \$1.45 trillion of U.S. agency mortgage-backed and unsecured debt and \$300 billion of U.S. Treasury securities. Since the announcement, the amount of outright securities held by the Fed has increased from \$492 billion to \$1.32 billion. Although the size of the Federal Reserve's balance sheet has remained fairly constant at slightly more than \$2 trillion, the portion of securities in the portfolio has increased and is expected to continue to grow. There are troubling implications regarding the unwinding of such a monetary easing.

With such a large portfolio, the ultimate sale of securities by the Fed should be conducted over a longer period of time to avoid severe market volatility and dislocations. However, the huge expected new-issuance of Treasury securities during the remainder of the year and the magnitude of rate-declines of U.S. agency mortgage-backed securities driven by the Fed purchases suggest that any sales would significantly raise Treasury and mortgage rates, as it would signal a potential change in policy. Such a large movement in interest-rates would be expected to further damage the home-purchase and the mortgage re-financing markets and the economy by pushing housing prices lower and all borrowing rates higher. The markets experienced such a move in interest rates in early-June, as an improvement in economic activity pushed the yield on the 10-year Treasury to 4.00% on 6/10/09, from 3.47% in 5/29/09. As the Fed allayed fears that monetary policy was

expected to tighten, the yield on the 10-year Treasury fell as low as 3.32%. The ten-year Treasury yield has risen to 3.75%, on renewed signs of strength in the economy.

With U.S. mortgage-backed issuance in the first-half of 2009 totaling \$87.5 billion, the Fed purchased \$526 billion of secondary U.S. agency mortgage-backed securities. The size of the Fed's purchases have not only pushed mortgage-rates to levels that have increased mortgage re-financings, but they have also 'crowded out' private capital-investment in agency mortgage-backed debt by distorting market prices. Any attempt to sell such large holdings into this market would cause a catastrophic dislocation. Moreover, the departure from the market by the Chinese, the financial instability of Fannie Mae and Freddie Mac, the exploding government deficit, stubbornly high foreclosure rates, deteriorating job-market would suggest that this illiquid portfolio would be extremely difficult to sell without a precipitous drop in price and rise in rates. We fear that the Fed is unable to begin to tighten because of the likelihood of significant market dislocations.

The tools which the Fed has utilized to tighten monetary policy include reverse-repurchase agreements and T-bill sales. The Fed has recently received the approval to pay interest on banks' deposits at the Fed. Also, the Fed's purchase of government securities necessitates the future sale of these securities. While we expect that the Fed would be reluctant to sell its holdings of long-dated securities, especially the U.S. agency mortgage-backed debt, because of the potential impact on borrowing rates, the utilization of the other three reserve-draining tools, which are short-term vehicles, would be expected to contribute to heightened volatility in interest-rates and the slope of the yield-curve. While we would expect heightened interest-rate- and yield-curve volatility to have a dampening impact on borrowing, changes in the slope of the yield-curve could provide incentives to borrow in different maturities and offset the goal of the tightening of policy.

The Federal Reserve has a poor track record of managing monetary policy to avoid asset bubbles and inflation. The easy monetary policy of the Greenspan Fed, which began in 1/01, was responsible for the inflationary rise in home prices in the period from 1/01-6/06. The Fed lowered rates to address concerns regarding potential deflation from the bursting of the NASDAQ 'bubble'. Negative real interest-rates, which resulted from the fed-funds rate being below the rate of inflation, provided a debt-market 'subsidy' that encouraged the accumulation of large amounts of consumer, commercial and mortgage debt. While the Fed began to tighten policy in 6/04, its gradual rate-hikes kept policy 'loose' until it reached neutrality in 6/06, two-years later. The Fed allowed the depreciation of the dollar, the inflationary increases in housing, gold and crude-oil prices and a negative real fed-funds rate as gross domestic product reached 7.5% in the third quarter of 2003, as it maintained its policy accommodation much too long.

Chairman Bernanke lowered the fed-funds rate 3.25% between 9/07 and 4/08. The policy contributed to the forming of 'bubbles' in foreign currencies versus the dollar, food and energy prices, which include corn and crude-oil, and gold. The Bernanke Fed left the fed-funds rate at 2.00% into 10/08, as consumer and producer-price inflation reached 5.6% and 9.8% in July 08, respectively. The Fed pursued this easy monetary

policy that not only caused a severe economic contraction and financial meltdown in the U.S., but it also drove the global economy into freefall. In an attempt to address potential deflation, it generated significant inflation in goods and services and large losses in housing and financial assets.

Current consumer and producer-price inflation show troubling trends. Although the headline producer and consumer-price indices are running at negative annual rates of 4.7% and 1.2%, respectively, the core inflation readings, which exclude volatile food and energy prices, are rising at positive rates of 3.4% and 1.7%. Most of the negative year-over-year comparisons are a result of the comparison to much-higher energy prices. Also, the core consumer inflation measure preferred by the Federal Reserve, the personal consumption expenditures price index, is running at 1.8%, which is above the FOMC's central tendency for 2009 and at the high-end for 2010, at a time when economic growth is showing signs of stabilization. As the Fed continues to emphasize that monetary policy will remain accommodative, even as core-inflation measures, commodities prices, interest-rates, TIPs break-even spreads and the dollar flash warning signs, we remain worried that the Fed will follow its pattern of easing monetary policy facilitating the building of asset 'bubbles'.

The fiscal policies of the Obama administration, which include the \$787 billion stimulus package and recent discussions about the need for a second package and health-care legislation, demonstrate their focus on stimulating economic growth. The proposed \$3.55 trillion fiscal-year 2010 budget also demonstrates the spending priority of the administration. In addition, any slowdown in the economy and rise in the financing costs of the Democrats spending plans that are a result of a less accommodative Fed would be met with significant opposition, especially with unemployment at 9.5%.

We expect Federal Reserve policy to remain very accommodative indefinitely. The history of Chairmen Greenspan and Bernanke demonstrate their inability or unwillingness to tighten monetary policy to avoid the creation of asset 'bubbles'. The magnitude of credit and government spending in the system will cause a troubling rise in inflation not only because the Fed will maintain an easy policy, but also because the Fed cannot tighten policy without causing the economic turnaround to fail. We can see the impact from the large amounts of money in the system in the decline in the dollar, the rise in the price of crude oil, the steepening of the Treasury yield-curve, the widening break-even TIPs spreads, the rise in equity prices and the tightening of corporate spreads, since March 5<sup>th</sup>. Although monetary policy remains too accommodative, the withdrawal of the policy will not be able to withdraw the total amount of credit and stimulus in the system.

## **The Team at Veritas Partners**