Daiwa Capital Markets

U.S. FOMC Review

- The Fed: market-friendly changes, but not quite an easing in policy

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The Fed's Focus: Smooth Market Functioning

On both Monday and Wednesday of this week, the Fed took steps to boost the amount of repurchase agreements that it will make available to primary dealers. The combined changes lifted the size of overnight RPs from at least $100 billion to $175 billion and two-week RPs from $20 billion to $45 billion.

Today, the Fed became much more aggressive in its planned use of RPs, introducing both one-month and three-month transactions, with sizes that dwarf those for overnight and two-week operations (three-month RPs today and tomorrow, $500 billion each; a one-month transaction tomorrow totaling $500 billion). In addition, the Fed altered its so-called reserve-management purchases of Treasury securities. The Fed had been buying Treasury bills since October to inject permanent reserves in the banking system. It will now buy the full range of Treasury securities rather than bills only.

Many observers might describe these changes as policy easings, but that description is perhaps an overstatement. The intent is not to push interest rates lower; yields already are at rock-bottom levels. Also, if the Fed had wanted to reduce short-term interest rates, it would have lowered the rate on excess reserves and the rate on reverse repurchase agreements. Those rates remained steady (although the Fed could well reduce them next week in conjunction with the FOMC meeting). The intent was to maintain smooth functioning of short-term funding markets. That is, to avoid episodes like the spike in RP rates last September.

The amount of RPs arranged by the Fed will balloon in the next few weeks. The $1.5 trillion of one-month and three-month transactions arranged this week will be joined by additional transactions over the next four weeks ($500 of both one-month and three-month RPs per week.). By the end of the four-week plan released today, the cumulative amount of one-month and three-month RPs will exceed $5 trillion. In addition, the Fed will continue to offer $175 billion of overnight RPs and $45 billion of two-week RPs. Chances of a replay of the September disruption seem low.

The shift in purchases of Treasury securities (full range rather than bills only) will strike many observers as a type of quantitative easing. We do not view this as quite accurate. Long-term interest rates already are at rock-bottom levels. We doubt the Fed sees a need to push them lower. This action, we believe, was taken to preserve liquidity in the bill market. The Treasury has recently started to trim bill sizes because of reduced near-term funding needs. At the same time, demand for bills has been strong because of the flight to quality among investors. If the Fed had continued to absorb bill supply in this environment, liquidity in this market would most likely become strained. The minutes from recent FOMC meetings noted that officials saw liquidity strains as a potential issue, and they discussed the possibility of altering the range of purchases in order to limit problems. Today, they decided to take this path.