Philequity Corner (Dec. 22, 2008)
By Valentino Sy

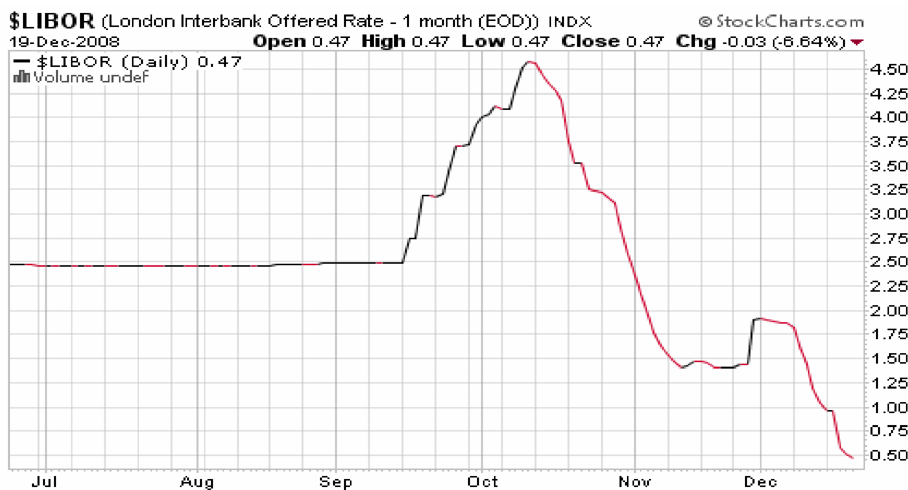
Here comes Feddy Claus

Santa Claus (Fed) delivered his gifts ahead of Christmas. Last week, the US Fed presented a new set of unprecedented measures aimed at stimulating credit and lowering borrowing costs to all sectors of the economy, starting with housing.

Christmas gifts from the Fed

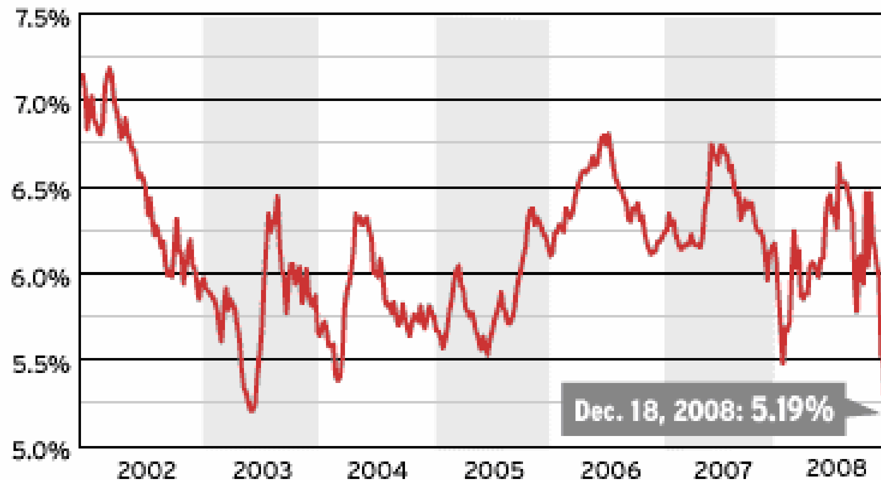
Gift #1 – Cutting the fed funds rate target to near zero. Nine rate cuts in the prior 14 months and $1.4 trillion in emergency lending had failed to unfreeze the credit markets. Last week, the Fed cut its fed funds rate target to between zero and 0.25 percent, the lowest in its history.

The graph below shows that since the Fed turned on the monetary spigot in October (at the height of the credit crisis), the LIBOR rate has declined from 4.6 percent to .47 percent.



Gift #2 – Commitment to buy mortgage bonds and other assets at a massive scale. While the Fed has reached the end of the line on cutting rates (since it cannot go below zero), it has unlimited flexibility to stimulate the housing market and the broader economy by buying up mortgage backed securities, Fannie Mae and Freddie Mac corporate debt, and other assets.

Average Rate for 30-Yr Fixed Rate Mortgages



Source: Freddie Mac, MSNBC

In fact, the Fed's efforts are already showing some success as shown above. Since it first announced it was buying housing-related debt in November, the 30-year mortgage rates have fallen from 6.5 percent to 5.19 percent (the lowest on record since 1971), and refinance applications have more than tripled.

Gift #3 – Pledge to keep rates low for a long period of time. In their statement last week, the Fed said, "*Weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time*." This is probably the first time the Fed explicitly stated that it will keep interest rates low as long as necessary. Implicitly, the Fed is also saying that it will print money to an unlimited extent until the economy regains traction.

Another Great Depression?

Lessons can be learned from the 1930s Great Depression and the deflation period in Japan, although each situation may be different. During the Great Depression, the Fed constricted money supply. Now the Fed is pumping large sums of money to make sure there is enough liquidity in the system.

Unlike in the 1930s, the Fed is now authorized to buy hard-to-value securities (e.g. mortgage-backed securities and other assets) from financial institutions. By buying these assets, the Fed improves transparency in the system and enables banks to sell these securities to raise capital. This, in turn, should help banks begin lending again.

In addition, the linkages between fiscal policy and the economy are more understood today than before in the 1930s. Now, policymakers are more willing to use deficit spending to provide massive amounts of fiscal stimuli and give the economy a jump-start.

Another Japan?

Between 2001 and 2006, the Bank of Japan set its policy rate to zero using "quantitative easing" to end deflation. With quantitative easing, the BOJ flooded commercial banks with excessive liquidity to promote lending, leaving them with large stocks of excess reserves, and therefore little risk of a liquidity shortage.

But while it was effective in stabilizing the financial markets, it took a long time for excess liquidity to stimulate lending because the banking system was weak and the companies were busy cleaning up their balance sheets. This is the path the Fed is pursuing at the moment.

No more bullets?

Some have argued that since short-term policy rates are already near zero, the Fed's monetary policy is now impotent (since lowering it is no longer feasible). But in a 2004 paper, Bernanke noted that quantitative easing can stimulate the economy even when interest rates are near zero.

Bernanke argues that quantitative easing may affect the economy through the following channels:

1) **Portfolio substitution** - Large increases in money supply will lead investors to rebalance portfolios, raising prices and reducing yields on alternative, non-monetary assets. Lower yields on long-term assets will in turn stimulate investment, consumption and other economic activity.
2) **Altering expectations of the future path of policy rates** – Keeping reserves at a high level and committing to maintain it until certain conditions have been fulfilled is a more visible and credible way to stimulate growth, than a purely verbal promise to maintain a low interest rate.
3) **Expansionary fiscal effects** - By expanding its balance sheet and replacing public holdings of interest-bearing government debt with non-interest bearing (or very low

interest) money and reserves, the central bank may attempt to hold down yields on a range of government securities, making borrowing cheaper, and cutting the costs of an expansionary fiscal policy.

Helicopter Santa

We are fortunate that Bernanke is at the helm of the Fed. He is a keen student of liquidity traps during the Great Depression and Japan's decade long banking and economic slump. There is probably no one who understands better how the dynamics of a depression works. There's nobody more familiar to the mistakes other policymakers made in previous periods, not just in the United States but also in other parts of the world.

Bernanke once threatened to send monetary helicopters if that were necessary to avoid deflation and another Great Depression. Last week's unprecedented action by the Fed meant that money gifts (or helicopter money) are being dropped just in time for Christmas. Quantitative easing has formally begun.