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FED SHADOW

Check the Exit

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Bernanke's vision for ending the Fed's hyper-accommodation is all tools and no timing.

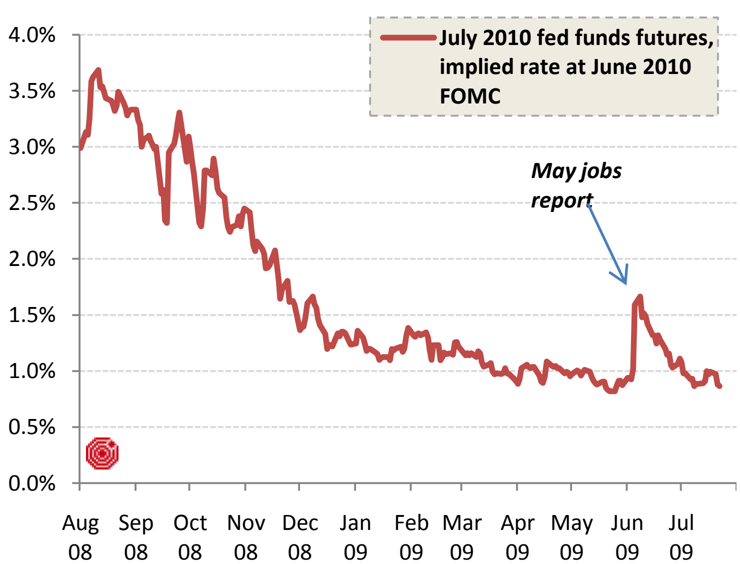
Ben Bernanke may have thought that the key takeaway from his *Wall Street Journal* op-ed and House testimony yesterday would be his exposition of an "exit strategy" to avoid a resurgence of inflation as the outcome of the Fed's extraordinarily easy policy stance. But the markets thought otherwise, seeing the critical point as the assertion -- expressed in both the Bernanke's *Journal* article and his testimony -- that "accommodative" policy will be appropriate for an "extended period." Treasury yields fell across the curve, out-month fed funds rate expectations dropped to near cycle lows, and gold held steady near six-week highs around $950.

Update to strategic view

FED FUNDS, US MACRO: Bernanke has sought to shape expectations that the Fed can withdraw excess liquidity before it becomes inflationary. While explicating various policy options, he has not said how he'll determine when to execute them -- except to indicate that it will be a very long time away, which inflames the very expectations he is trying to soothe.

[see Investment Strategy Dashboard]

Bernanke may well have seen his elucidation of an eventual exit strategy as sufficient to give the Fed the latitude to sustain its current posture indefinitely, while containing perceived inflation risks. If the Fed can instill confidence that it will take appropriate action to normalize policy at the right time, the challenge of using a hyper-accommodative policy to support the economy and stabilize the markets is considerably less daunting. As we've learned over and over in this crisis, confidence is at least half the battle (see "The Stress Tests' Hidden Mickey" May 4, 2009).



We remain to be convinced that this exercise will prove effective in building the necessary confidence -- talk is cheap. Even granting the technical merits of the strategy outlined by

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Bernanke -- a reach, considering that he is talking about the Fed operating in utterly unexplained methodological territory -- the *timing and conditions* under which the Fed will be prepared to begin reversing course remains an unaddressed yet critically important issue clouding the policy outlook. As the *Journal* skeptically asked in an editorial today, "So how long is extended? Mr. Bernanke didn't say, and we are all supposed to assume that he'll know the right moment when he sees it."

Beyond that, it remains unclear to what extent the measures described by Bernanke yesterday would effectively tighten the central bank's ultra-loose stance. The Fed is most concerned that as the economy recovers, banks' massive reserve holdings at the Fed -- which now total about $800 billion, including about $745 billion in excess reserves -- "could ultimately result in inflationary pressures," as Bernanke put it in his *Journal* article, as banks "find more opportunities to lend out their reserves," producing "faster growth in broad money."

To guard against that, the Fed's primary objective would be to maintain reserve demand by using its recently granted authority to pay interest on reserves. "When the time comes to tighten policy, we can raise the rate paid on reserve balances as we increase our target for the federal funds rate," Bernanke said in the *Journal*. "Banks generally will not lend funds in the money market at an interest rate lower than the rate they can earn risk-free at the Federal Reserve… Thus the interest rate that the Fed pays should tend to put a floor under short-term market rates including…the federal funds rate." Raising the rate paid on reserves would also discourage "excessive growth in money and credit, because banks will not want to lend out their reserves at rates below which they can earn at the Fed."

However, short-term money market instruments are not the only option available to the banks, and it already appears that they are beginning to find higher-yielding alternatives to their excess reserve holdings (see "A Run on the Fed?" July 10, 2009). Although Bernanke didn't specifically address it yesterday, he must also be counting on banks maintaining their excess reserve balances to provide the Fed with a funding source for its asset acquisition programs.

The Fed would also have the ability to offer term deposits -- akin to certificates of deposit -- to attract reserves. But that would still leave the banks with the ability to find alternatives to keeping their funds at the Fed once the term matures. But Bernanke did acknowledge that under certain conditions, paying interest on reserves might not be enough to draw in sufficient reserves and keep the funds rate at target, in which case the Fed would take "steps to reduce reserves and drain excess liquidity from markets." That could be done by effecting reverse repurchase agreements, under which the Fed temporarily sells assets from its portfolio. But these are temporary transactions; eventually the Fed buys back the assets and, in so doing, replaces the liquidity originally drained. Also, under the Supplemental Financing Program the Treasury "could sell bills and deposit the proceeds" with the Fed. However, Bernanke cautions, "to protect the independence of monetary policy, we must take care to ensure that we can achieve our policy objectives without reliance on the Treasury." Finally, "if necessary," Bernanke wrote, "the Fed could reduce reserves by selling a portion of its holdings of long-term securities into the open market." In other words, the last thing the Fed wants to do is to drain liquidity by paring back the enormous expansion of its balance sheet.

But even under the best-case scenario, assuming that by paying interest on reserves the Fed can keep those reserves on deposit, it's a limited-life scenario. At some point, the added reserve holdings will be evacuated, bringing on the liquidity surge that the Fed recognizes would potentially be inflationary. Unless the Fed can find some way to have the reserves absorbed beyond what was delineated by Bernanke, the most it can do is delay the inevitable.

BOTTOM LINE: Bernanke has sought to shape expectations that the Fed can withdraw excess liquidity before it becomes inflationary. While explicating various policy options, he has not said how he'll determine when to execute them -- except to indicate that it will be a very long time away, which inflames the very expectations he is trying to soothe.