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Fed Embraces Japan-Style Tools With Floor on Securities

By Scott Lanman and Joshua Zumbrun - Aug 12, 2010

The Federal Reserve's decision to sustain the current level of its assets intensifies the focus of the central bank on policy tools similar to those used with little impact by Japan last decade.

The Fed on Aug. 10 set a floor on its holdings at the current $2.05 trillion level, aiming to stop any contraction in the balance sheet from pushing up borrowing costs during a slowdown in economic growth. Other Fed tools, including a reduction in the benchmark interest rate almost to zero, revived credit markets without yet ensuring a sustained recovery.

A policy that associates the Fed with the Bank of Japan's unsuccessful strategy of expanding reserves poses a risk for U.S. central bankers, said Stephen Stanley, a former Fed researcher. Chairman Ben S. Bernanke has called Fed policy credit easing to differentiate it from Japan's so-called quantitative easing from 2001 until 2006, which failed to spur bank lending in the world's No. 2 economy.

"I don't think anyone in the market is fooled" by the distinction, said Stanley, chief economist at Pierpont Securities LLC in Stamford, Connecticut. "That is a problem, both substantively and also from a perception standpoint."

Fed officials would probably "try to argue their way around that and say it wasn't so much that quantitative easing doesn't work at all, it's that there were problems with the Japanese carrying out of various policies," Stanley said. He and other Fed watchers dubbed this week's move "QE Lite."

Stocks Fall

Treasuries rallied and stocks fell yesterday for a second day after the Fed's move to start reinvesting principal payments on mortgage holdings into long-term government bonds. The yield on 10-year Treasuries dropped at 4:03 p.m. to 2.68 percent from 2.76 percent, while the two-year note yield fell to 0.51 percent, near a record 0.49 percent.

The Standard & Poor's 500 Index declined 2.8 percent to 1,089.47 at the close of trading in New York, the biggest drop since July 16.

The Fed said yesterday it will buy about $18 billion of Treasury securities and Treasury Inflation-Protected Securities through mid-September in the first month of purchases under the new plan.

The Bank of Japan kept its benchmark rate near zero as it used quantitative easing, becoming the first central bank in modern history to embark on the policy. The BOJ targeted the level of reserves and pumped trillions of yen in excess cash into the economy, trying to encourage bank lending to companies and beat deflation.

Target Increased

The policy failed because the BOJ's funds sat static in commercial lenders' accounts at the central bank, even though the target was increased by almost nine times to 35 trillion yen ($411 billion) by early 2004. The money didn't spark business investment and consumption, and deflation plagued the economy through 2005.

The Fed, by comparison, is trying to lower borrowing costs by targeting the level and composition of assets it holds that correspond with bank reserves instead of the actual level of excess reserves, which totaled $1.01 trillion as of July 28.

Separately yesterday, the central bank posted a paper co- written by Seth Carpenter, associate director of the Fed's monetary-affairs division, finding that the "quantity of reserve balances itself is not likely to trigger a rapid increase in lending."

Greg Hess, a former Fed researcher, said the comparison between the Fed and the BOJ was overdrawn.

'Aggressive' Fed

"The way it is not like the Japanese policy is the Fed was aggressive, it's still early in the process, and the U.S. economy is still in the position of having reasonable growth" in nominal gross domestic product, said Hess, an economics professor at Claremont McKenna College in California. "We have learned many of the lessons that Japan has learned the hard way."

The U.S. economy's headwinds may be related more to federal debt and won't be cured by Fed actions, according to Gerald O'Driscoll, former Dallas Fed vice president and now senior fellow at the Cato Institute in Washington. "There's no additional role for the central bank in curing what ails us," he said. "The problem is on the fiscal side."

With the action, the Fed is aiming to stop the shrinkage in its balance sheet from prompting an

increase in long-term borrowing costs, potentially allowing rates to fall further. While the move shows a change in policy direction away from exiting monetary stimulus, the Fed didn't indicate it was ready to pursue larger-scale purchases of securities.

Prepaid Securities

The New York Fed estimated in March that more than $200 billion of the agency debt and mortgage-backed securities held by the central bank would mature or be prepaid by the end of 2011, and the pace in payments has since accelerated.

"This is a strategic ploy of testing the waters regarding how receptive global financial markets might be to the application of quantitative easing," said John Lonski, chief economist at Moody's Capital Markets Group in New York.

The central bank acted this week after companies cut the pace of hiring since April and a government report showed the worst U.S. recession since the 1930s was deeper than previously estimated. Household spending fell 1.2 percent in 2009, twice as much as previously projected and the biggest decline since 1942, according to revisions released July 30.

Companies hired an average 51,000 employees a month from May to July, compared to 241,000 in April and 158,000 in March, Labor Department data show. A swelling trade gap, less inventory stockpiling and weaker construction indicate the U.S. economy slowed further in the second quarter than first estimated.

"Working with the size of the balance sheet is the only thing they've got left," said former Fed Governor Lyle Gramley, now senior economic adviser with Potomac Research Group in Washington.

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