Weekly commentary by Professor Jeremy J. Siegel

Bold Fed Move on Target despite Foreign Reaction

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Clearly the most important event this past week was the surprising announcement that the FOMC is going to purchase up to $750 billion in additional mortgage related agency debt and up to $300 billion in long term treasuries (both nominal and TIPS). The impact of the announcement on the long-term treasury market was dramatic, with the ten-year government bond falling 45 bps to 2.45% (The bond now trades at 2.61%).

The reaction in the foreign market was negative, as the dollar fell sharply and commodities rose. The prevailing opinion was that the Fed was desperate and is now "throwing money" at the economy. Many believe this will eventually lead to inflation and a depreciation of the currency.

But I believe that assessment is wrong. The Fed moves did have a positive impact on commodity prices. But this is not altogether unwelcome, as the Fed wants to avoid deflation. Certainly if commodity prices, especially oil, move up substantially, this will become a problem. But that is unlikely unless world energy demand strengthens and that means the world economy is turning around.

The Fed policy is designed to reduce the spreads between the mortgage-backed bonds and treasury bonds in order to stabilize the housing sector and reduce the cost of long-term debt. Mostly the Fed will be swapping short-term treasuries for long-term treasuries. Since the appetite for short governments is so great, it is sensible for the Federal Reserve to sell them into the private market in exchange for assets that are in lesser demand.

But the Fed's intentions are not just to swap short for long; the central bank also wants to increase the balance sheet of the Fed so as to provide even more reserves to the banking system and encourage banks to lend to the public. This policy, called quantitative easing, will not (initially at least) increase the currency in the hands of the public but it will increase bank reserves. If banks do not wish to hold these reserves they can pay back their borrowings either through the discount window or their borrowed funds from the Term Auction Facility (TAF), from which banks have borrowed almost $500 billion dollars. The Fed's policy will narrow spreads so that the private sector will be encouraged to borrow when profitable opportunities present themselves. I would not be surprised if other foreign central banks eventually follow the Fed's lead.
