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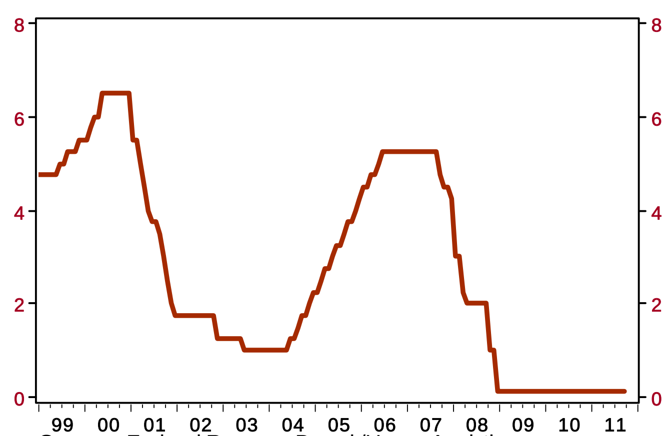
Fed Actively Twists But Holds Off on QE3

Today the Federal Reserve announced major changes to the composition of its balance sheet as well as major changes to its description of the economy.

From now through the middle of next year, the Fed will sell $400 billion of Treasury securities with maturities of three years or less and purchase $400 billion in Treasury securities with maturities of six years to thirty years. This is an "active" form of "twisting" the maturities in its balance sheet in an attempt to bring down long-term interest rates. It is more aggressive than the "passive" alternative in which the Fed would roll some of its maturing short-term Treasury securities into longer-term Treasury debt. It is unclear at this point whether the Fed will employ the passive approach *in addition* to the active twist of $400 billion.

Fed Funds Target Rate
%



Source: Federal Reserve Board /Haver Analytics

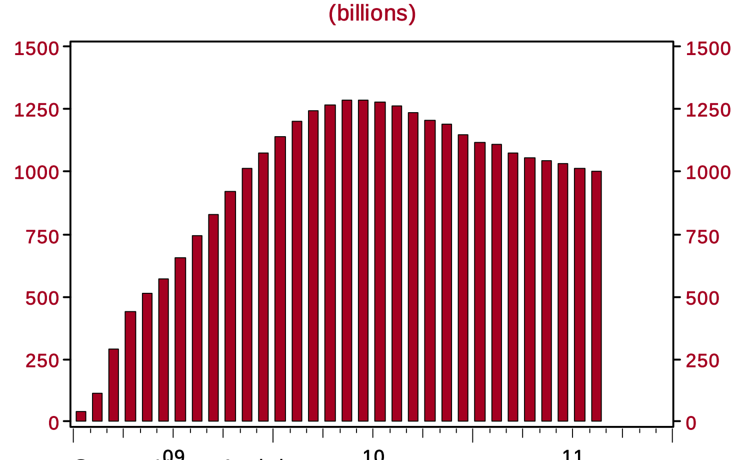
The Fed also announced that it will cease shifting its portfolio of mortgage backed securities (MBS) and the debt of Fannie Mae and Freddie Mac (GSE debt) into Treasury securities. Since mid-2010, the Fed has reduced its holdings of these residential mortgage-based assets by about $300 billion, to $1 trillion from $1.3 trillion, buying Treasury securities with the principal as MBS and GSE debt matured. Now the Fed will use the principal to buy MBS. The Fed did not provide a date for that process to end. In other words, going forward and for the foreseeable future the Fed will maintain a stable amount of Treasury securities and a stable amount of mortgage-based assets.

All of these measures come on top of the decision at the Fed's last meeting in early August to commit to maintaining the current federal funds rate at nearly zero percent through at least mid-2013.

Notice, however, that neither the active twist nor a passive twist, nor maintaining the size of its mortgage-related assets will alter the overall size of the Fed's balance sheet. In other words, the Fed did *not* announce a third round of quantitative easing. The Fed also did not reduce or eliminate the interest rate it pays banks on their excess reserves, another policy move it surely discussed at the meeting over the last two days.

The changes to the language of the Fed's statement were also significant. The Fed noted a modest increase in household spending but suggested the recovery should be stronger given the easing of supply-chain disruptions related to Japan's disasters. More importantly, the Fed said downside risks to the economic outlook were "significant," including recent problems in "global financial markets," an obvious reference to the European sovereign debt problems. Remarkably, even with consumer prices up 0.5% in July, 0.4% in August and 3.8% in the past year, the Fed said that "inflation appears to have moderated since earlier in the year," the exact same language it used at the prior meeting. Message to markets: the Fed does not care about inflation right now.

Fed Holdings of MBS and GSE Debt
(billions)



Source: Haver Analytics

Three members of the Federal Open Market Committee (Fisher, Kocherlakota and Plosser), all reserve bank presidents, not members of the Washington DC-based Board of Governors, voted against today's decision to shift the composition of the Fed's Treasury assets to longer-dated maturities and maintain the size of the Fed's mortgage-related assets. These same three members dissented last month against the decision to commit to maintaining near zero short-term rates through at least mid-2013.

We believe the changes announced today are unlikely to have the beneficial effects on the economy that the Fed majority thinks. The Fed is clearly trying to reduce mortgage rates as well as other long-term interest rates. But the policy measures taken today will, if they have a financial impact, flatten the slope of the yield curve, reducing bank earnings.

Moreover, the shift in the composition of the Fed's portfolio of Treasury securities means that, on net (Treasury issuance minus Fed purchases), the federal government is issuing less long-term debt and more short-term debt. This is poor management of the federal debt. Given historically low interest rates, the federal government should be issuing more long-term debt and less short-term debt, not the other way around.

Ultimately, we believe today's policy moves were more about appearing to do something than getting actual results.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in August indicates that economic growth remains slow. Recent indicators point to continuing weakness in overall labor market conditions, and the unemployment rate remains elevated. Household spending has been increasing at only a modest pace in recent months despite some recovery in sales of motor vehicles as supply-chain disruptions eased. Investment in nonresidential structures is still weak, and the housing sector remains depressed. However, business investment in equipment and software continues to expand. Inflation appears to have moderated since earlier in the year as prices of energy and some commodities have declined from their peaks. Longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee continues to expect some pickup in the pace of recovery over coming quarters but anticipates that the unemployment rate will decline only gradually toward levels that the Committee judges to be consistent with its dual mandate. Moreover, there are significant downside risks to the economic outlook, including strains in global financial markets. The Committee also anticipates that inflation will settle, over coming quarters, at levels at or below those consistent with the Committee's dual mandate as the effects of past energy and other commodity price increases dissipate further. However, the Committee will continue to pay close attention to the evolution of inflation and inflation expectations.

To support a stronger economic recovery and to help ensure that inflation, over time, is at levels consistent with the dual mandate, the Committee decided today to extend the average maturity of its holdings of securities. The Committee intends to purchase, by the end of June 2012, $400 billion of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less. This program should put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative. The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate.

To help support conditions in mortgage markets, the Committee will now reinvest principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities. In addition, the Committee will maintain its existing policy of rolling over maturing Treasury securities at auction.

The Committee also decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.

The Committee discussed the range of policy tools available to promote a stronger economic recovery in a context of price stability. It will continue to assess the economic outlook in light of incoming information and is prepared to employ its tools as appropriate.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; Charles L. Evans; Sarah Bloom Raskin; Daniel K. Tarullo; and Janet L. Yellen. Voting against the action were Richard W. Fisher, Narayana Kocherlakota, and Charles I. Plosser, who did not support additional policy accommodation at this time.