Godsey & Gibb Associates

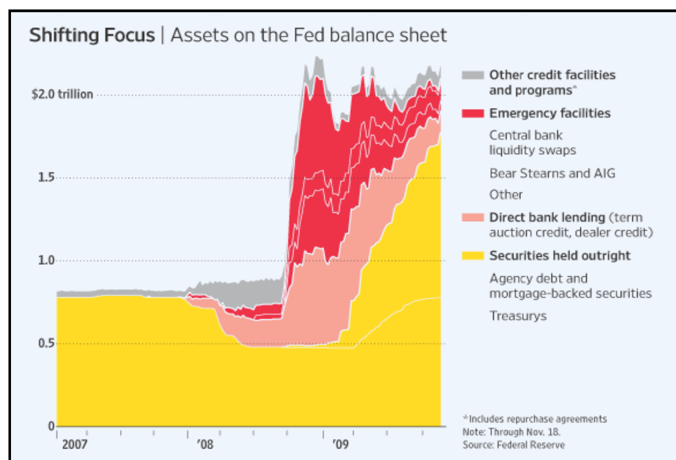
January 2010

Central Banks Devise, Test Exit Strategies Amidst Gradual Economic Recovery

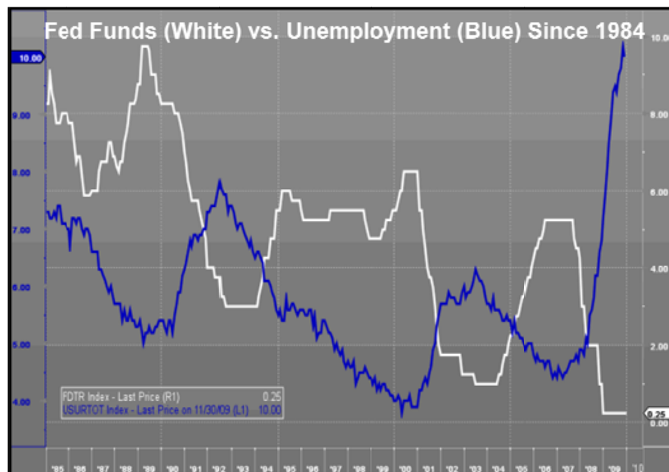
With the U.S. economy's 2.2% expansion in gross domestic product in the third quarter of 2009, along with the financial market recovery, the Federal Reserve (the Fed) has indicated that it is prepared to withdraw its extraordinary policy measures in a smooth and timely way that supports both job creati0n and price stability. Similarly, the European Central Bank has announced plans to scale back its non-standard operations starting in early 2010 in order to prevent excess inflation.

In its attempts to mitigate the impacts of the worst recession since World War II, the Fed has held benchmark lending rates close to zero for a year while using asset purchases, including $300 billion of Treasuries and $1.4 trillion in purchases of housing debt, as its main policy tool. Since the fall of 2007, the Fed introduced a total of 14 programs to provide liquidity and promote lending from banks to both businesses and consumers. These asset purchases and loan facilities led to an expansion in the Federal Reserve System's assets from $9.0 billion in August 2007 to over $2.2 trillion as of November 2009. The Fed's efforts injected $1.1 trillion in reserves into banks, which the banks now hold at the Fed. Once the banks want to start lending the excess reserve balances, the Fed will need to act in order to control inflation.

The Fed's exit strategies could eventually take three potential routes: (1) lower borrowing from its nontraditional facilities will decrease as the economy recovers, lowering reserve levels; (2) the Fed could raise the interest rate it pays on reserves, thereby raising market rates in order to prevent inflation; and (3) asset reduction through a combination of reverse repurchase agreements, increased Treasury balances, and selling some of its holdings. The exit process began in November 2009, with the announcement that it had approved a reduction in the maximum maturity of loans at the discount window to 28 days from 90 days effective January 14, 2010. Moreover, the Fed indicated that its $1.25 tillion in targeted purchases of mortgage-backed securities will end by the first quarter of 2010. Fed purchases, which amounted to approximately 80% of agency mortgage production, have already started to decrease. The goal of these purchases was to lower interest rates on home mortgages. In December 2009, the Fed conducted test reverse repos, where it sells securities with an agreement to buy them back at a higher rate. Consensus estimates are for an increase in the Fed Funds target rate, currently a range of 0% to 0.25%, in the second half of 2010; however more evidence of a sustained economic recovery, including a material decrease in the unemployment rate, will be necessary before the Fed can increases its target interest rate.



Source: The Wall Street Journal



Source: Bloomberg and Godsey & Gibb Associates

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