



Fed Watch

January 13th, 2009

Bernanke's Speech: The Crisis and the Policy Response

- Further alternative measures are likely to be implemented in the short-run
- Fed will continue using its "credit easing" strategy and keep interest rates low subject to economic outcomes

Bernanke highlighted a significant degree of uncertainty surrounding the economic outlook. *"The global economy will recover, but the timing and strength of the recovery are highly uncertain."* There was also an explicit recognition that former steps have not been enough to restore the financial meltdown, opening the door for additional measures in the near future. *"The Fed's monetary easing has been reflected in significant declines in a number of lending rates, especially shorter-term rates, thus offsetting to some degree the effects of the financial turmoil on financial conditions. However, that offset has been incomplete, as widening credit spreads, more restrictive lending standards, and credit market dysfunction have worked against the monetary easing and led to tighter financial conditions overall."*

Going forward the Fed will modified its communication strategy to emphasize its long-term prospects and the fact that the recent adoption of an interest rate range and the use of the asset side of its balance sheet are transitory and subject to economic outcomes. *"...the Committee should be able to influence longer-term interest rates by informing the public's expectations about the future course of monetary policy...It is important, however, that statements of this sort be expressed in conditional fashion--that is, that they link policy expectations to the evolving economic outlook. If the public were to perceive a statement about future policy to be unconditional, then long-term rates might fail to respond in the desired fashion should the economic outlook change materially."*

The speech revealed that Fed stands for the use of the asset side of its balance sheet "credit easing" and that it has no intentions so far to focus on the quantity of banks' reserves. In addition, Bernanke also expressed the view that stabilizing the financial system should go hand in hand with the stimulus package. The Fed supports further capital injections in the short-term and a tighter regulation in the long-term.

Bottom Line. Bernanke's speech confirms that interest rates will stay low for a long period of time and that FOMC is discussing the use of the right side of its balance sheet to deal with the financial turmoil and during the exit strategy. The remarks also emphasized that the Fed supports further capital injections to financial institutions –if conditions deteriorate-, a large fiscal policy response, significant changes to the regulatory framework and more international coordination.

Fed Funds: 0 to 0.25%
Next Meeting: January 27-28th
Minutes Release: February 18th

Bernanke Speech: The Crisis and the Policy Response January 13, 2009 (Selected quotes)

"However, at some point, when credit markets and the economy have begun to recover, the Federal Reserve will have to unwind its various lending programs. To some extent, this unwinding will happen automatically, as improvements in credit markets should reduce the need to use Fed facilities. Indeed, where possible we have tried to set lending rates and margins at levels that are likely to be increasingly unattractive to borrowers as financial conditions normalize."

"...the Federal Reserve's credit easing approach focuses on the mix of loans and securities that it holds and on how this composition of assets affects credit conditions for households and businesses. This difference does not reflect any doctrinal disagreement with the Japanese approach, but rather the differences in financial and economic conditions between the two episodes."

"In my view, however, fiscal actions are unlikely to promote a lasting recovery unless they are accompanied by strong measures to further stabilize and strengthen the financial system. History demonstrates conclusively that a modern economy cannot grow if its financial system is not operating effectively... However, with the worsening of the economy's growth prospects, continued credit losses and asset markdowns may maintain for a time the pressure on the capital and balance sheet capacities of financial institutions. Consequently, more capital injections and guarantees may become necessary to ensure stability and the normalization of credit markets."

"We need stronger supervisory and regulatory systems under which gaps and unnecessary duplication in coverage are eliminated, lines of supervisory authority and responsibility are clarified, and oversight powers are adequate to curb excessive leverage and risk-taking. In light of the multinational character of the largest financial firms and the globalization of financial markets more generally, regulatory oversight should be coordinated internationally to the greatest extent possible."