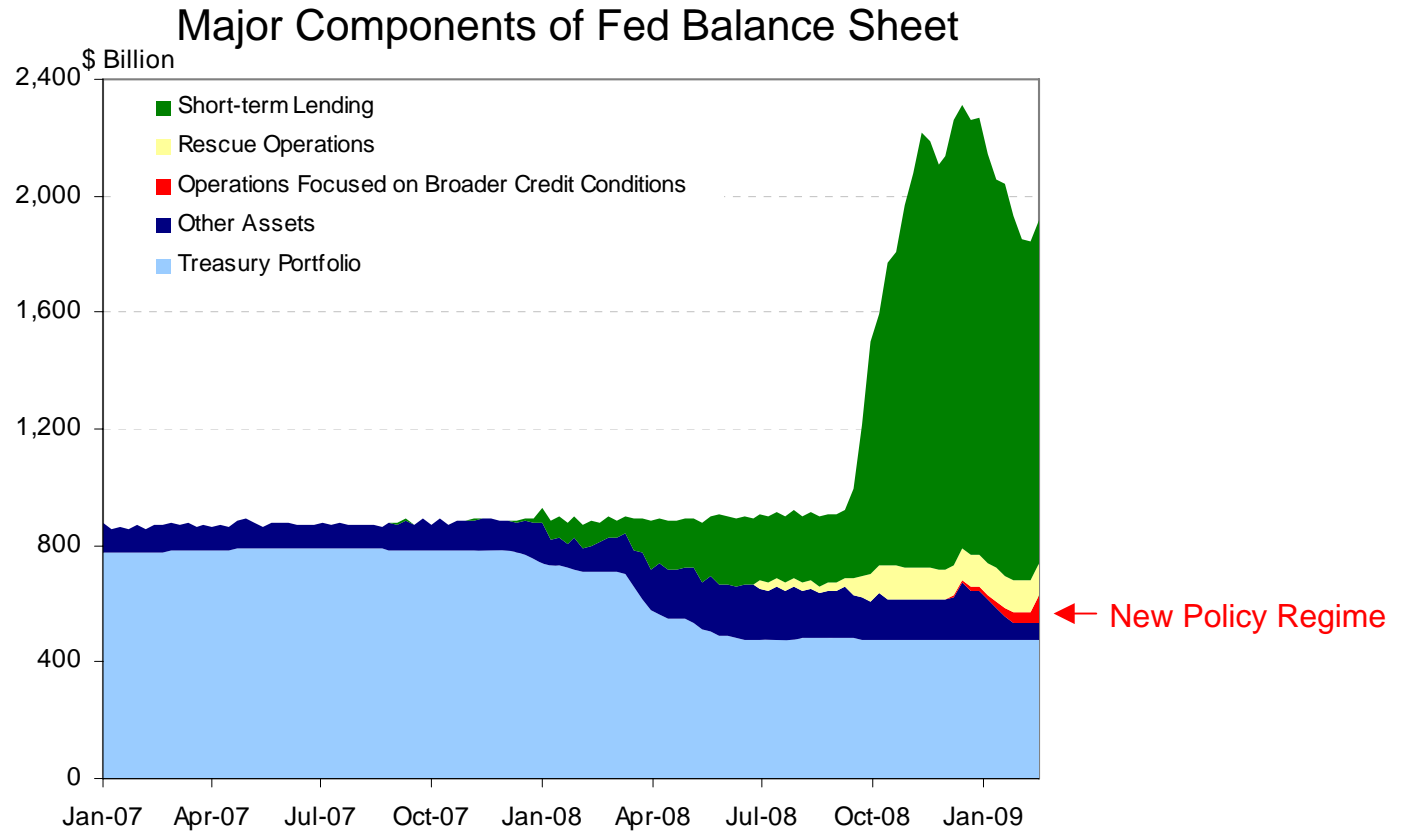


***Fed Balance Sheet Policy:
(Almost) All Available Tools***

Brian Sack
February 2009

Federal Reserve Balance Sheet Watch

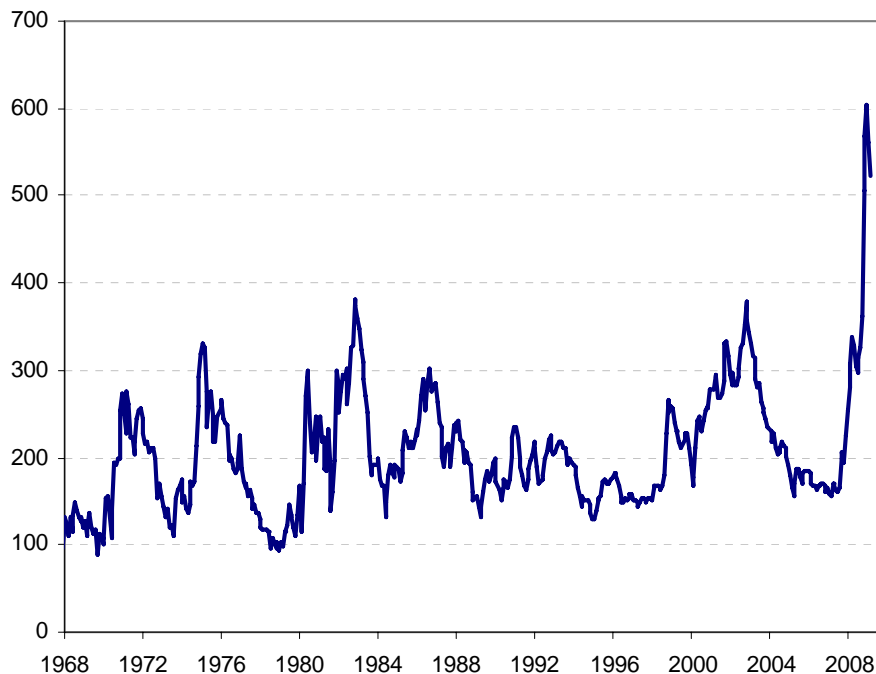


Fed Policy Regime: (Almost) All Available Tools

- Aggressive use of balance sheet
 - Initial focus was on providing term liquidity
 - Now expanded to address broader credit conditions
- Involves taking risk onto Fed's books
 - Reduce private sector risk holdings to reduce the price of risk
- Policies under this category:
 - TALF (non-recourse loans for ABS)
 - Agency and GSE purchases
- Questions:
 - Why not Treasury purchases?
 - Is the Fed's balance sheet big enough?

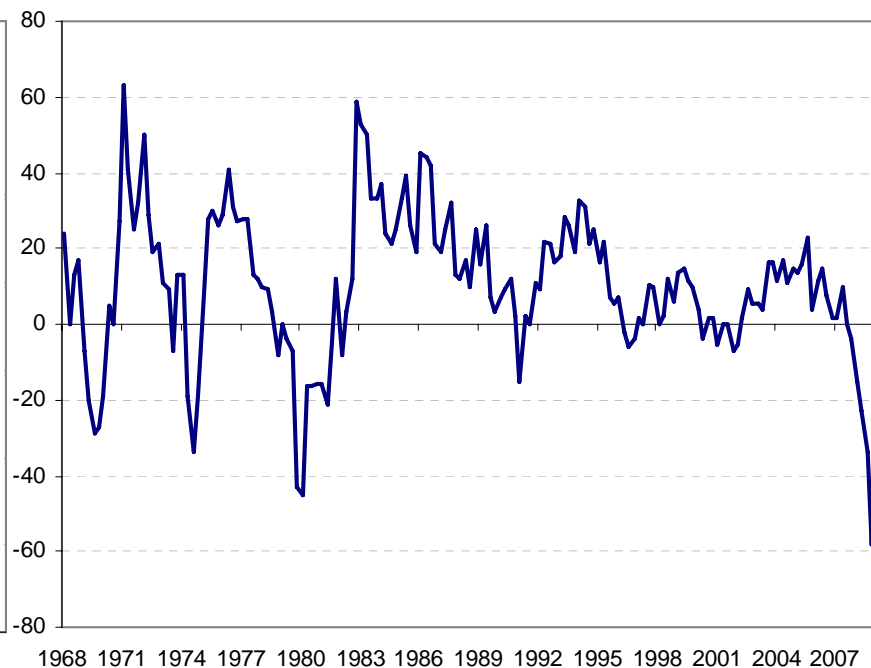
Private Credit Markets: Considerable Strains

Baa Corporate Spread



Note: Baa corporate yield over ten-year Treasury yield.

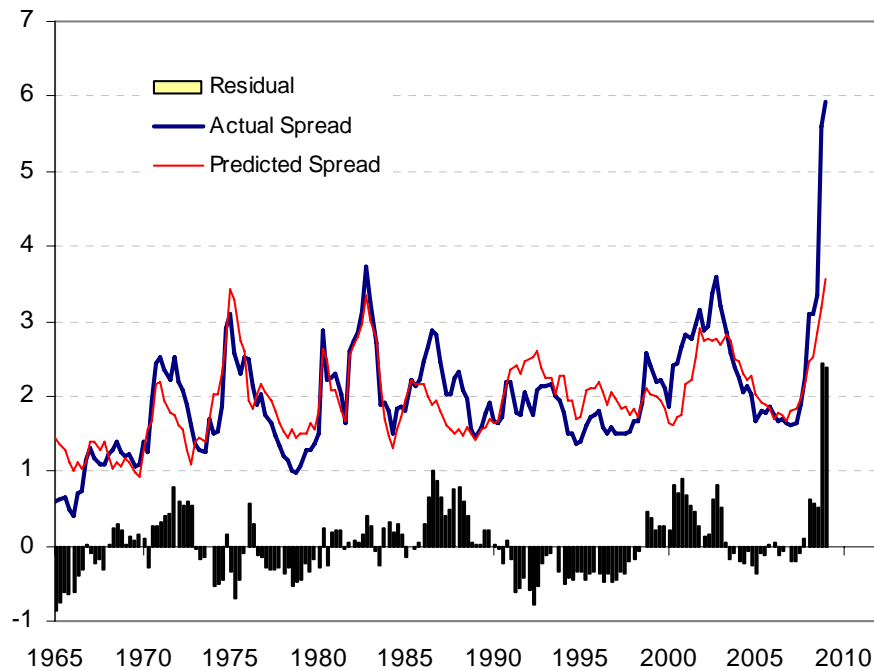
Banks' Willingness to Lend



Note: Net portion of banks (weighted diffusion) more willing to make consumer installment loans. We averaged the observations for 1980Q2 and 1980Q3 to smooth through the distortions created by the credit controls at that time.

Private Credit Markets: Considerable Strains

Baa Corporate Spread



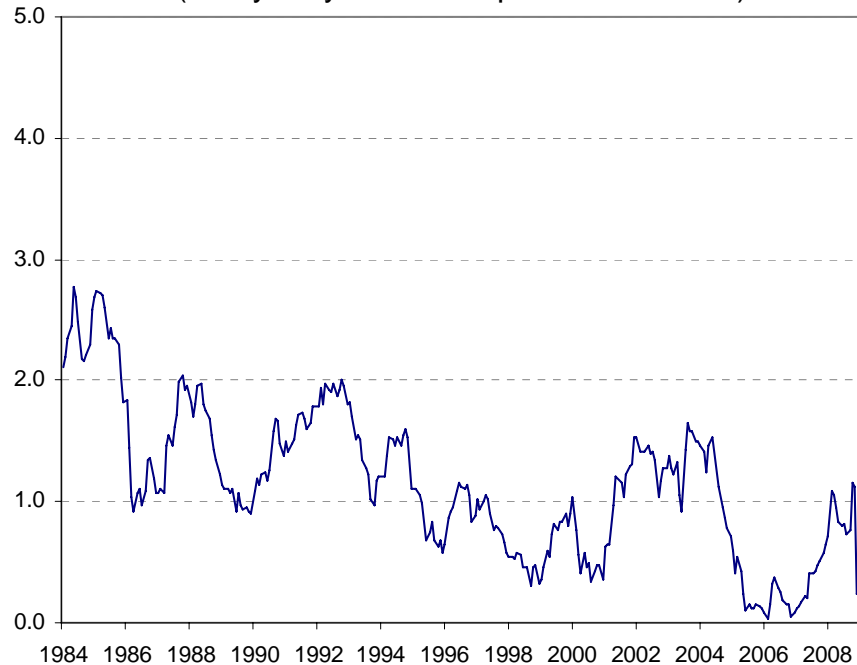
- Most credit spreads appear wide compared to macro fundamentals
- Lower-quality markets not functioning at all
- Raises possibility of discrete and significant improvement from Fed involvement

Why Not Treasuries?

- Some cost to expanding the balance sheet in any direction
 - Implementation issues
 - Exit issues
 - Appearance issues
 - Political issues
- Doubts about effectiveness of Treasury purchases
 - Treasury yields are not high by historical standards
- Use balance sheet where most effective
 - Private credit seen as very tight or completely dysfunctional
 - Housing at center of crisis

Treasury Yields: Not Uncomfortably High

Term Premium on Treasury Securities
(Ten-year yield less expected short rate)

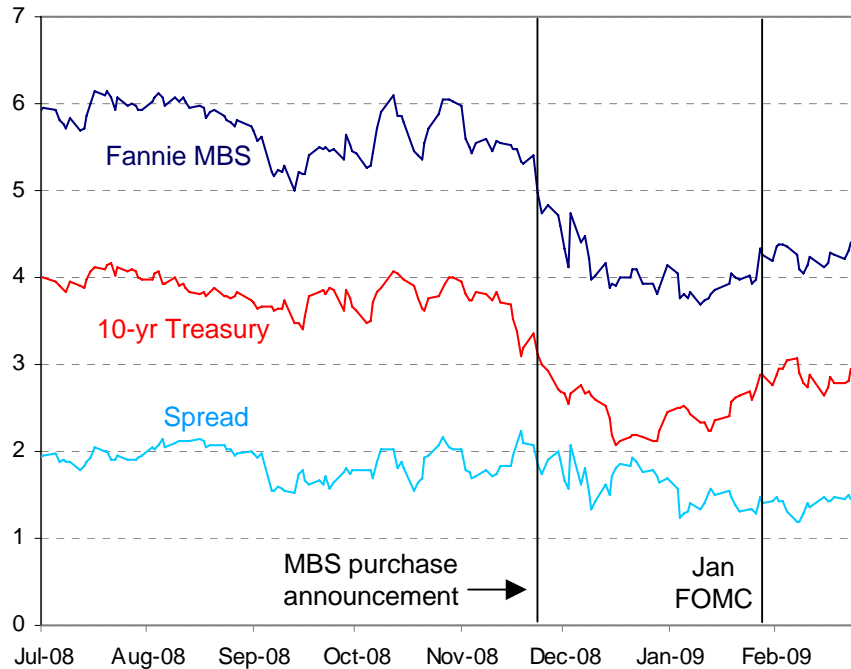


Note: Measure derived from regression model developed by Macroeconomic Advisers.

- Term premium is not (yet) high by historical standards
- Another measure (Kim-Wright) puts term premium at negative value (unprecedented)
- How much could the Fed push it down?

MBS Purchases: Are They Sufficient?

Treasury and MBS Yields



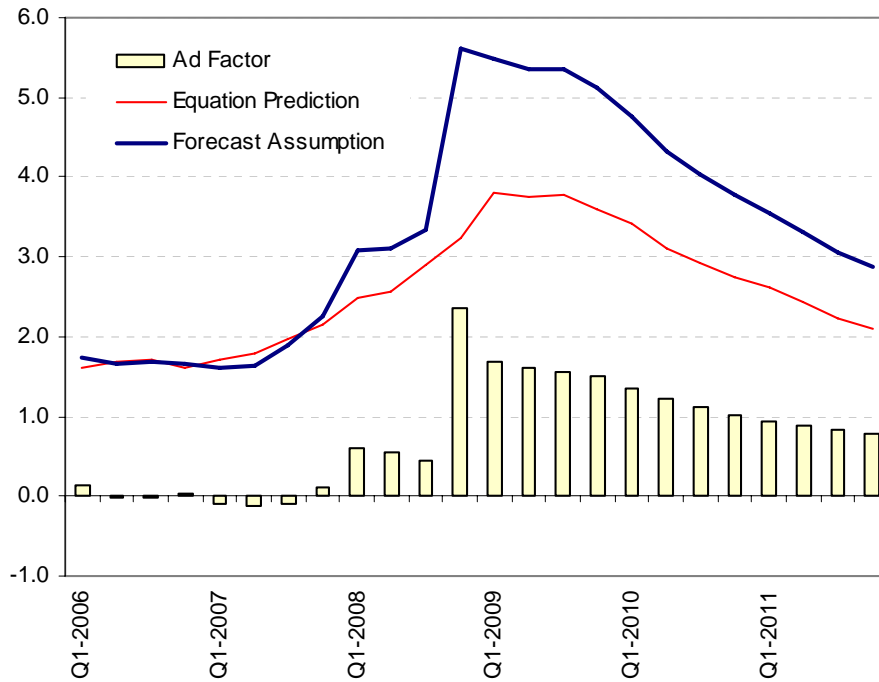
- Fed purchases appear to have narrowed MBS spread
- However, swings in Treasury yields have had considerable influence on MBS rate
- Those swings appear partly related to supply and prospects for Fed purchases

Advantages of Buying Treasuries

- Would likely have some effect
 - Prevent term premium from rising in response to supply
 - Evidence of supply effects from Treasuries vs OIS rates
- Easy to implement
 - Fed has considerable experience buying Treasuries
- Easy to exit
 - Holdings can be sold easily
 - Unlike MBS purchases or TALF
- Avoids making credit allocation decisions
 - Other programs must decide which private assets to include

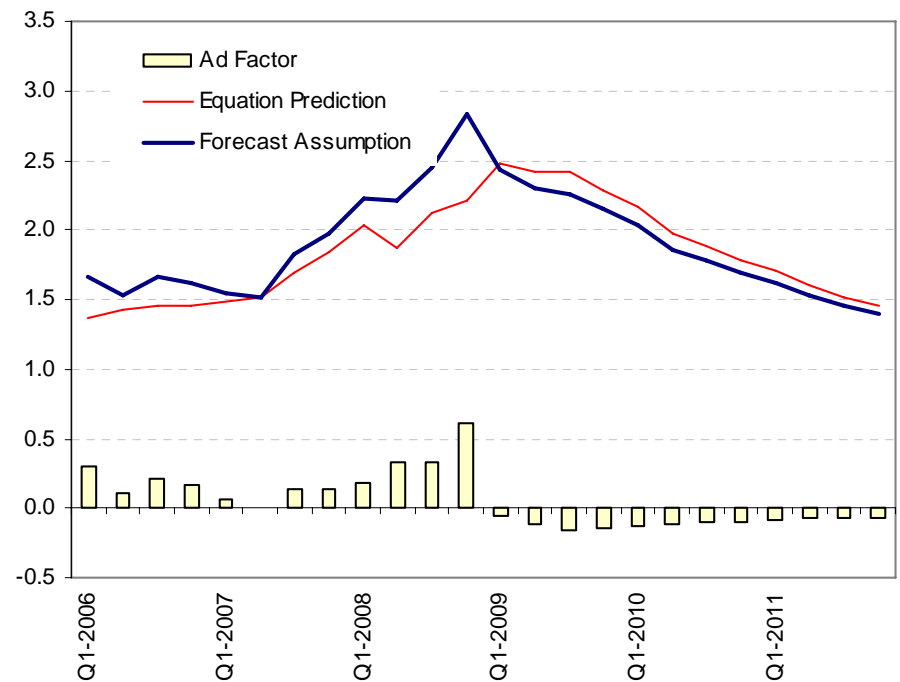
Balance Sheet Policies and the Forecast

BAA Corporate Yield Spread



Note: Moody's BAA yield less ten-year Treasury yield.

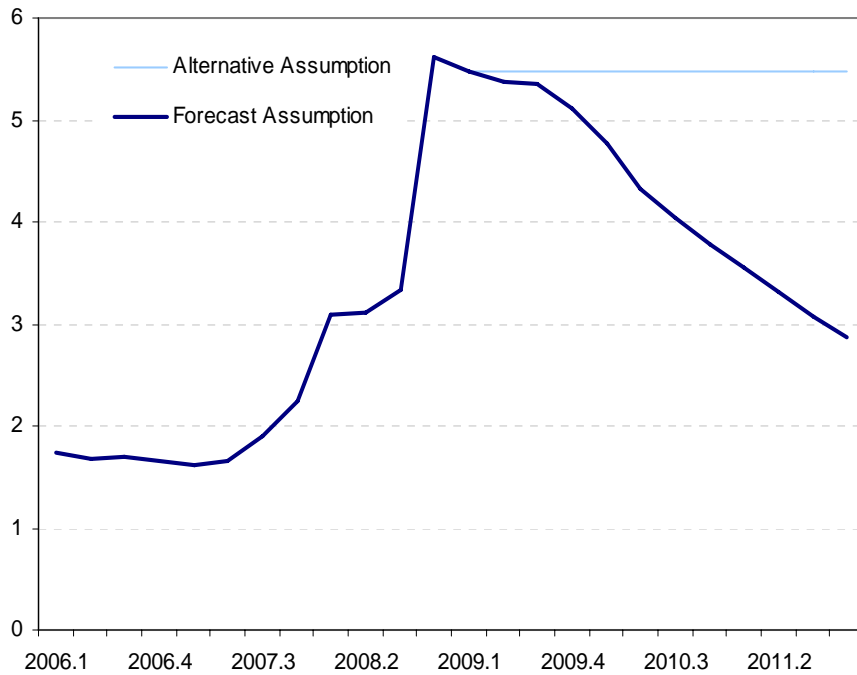
Conforming Mortgage Spreads



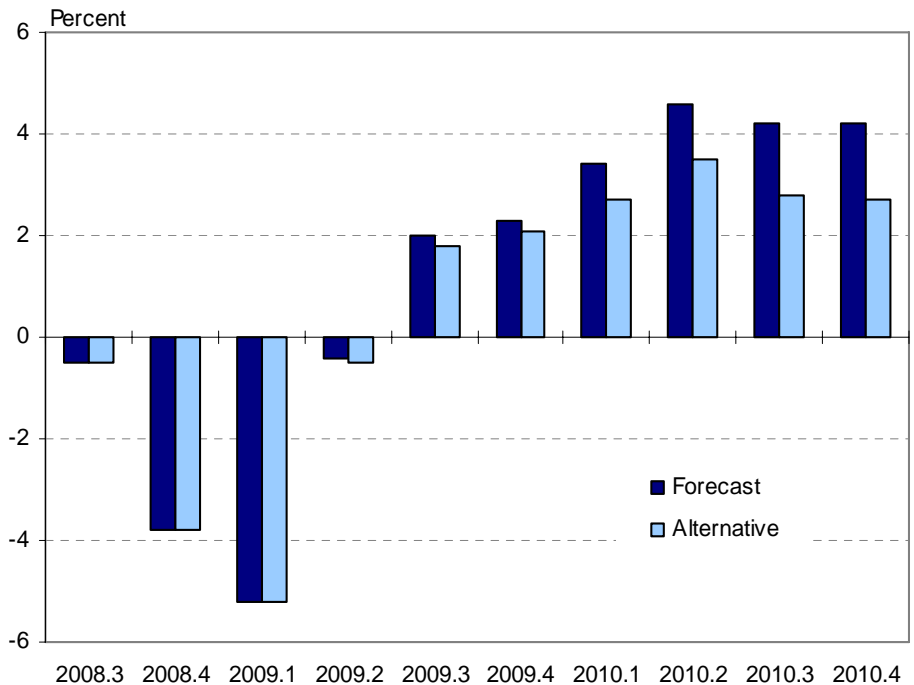
Note: Conforming mortgage rate less ten-year Treasury yield.

Balance Sheet Policies and the Forecast

BAA Corporate Yield Spread



Real GDP Growth



Is the Fed's Balance Sheet Big Enough?

Central Tendency of Forecasts of FOMC Members

	2009	2010	2011	Longer-run
Growth of Real GDP				
January projections	-1.3 to -0.5	2.5 to 3.3	3.8 to 5.0	2.5 to 2.7
<i>MA forecast</i>	<i>-0.3</i>	<i>4.1</i>	<i>4.7</i>	<i>2.6</i>
Unemployment Rate				
January projections	8.5 to 8.8	8.0 to 8.3	6.7 to 7.5	4.8 to 5.0
<i>MA forecast</i>	<i>8.8</i>	<i>8.3</i>	<i>7.1</i>	<i>4.8</i>
Headline PCE Inflation				
January projections	0.3 to 1.0	1.0 to 1.5	0.9 to 1.7	1.7 to 2.0
<i>MA forecast</i>	<i>-0.3</i>	<i>0.1</i>	<i>0.0</i>	<i>1.75</i>
Core PCE Inflation				
January projections	0.9 to 1.1	0.8 to 1.5	0.7 to 1.5	<i>na</i>
<i>MA forecast</i>	<i>0.3</i>	<i>0.0</i>	<i>-0.1</i>	<i>na</i>

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