

US FOMC – QE2 comes sailing in

Economic research note

4 November 2010

- The US Fed has embarked on its second round of quantitative easing (QE2). The Fed will purchase \$US600bn of Treasury bonds out to mid-2011 at an average of \$US75bn per month.
- As a result and with re-investment of flows from current holdings, the Fed's balance sheet will expand to approx. \$US3tr by mid-2011, three-times the size prior to the GFC.
- Quantitative easing is one way to ease monetary policy when interest rates are zero. This can help the economy by providing increased liquidity for the banks to lend to households and businesses, lower bond yields, flatten the yield curve, increase incentives to buy "risk" assets, such as equities and credit, and lower the value of the USD.
- While there remains doubts over the effectiveness of this policy, with interest rates already at zero and fiscal policy hamstrung by the political process, it looks to be worth a try!

US FOMC – QE2 comes sailing in:

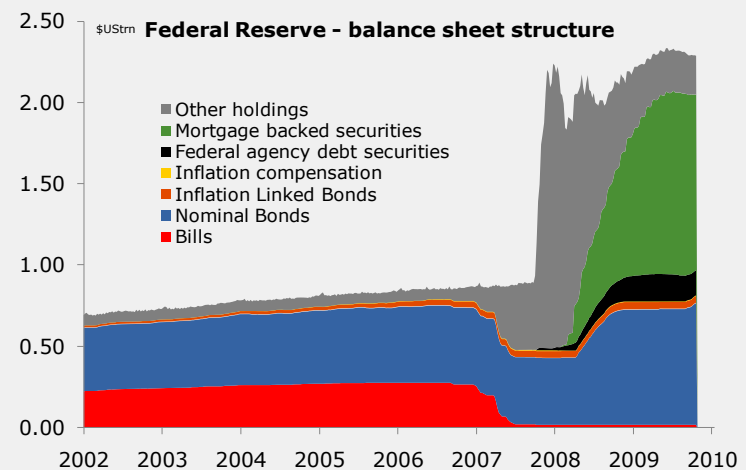
After weeks of speculation, the US Federal Reserve has announced the long awaited second round of quantitative easing (QE2). Starting this month the Fed will "purchase a further \$US600bn of longer-term Treasury securities by the end of the second quarter 2011, a pace of about \$US75bn per month."

The Fed also stated that these purchases would be in addition to the existing policy of reinvesting principal payments from its securities holdings." These purchases are estimated at \$US250bn-\$US300bn. (Further details on how these purchases will occur can be found below).

This means that the Fed's balance sheet, which currently stands at just on \$US2.4tr, will expand to approx. \$US3tr. As shown in the chart below, this is more than triple the size of the balance sheet that existed prior to the failure of Lehman Bros.

Importantly, today's statement from the Fed was open-ended, stating that "the Committee will regularly review the pace of its securities purchases and the overall size of the asset-purchase program in light of incoming information and will adjust the program as needed". This was seen by the market as an important sign of flexibility for QE2.

US Federal Reserve balance sheet



Source: US Federal Reserve



Stephen Halmarick
 Head of Investment Markets
 Research

Belinda Allen
 Analyst, Investment Markets Research

James White
 Analyst,
 Investment Markets Research

In justifying this further easing of monetary policy the FOMC stated that “the pace of recovery in output and employment continues to be slow. Household spending is increasing gradually, but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software is rising, though less rapidly than earlier in the year, while investment in non-residential structures continues to be weak. Employers remain reluctant to add to payrolls. Housing starts continue to be depressed.”

The FOMC mentioned on a number of occasions their “dual mandate” to “faster maximum employment and price stability”. Clearly at present the Fed’s sees the unemployment rate as too high and the rate of inflation as too low, noting that “measures of underlying inflation are somewhat low, relative to levels that the Committee judges to be consistent, over the longer run, with its dual mandate.”

The FOMC also stated that the target range for the Fed Funds rate will remain at 0%-0.25% “for an extended period.”

How QE works (in theory anyway):

At its essence, quantitative easing (QE) is a way of easing monetary policy or loosening financial conditions, when interest rates are already at or near zero. By buying government securities from financial institutions, the central bank is pushing more liquidity (money) into the financial system, on the expectation that this money will then be lent out to the economy.

In addition to providing more funds to be lent to business and households, to support the economy QE must also loosening financial conditions. It can do this in a number of ways:

- By buying government bonds the Fed can lower bond yields relative to what they otherwise would have been;
- Depending on in what part of the yield curve the purchases occur, this can also flatten the yield curve;
- Lower bond yields and a flatter curve can lower the interest rates applying to corporate borrowers;
- The lower government bond yields should encourage more “risk-taking” behaviour by investors, increasing equity prices and lowering credit spreads;
- The “printing money” aspect of QE can lead to a weakening of the USD, making US exports more attractive to international buyers (and seeing the AUD trade consistently above parity in local trading today).

Given the experience in Japan, however, the jury is still out on the effectiveness of QE. But with interest rates already at zero and with the chances of further fiscal policy stimulus seeming very low given the political situation in the US, further monetary policy easing through QE looks to be a policy initiative that needs to be explored (ie. it is better than doing nothing!).

The New York Fed’s operations:

The physical purchase of bonds under the QE2 program will be undertaken by the Federal Reserve Bank of New York. In a statement released today the NY Fed has noted that the \$US600bn new QE2 program and the re-investment of flows of \$US250bn-\$US300bn from current holdings will mean that “taken together, the (open market trading desk at the NY Fed) anticipates conducting \$US850bn to \$US900bn of purchases of longer-term Treasury securities through the end of the second quarter. This would result in an average purchase pace of roughly \$US110bn per month, representing about \$US75bn per month associated with additional purchases and roughly \$US35bn per month associated with reinvestment purchases.”

“The Desk plans to distribute these purchases across the following eight maturity sectors based on the approximate weights below:

1.5-2.5 yrs	2.5-4 yrs	4-5.5 yrs	5.5-7 yrs	7-10 yrs	10-17 yrs	17-30 yrs	TIPS 1.5-30 yrs
5%	20%	20%	23%	23%	2%	4%	3%

Source: NY Fed

The NY Fed has also stated that “under this distribution, the Desk anticipates that the assets purchased will have an average duration of between 5 and 6 years. The distribution of purchases could change if market conditions warrant, but such changes would be designed to not significantly alter the average duration of the assets purchased.”

In addition, the NY Fed stated that “to provide operational flexibility and to ensure that it is able to purchase the most attractive securities on a relative-value basis, the Desk is temporarily relaxing the 35% per-issue limit on SOMA holdings under which it has been operating. However, SOMA holdings of an individual security will be allowed to rise above the 35% threshold only in modest increments.”

For further information

Stephen Halmarick	Head of Investment Markets Research	+61 2 9303 3030	shalmarick@colonialfirststate.com.au
Belinda Allen	Analyst, Investment Markets Research	+61 2 9303 3110	ballen@colonialfirststate.com.au
James White	Analyst, Investment Markets Research	+61 2 9303 2645	jwhite@colonialfirststate.com.au

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