

UNITED STATES ECONOMICS UPDATE

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Bernanke lays out exit strategy

Rate payable on reserves to become primary policy tool

- It's a shame that Congress is taking a snow day, because Ben Bernanke's written testimony provides a full schooling on the design of the Fed's exit strategy. The key point is that, as we thought, **the Fed intends to use the interest rate payable on bank reserves as its main tool to tighten monetary policy.**
- Hiking that rate "should put upward pressure on all short-term interest rates (including the fed funds rate), as banks will not supply short-term funds to the money markets at rates significantly below what they can earn by holding reserves at the Federal Reserve banks." The Fed is concerned, however, that the link between the rate payable on reserves and the fed funds rate might not be as close as it would like.
- Not all institutions earn interest on their reserves at the Fed. Those institutions, such as the government agencies Fannie Mae and Freddie Mac, have an incentive to lend at lower rates, which could leave the fed funds rate lower than the FOMC wanted.
- To counter this problem, **the Fed will use two additional tools: large scale reverse repos and a new term deposit facility.** Both are designed to reduce the amount of bank reserves in the system, which should improve the Fed's ability to accurately target any particular fed funds rate using the rate payable on reserves. **The Fed would only consider selling the assets it has bought in the longer term when the economic recovery is much more mature.**
- **What we didn't know before is that the Fed intends to deploy both reverse repos and the term deposit facility before it starts to hike short-term interest rates.** The term deposit facility could be up and running in the second quarter, although the Fed may not make use of the system in earnest until much later.
- In addition, the Fed is concerned the level of activity in the fed funds market has declined so considerably that the prevailing rate might not be an accurate reflection of other short-term interest rates in the economy. Therefore **in all likelihood it intends to make the interest rate payable on reserves its key policy rate, at least for a while. Monetary policy, as communicated in future FOMC statements, will be defined by two new variables: the rate payable on reserves and a target for reserve balances. Eventually the Fed would go back to using the fed funds rate.**
- Finally, Bernanke suggested that the Fed will increase the spread between the **discount rate** and the fed funds target rate "before long", reversing some of the decline from 100 basis points to only 25 basis points during the financial crisis. **This is one of the final steps in winding down the emergency liquidity measures put in place, but, as Bernanke himself made clear again today, these changes "should not be interpreted as signaling any change in the outlook for monetary policy".**
- Overall, there's nothing here to suggest that the Fed is in any hurry to tighten. We continue to believe that a slowdown in economic growth in the second half of the year will persuade the Fed to leave rates at near-zero for much longer than the markets currently expect. Furthermore, with bank lending shrinking at an already alarming rate, we don't expect the Fed to aggressively reduce bank reserves either. Indeed, there's still an outside chance the Fed could be forced to resume its large scale asset purchases later this year.

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