

U.S. Macro Focus

Fed Empties Its Toolkit

- The FOMC announced a major new attempt at easing financial conditions. In addition to an open-ended Agency MBS purchase program (QE), the Committee introduced a stronger easing bias and took a key step away from calendar-based guidance in favor of linking policy more explicitly to the outlook for the labor market.
- The new bond-buying program begins immediately at a monthly rate of \$40 billion and probably drew wide support for the flexibility it provides to ramp up or close off operations. The statement highlighted that the continuation of Operation Twist brings the total of longer-duration purchases to \$85 billion, a strong invitation to anticipate unsterilized Treasury purchases in January unless payroll numbers pick up significantly, an unlikely prospect in our judgment.
- The more aggressive tack implicitly acknowledges that policy's powers are more limited and yet downside risks remain. Initial market reactions are consistent with policy goals but the tougher test will be whether or not the improvement in financial conditions persists long enough to boost final demand.

Robert V DiClemente
+1-212-816-7942
robert.diclemente@citi.com

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Fed Empties Its Toolkit

The FOMC today stepped up its easing efforts in an aggressive fashion. The Committee introduced a new round of MBS purchases, committed to keep overnight rates low for longer than previously, and indicated that it expects to remain highly accommodative for a long time after the recovery strengthens. Although we anticipated both the supportive language and the asset purchases, the Fed now has gone considerably further than that in hopes of bolstering financial conditions and staying ahead of downside risks in an environment where monetary policy is stretching the limits of its power.

The policy statement incorporated a long list of accommodative elements including some notable policy innovations. On the two primary fronts, communications and balance sheet measures, the decisions were well in line with expectations. The Fed will begin buying (tomorrow) agency MBS at a monthly rate of \$40 billion and will continue Operation Twist to its yearend conclusion, effectively buying \$85 billion in longer-duration securities each month. In Q&A, Bernanke indicated that whether they continue to buy beyond yearend at that higher pace depends on the outlook at the time.

However, placing this language in the statement is a clear invitation to expect that Treasuries will become part of a larger unsterilized program (including MBS) unless the labor market strengthens over the next few months. We had thought the Fed might opt instead for a pre-determined QE plan to avoid the added policy uncertainty. It is possible this alternative approach attracted votes from both sides, pleasing hawks and doves for the element of flexibility to ramp up or shut down the operation at any time. Given the monthly pace, the implicit size of the new QE program, including MBS and unsterilized Treasuries beginning in January, would land just slightly larger than the upper range we anticipated for a nine-month plan to buy \$400-600 billion ($\$23 \text{ billion over the balance of September} + 40 \times 9 + 6 \times 45 = \653 billion).

On extending forward rate guidance, the Committee moved out the expected horizon for keeping near-zero rates from "at least late 2014" to "at least through mid-2015" as was widely anticipated. This represented unfinished business left over from the August meeting and by itself does not provide any additional accommodation given where forward rates are. Nonetheless, the Committee introduced important new language that substantially boosts the easing effect of the rate commitment.

First, the statement indicated that "the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens." This is a nod to arguments from Bernanke and Yellen that in a zero-bound world with risks tilted to the downside, it may be appropriate to keep rates low for longer than guides like policy rules would prescribe. Indeed, it is notable that in the new projected rate paths 13 officials have a funds rate in 2015 below levels that Yellen's version of the Taylor rule would suggest.

Second, the policy statement took an important step away from so-called calendar-based guidance in the direction of linking exit strategy more explicitly to how well the labor market does. The Committee indicated that "If the outlook for the labor market does not improve substantially," the Fed will continue to buy MBS as well as other assets, along with the use of other tools "until such improvement is achieved." Again, this is a clear indication to expect unsterilized Treasury purchases in addition to MBS come January. In Q&A, with reference to the sort of threshold for payroll growth they have in mind, Bernanke said "the last six months isn't it."

Still in other ways, the Fed today also strengthened its easing bias. The fact that they did not downgrade the economic forecasts beyond this year reflects at least for some the idea that they are counting on these measures to buoy growth prospects. But the aggressive words and deeds are also an acknowledgment policymakers know their powers are more and more limited. With these measures, they are attempting to give policy the best possible chance to make a positive contribution to recovery. Initial market responses have been favorable from the Fed's perspective. But the key test that recent rounds have failed will be how persistent the improvement in financial conditions is over coming weeks and months.

Appendix A-1

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