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Fed Effectively Adopts A Zero Interest Rate Policy (ZIRP)

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Highlights

- "Weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for sometime."
- The Fed's primary means of stimulating economic activity will be to expand the menu of assets that it buys to increase the supply of credit in the financial system as part of its *quantitative* easing.
- The Fed has committed to begin purchasing up to $500 billion in agency debt and mortgage-backed securities (Ginnie Mae, Fannie Mae, and Freddie Mac) through select asset managers by year end.

The Federal Reserve reduced its benchmark policy rate to a range between 0% and 0.25% at the conclusion of its policy meeting today. The central bank also said it anticipates "that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for sometime." Since interest rates cannot go below zero, today marks the official end of *conventional* monetary policy.

From this point forward, the Fed's primary means of stimulating economic activity will be to expand the menu of assets that it buys to increase the supply of credit in the financial system as part of its *quantitative* easing. Contrary to what some analysts claim, the Fed has not run out of ammunition to combat the weakening economy and global financial crisis. Instead, quantitative easing simply means the Fed is breaking out the Howitzer cannon and putting away the handgun.

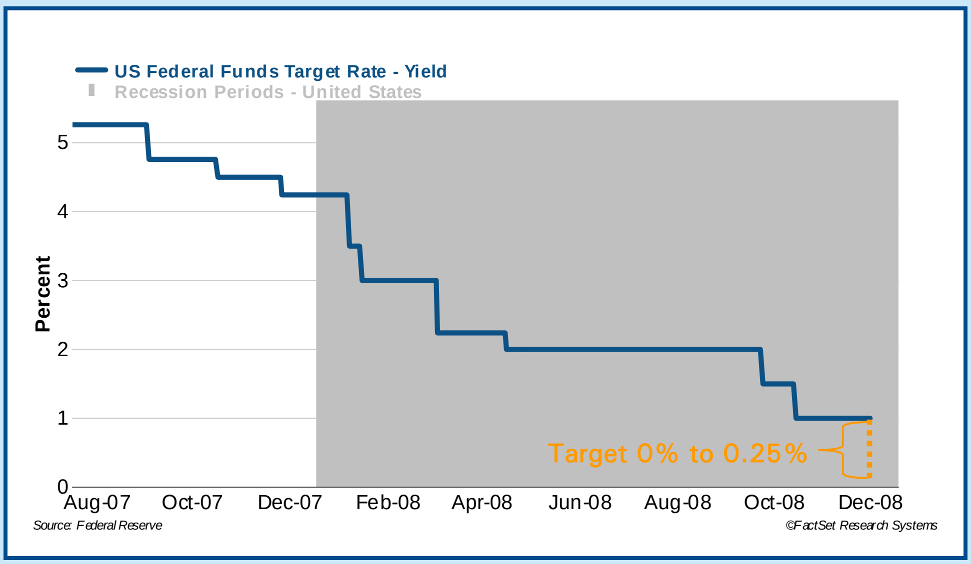
What Types of Assets Will the Fed Buy?

First and foremost, the Fed has committed to begin purchasing up to $500 billion in agency debt and mortgage-backed securities (Ginnie Mae, Fannie Mae, and Freddie Mac) through select asset managers by year end. This amounts to approximately 10% of the total agency-backed mortgage market and an even larger percentage of the pool that is tradable. The Fed also indicated that it is prepared to expand its purchases as conditions warrant.

Since announcing the plan, mortgage rates on 30-year conforming loans have fallen by approximately 81 basis points from 6.18% to 5.38%. If the Fed chooses, it could even target conforming mortgage rates at 4.5%, which is in line with the rate the Treasury is contemplating offering to new home buyers through Fannie and Freddie. The reason you can be confident that the Fed can achieve such low rates is twofold: 1) they have done so in the past with rates on T-bonds during the 1940s despite adverse conditions; and 2) they have unlimited resources to throw at the market.

On the first point, in the 1940s, the Fed targeted 10-year Treasury yields at 2.5% for nearly a decade. They accomplished this without ever holding a substantial share of the long-maturity bonds outstanding. For example, the Fed held 7% of

ZIRP to the Rescue?



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- Fed's balance sheet has already grown from 6% of GDP in August to 17% of GDP as of early December.
- The end game for the central bank is to stimulate aggregate demand and prevent the current down-cycle from feeding upon itself and resulting in a broad based deflation.
- Once the Fed succeeds in encouraging a refinancing boom and getting money into consumer pockets, the next step may be to attack the corporate bond market should conditions fail to improve.

outstanding Treasury securities in 1945 and as much as 9.2% in 1951, the last year they targeted rates. The central bank's stated commitment to buy 10-year T-bonds at 2.5% was sufficient to hold the rate steady.

What is even more impressive about this achievement is the fact that the macroeconomic environment would have justified Treasury rates that were four or five times higher. The US government debt to GDP ratio was 120% in 1947 compared to less than 70% today. Furthermore, inflation was high and volatile reaching 20% in the late 1940s. Comparable inflation rates in the early 1980s pushed 10-year yields up to nearly 16%.

How Will the Fed Pay for All This?

Even if you refuse to accept the idea that the Fed's decision to purchase 10% of the tradable agency-backed mortgage market is sufficient to push rates lower, you have to also consider that there is no reason why the Fed can't double the percentage of agency-mortgages it buys. To finance these purchases, the Fed will create new bank reserves –essentially print cash and expand its balance sheet. The Fed's balance sheet has already grown from 6% of GDP in August to 17% of GDP as of early December. There is little reason why it can't rise further. For some perspective, the Bank of Japan's balance sheet expanded to 30% of GDP in 2005 as part of their quantitative easing.

Thus, if mortgage rates are not falling to the Fed's desired level, the central bank can just throw more money at the problem. Theoretically, there is no limit to how large this program could become. Therefore, a sufficiently committed Fed is likely to be successful in driving mortgage rates lower.

Fed By-Passes the Banking System

The bigger question is not whether the Fed will manage to push mortgage rates sharply lower, but rather which market will they attack next. The Fed realizes that the money multiplier is broken (the Fed is pushing on a string), meaning that reductions in the central bank's policy rate have not had the intended effect on market interest rates for consumers or businesses. The problem is that the banking system is in capital preservation mode and is unwilling to make new loans and pass on lower rates to consumers and businesses because they already have their fair share of bad loans on their books. Consequently, the Fed is by-passing the banking system and going directly to the securitized market to drive down market interest rates. The end game for the central bank is to stimulate aggregate demand (consumer and business spending) and prevent the current down-cycle from feeding upon itself and resulting in a broad based deflation.

Once the Fed succeeds in encouraging a refinancing boom and getting money into consumer pockets, the next step may be to attack the corporate bond market should conditions fail to improve. Although the Fed cannot buy corporate bonds under current law, it can lend against corporates. Therefore, if it chose to, the central bank could begin printing money and making low or zero-interest loans to banks while accepting corporate bonds as collateral. Or the Fed could set up another credit facility to add to the myriad of credit facilities it has already created to purchase corporate debt. This would improve the liquidity in the corporate bond market which would theoretically drive down rates. Fed Chairman Ben Bernanke touched on all of the ideas above in his 2002 speech, "Deflation: Making Sure 'It' Doesn't Happen Here."