Daiwa Capital Markets

U.S. FOMC Review

- The Federal Reserve: using all available tools

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Heavy Artillery

John Williams, President of the New York Fed, argued in a recent speech that the Fed should act early and aggressively to confront challenges at a time when policy space is limited. The Fed put that strategy in practice today with a bold set of changes.

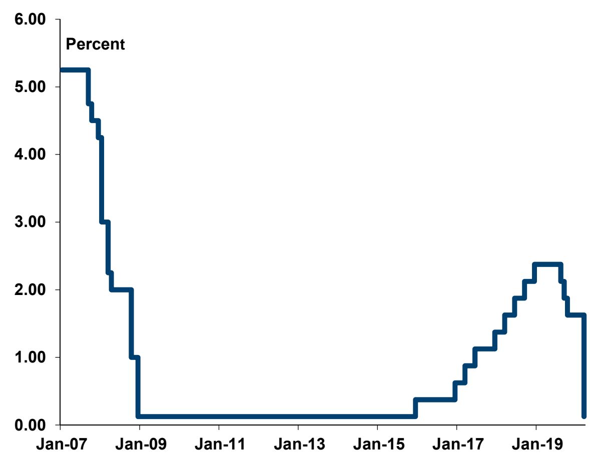
Interest rates. The Fed cut interest rates for the second time in two weeks, with the cumulative change totaling 150 basis points and pushing the target federal funds rate to the effective lower bound (0.00 to 0.25 percent). During the financial crisis, the sharpest change totaled 125 basis points (an intermeeting cut of 75 basis points to 3.50 percent on January 22, 2008 followed by a 50 basis point cut to 3.00 percent at the FOMC meeting on January 30).

QE. Not only did the Fed reduce short-term interest rates, but it also reinstituted quantitative easing, with plans in the months ahead (time frame not specified) to purchase at least $500 billion of Treasury securities and $200 billion of mortgaged-backed securities. It is difficult to compare the magnitude of this effort with that during the crisis and its aftermath because the earlier efforts underwent changes during their implementation, but combined purchases under three QE programs totaled approximately $3.8 trillion. Thus, the current program is sizeable, and it could be enlarged (note the planned purchases are *at least* $500 billion and $200 billion). The effort during the crisis was intended to reduce long-term interest rates, and perhaps to boost the stock market. Interest rates already are quite low; thus, the current effort is more to keep rates low and to promote orderly trading in the Treasury market.

The Fed also altered its planned reinvestment of mortgage backed securities. It had been reinvesting the first $20 billion of repayments into Treasury securities, with amounts in excess of $20 billion plowed back into MBS. Now, all repayments on mortgage-backed securities will be reinvested in new mortgage-backed securities. (Maturing Treasury securities will continue to be reinvested in Treasuries.)

Credit Flows. The Board of Governors of the Federal Reserve also took several steps to help maintain the flow of credit to individuals and businesses. Probably most important, the Board of Governors slashed the rate charged on borrowing from the discount window by 150 basis points to 0.25 percent. The tone of the announcement suggested that officials would be encouraging institutions to utilize the facility, a contrast to a common view that borrowing from the discount window is a privilege that should be used judiciously. In this regard, the Fed noted that this borrowing could be for periods of up to 90 days and can be renewed.

Midpoint of the Federal Funds Target Rate



Sources: Federal Open Market Committee via Haver Analytics

Depository institutions could well take advantage of the generous terms offered by the Fed, as discount-window borrowing has jumped at times in the past few years to levels in the neighborhood of $100 billion. During the financial crisis, the maximum borrowing totaled $112 billion on a weekly average basis, and the period of time in this neighborhood was brief.

The Board of Governors also pulled out a seldom used tool – reserve requirements – to add a bit of force to its other policy moves. Required reserve ratios will be reduced to zero effective March 26. The Fed also encouraged depository institutions to utilize excess liquidity and capital in granting loans to individuals and businesses.

Swap Lines. The Fed has so-called liquidity swap lines with five foreign central banks (Bank of Canada, Bank of England, Bank of Japan, European Central Bank, and the Swiss National Bank). Under these facilities, central banks lend to one another in foreign currencies, which allows the borrowing central bank to pass the funds along to depository institutions needing liquidity. Most of the transactions involve the Fed providing dollar-based loans to foreign central banks. The Fed reduced the rate on such borrowing by 25 basis points (now equal to the overnight index swap rate plus 25 basis points). In addition, the maximum maturity of the borrowing was pushed to 84 days from the current practice of one-week loans.

The facility has not been utilized extensively in recent years, with average borrowing typically less than $100 million. The largest total recently was $3.7 billion around the turn of the year. During the worst of the financial crisis borrowings from the Fed by foreign central banks was $450 billion or more from Late October 2008 to mid-January 2009.