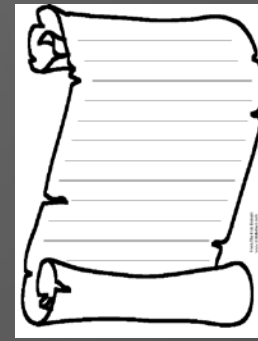


Quantitative easing: Entrance and exit strategies

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Princeton University
Homer Jones Memorial Lecture
Federal Reserve Bank of St. Louis
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Outline



1. The conceptual basis for quantitative easing
2. The Fed's entrance strategy
3. The Fed's exit strategy
4. Implications for central bank independence
5. Wrapping up

1. The conceptual basis for quantitative easing



The problem and a possible solution



- ▣ The zero lower bound on nominal interest rate
 - “liquidity trap”
 - $r = i - \pi$ can't get negative enough.
- ▣ Friedman's warning about fixing i : dynamic instability
- ▣ Idea: Shrink term and/or risk premiums
 - $R_j = r + \rho_j$
 - Requires imperfect substitutes or “frictions”

Specific strategies



To shrink term premiums

- Buy long-term government bonds...
 - and sell T-bills
 - by creating new bank reserves
- Relies on imperfect arbitrage across yield curve
- Another option: commit to keeping the overnight rate low for a long time

To shrink risk premiums

- Buy the risky asset...
 - and sell the safe asset
 - by creating new bank reserves

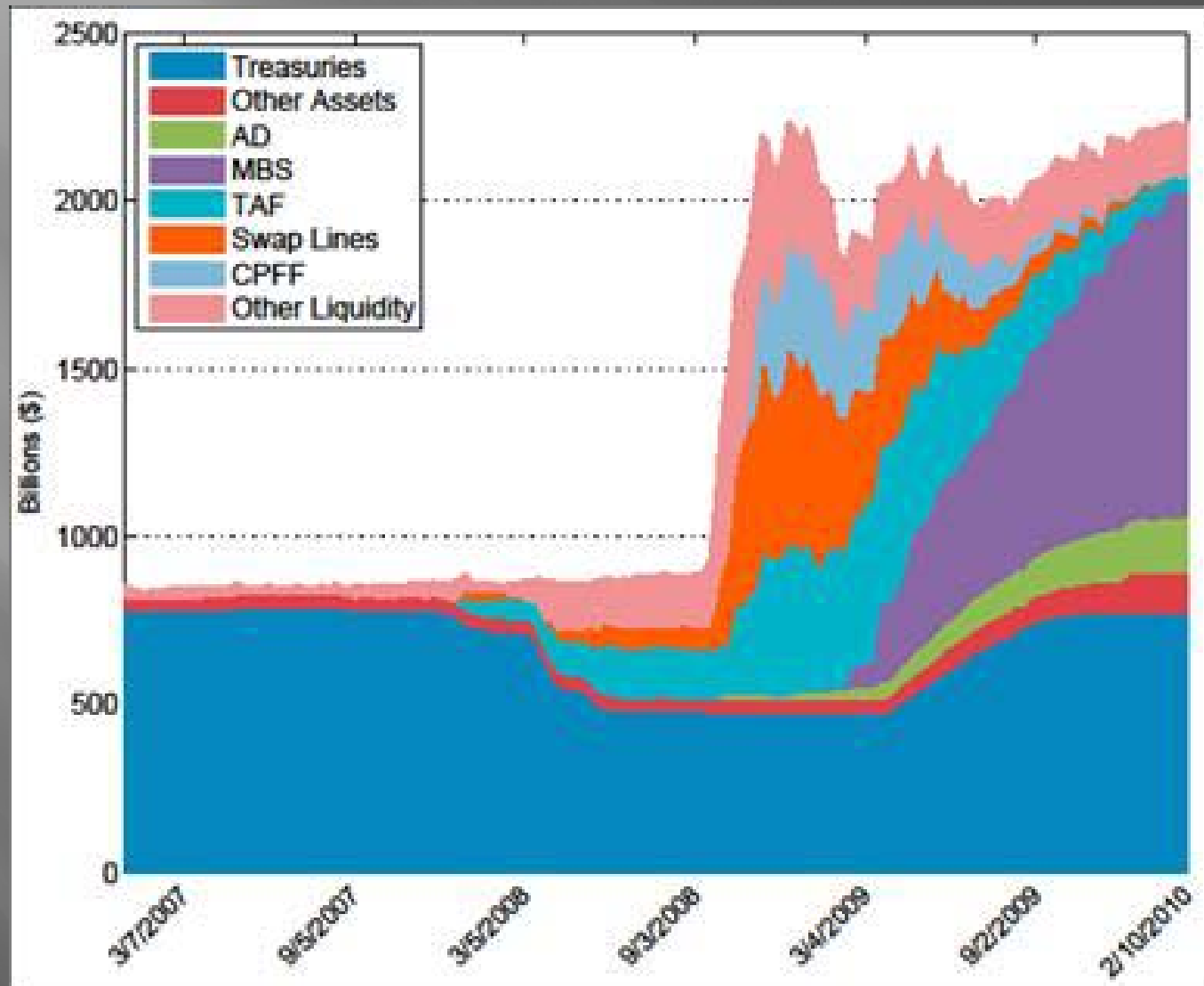
2. The Fed's entrance strategy



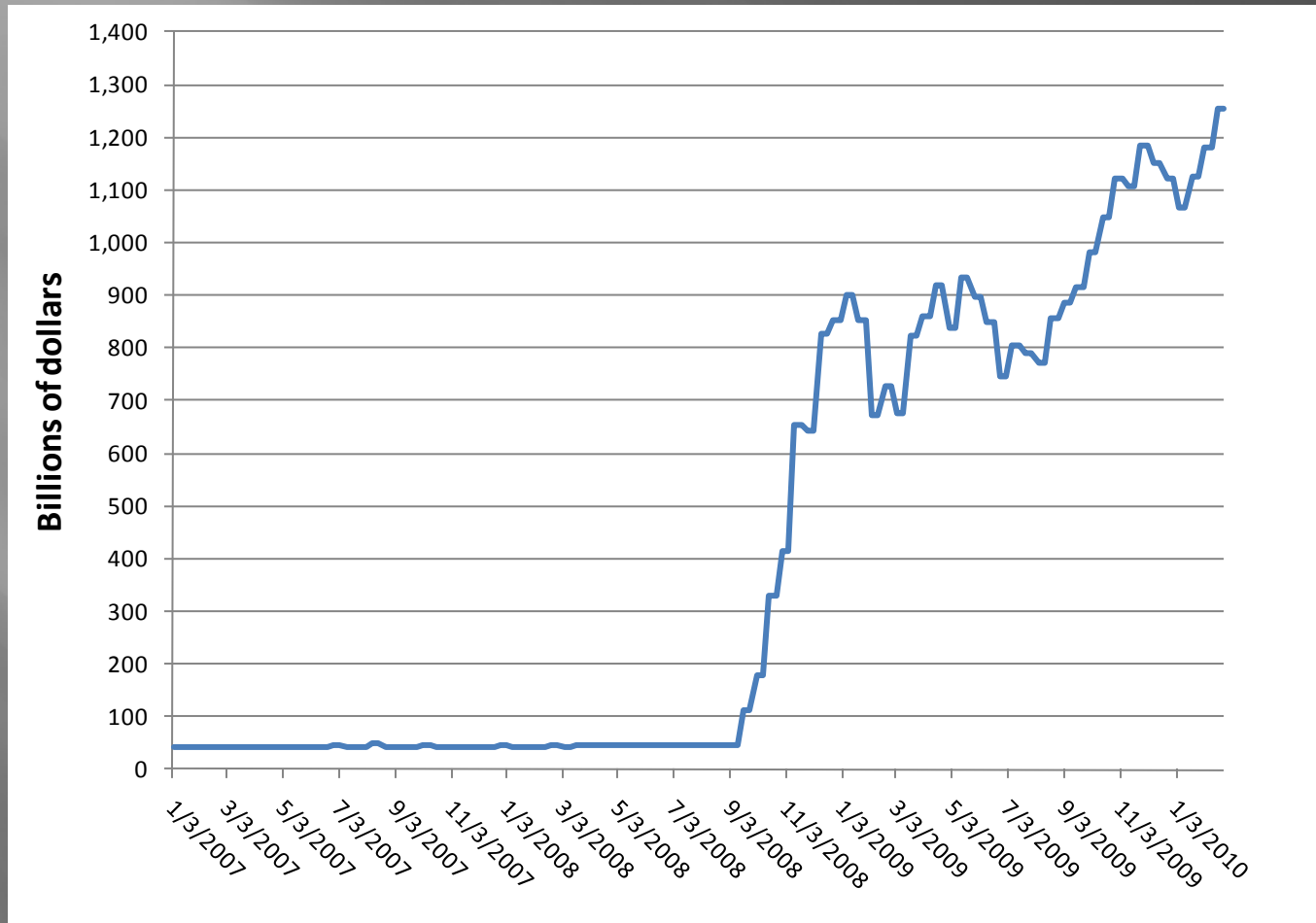
The funds rate first



Early QE did *not* blow up Fed's balance sheet...



...nor increase bank reserves much



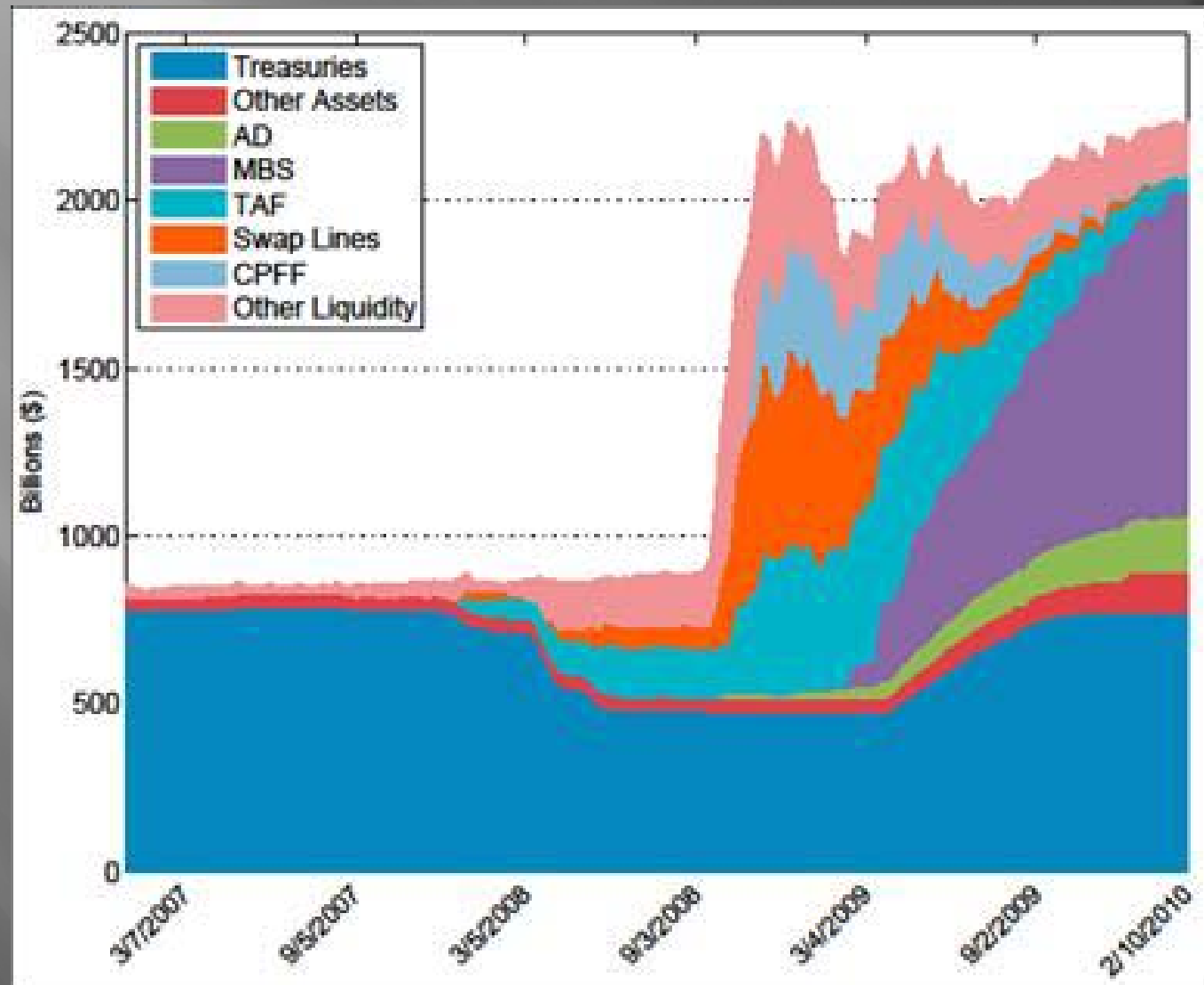
Simplified Fed balance sheet

ASSETS	LIABILITIES AND NET WORTH
Treasury securities	Currency
Less liquid assets	Bank Reserves
Loans	Treasury deposits
	<hr/>
	Capital

Swapping assets

ASSETS	LIABILITIES AND NET WORTH
Treasury securities↓	Currency
Less liquid assets↑	Bank Reserves
Loans	Treasury deposits
	<hr/>
	Capital

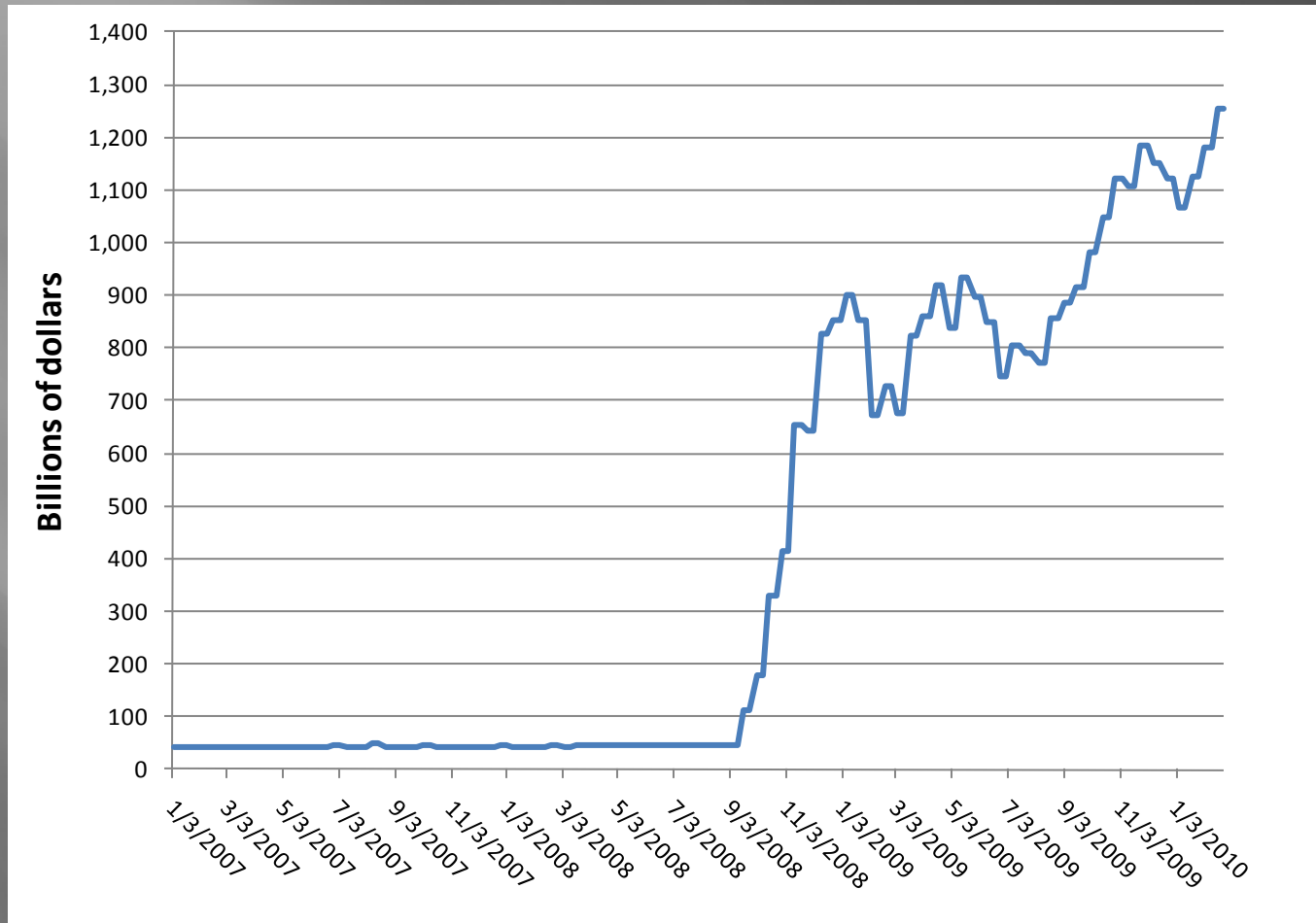
2008: Composition of the Fed's balance sheet starts to change



Adding Treasury deposits

ASSETS	LIABILITIES AND NET WORTH
Treasury securities	Currency
Less liquid assets ↑	Bank Reserves
Loans ↑	Treasury deposits ↑
	<hr/>
	Capital

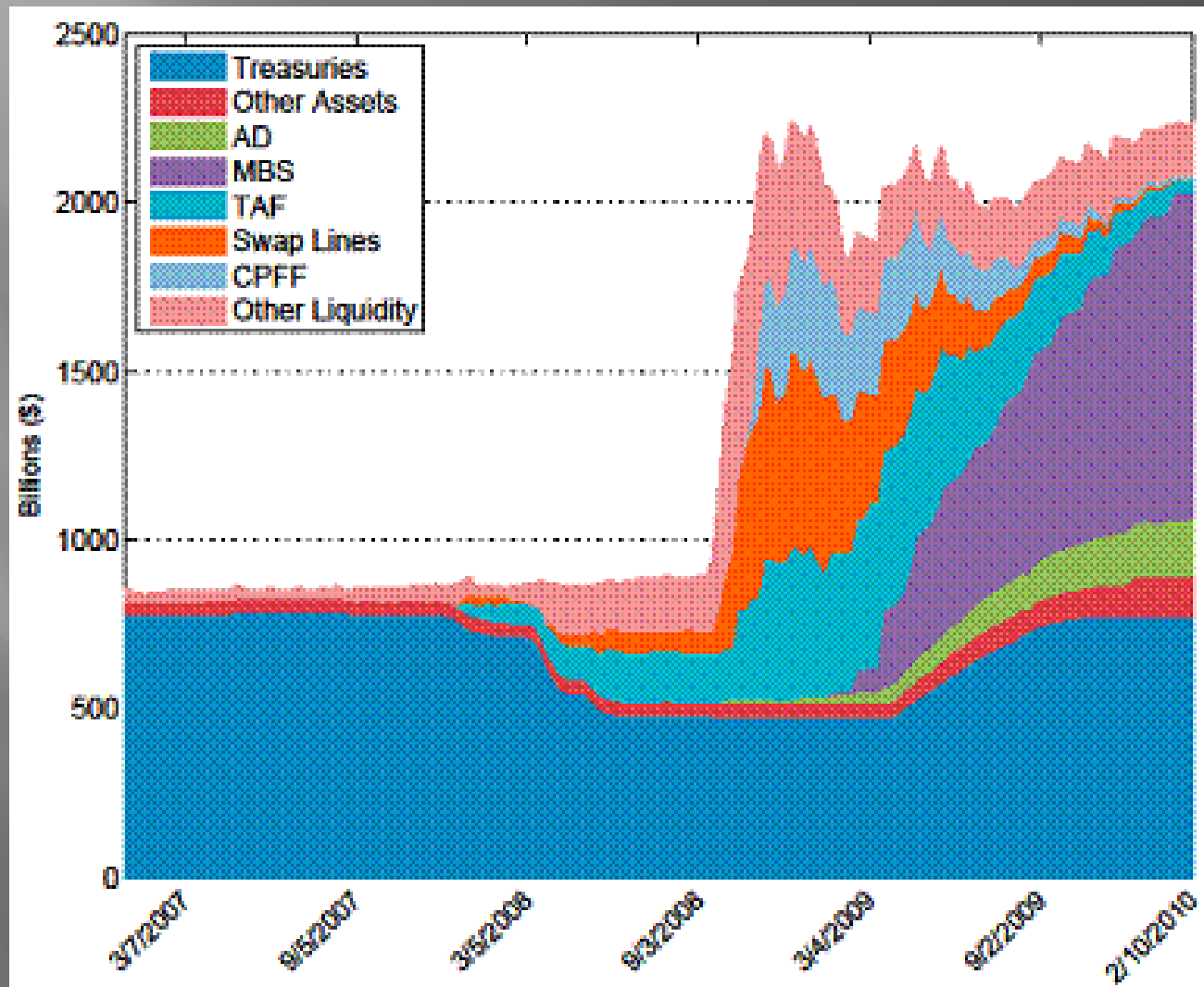
So bank reserves hardly budged



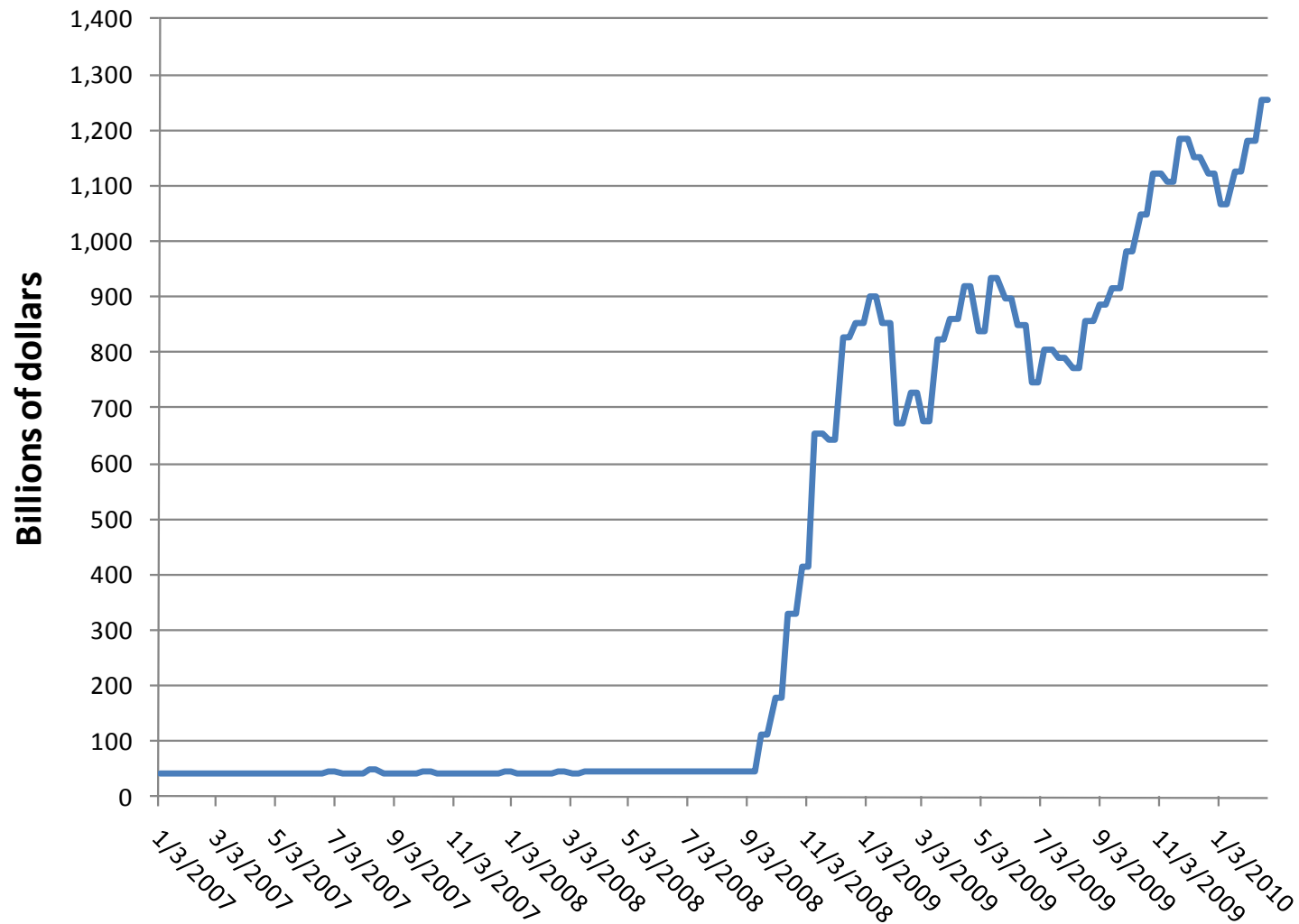
Lehman changed everything



Lehman changed everything



Lehman changed everything



Two-stages in QE entrance



Stage I

Ad hoc, reactive, institution-based
Ex: Bear, AIG,...

Stage II

Systematic, thoughtful, market-based
Ex: CPFF, MBS,...

Working on risk premiums

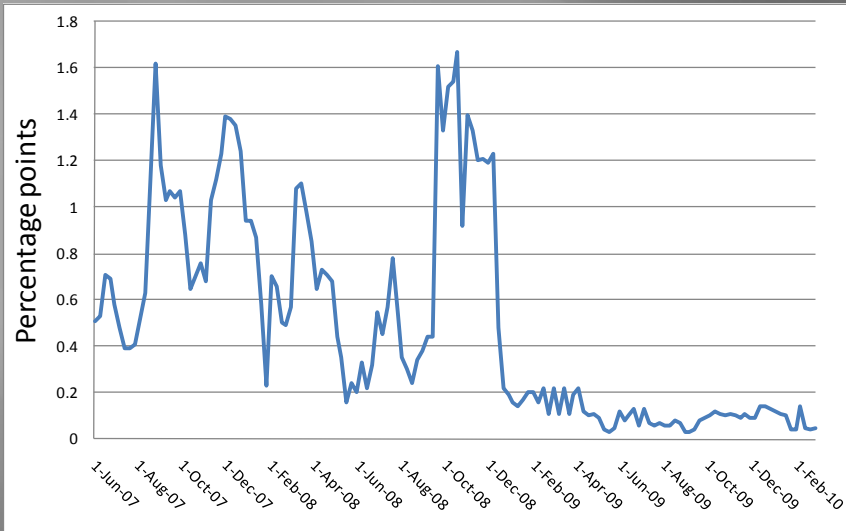
$$R_i = r + \rho_i$$



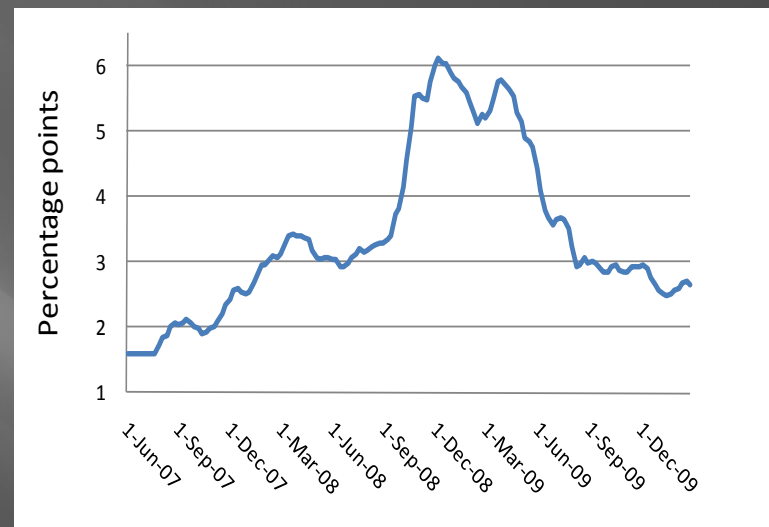
riskless rate

Did it work?

CP vs. T-Bill risk spread



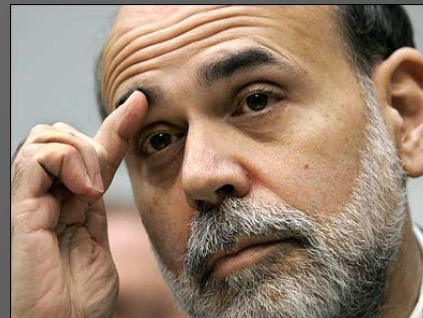
Corporate bond vs. T-note risk spread



3. The Fed's exit strategy

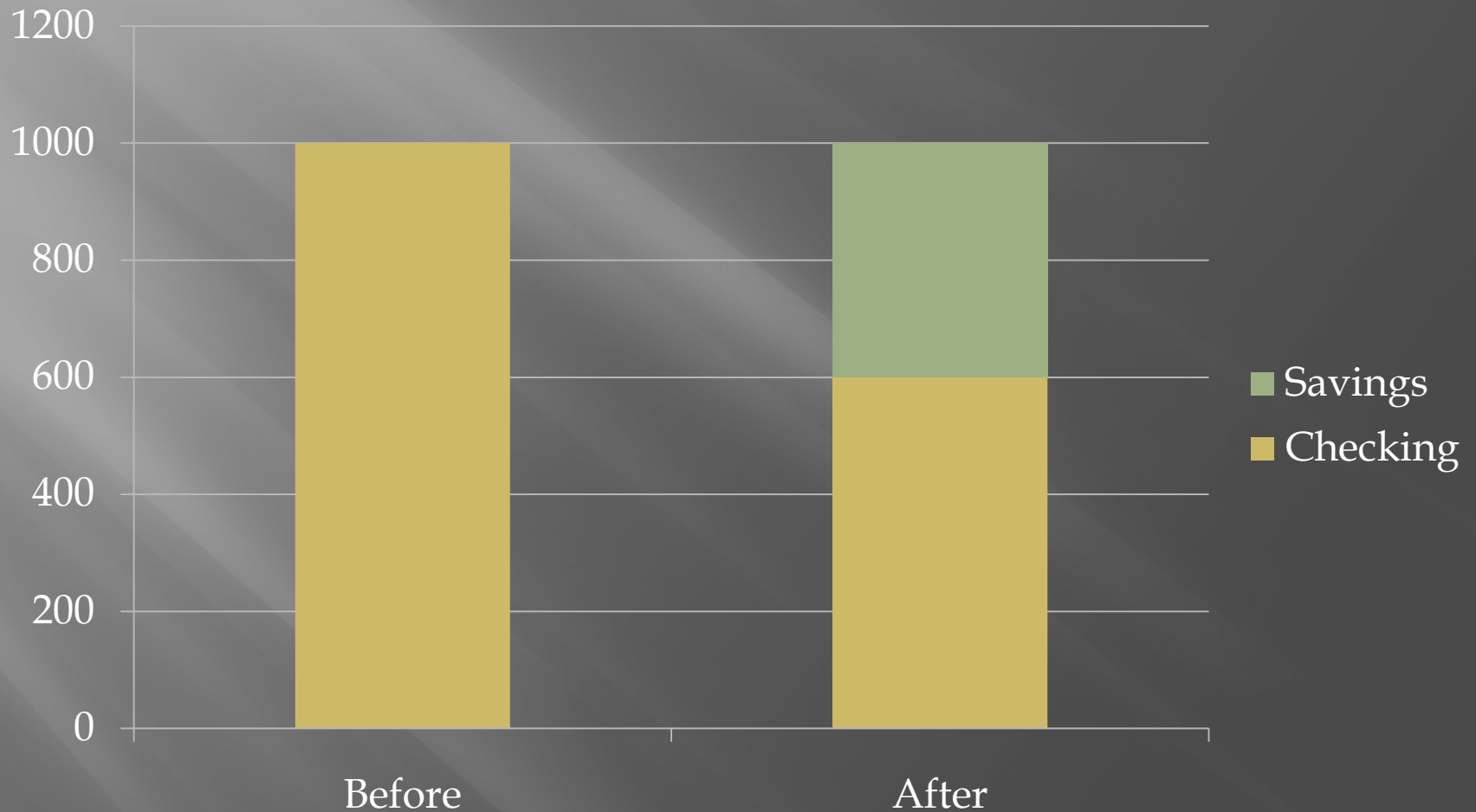


Bernanke's list

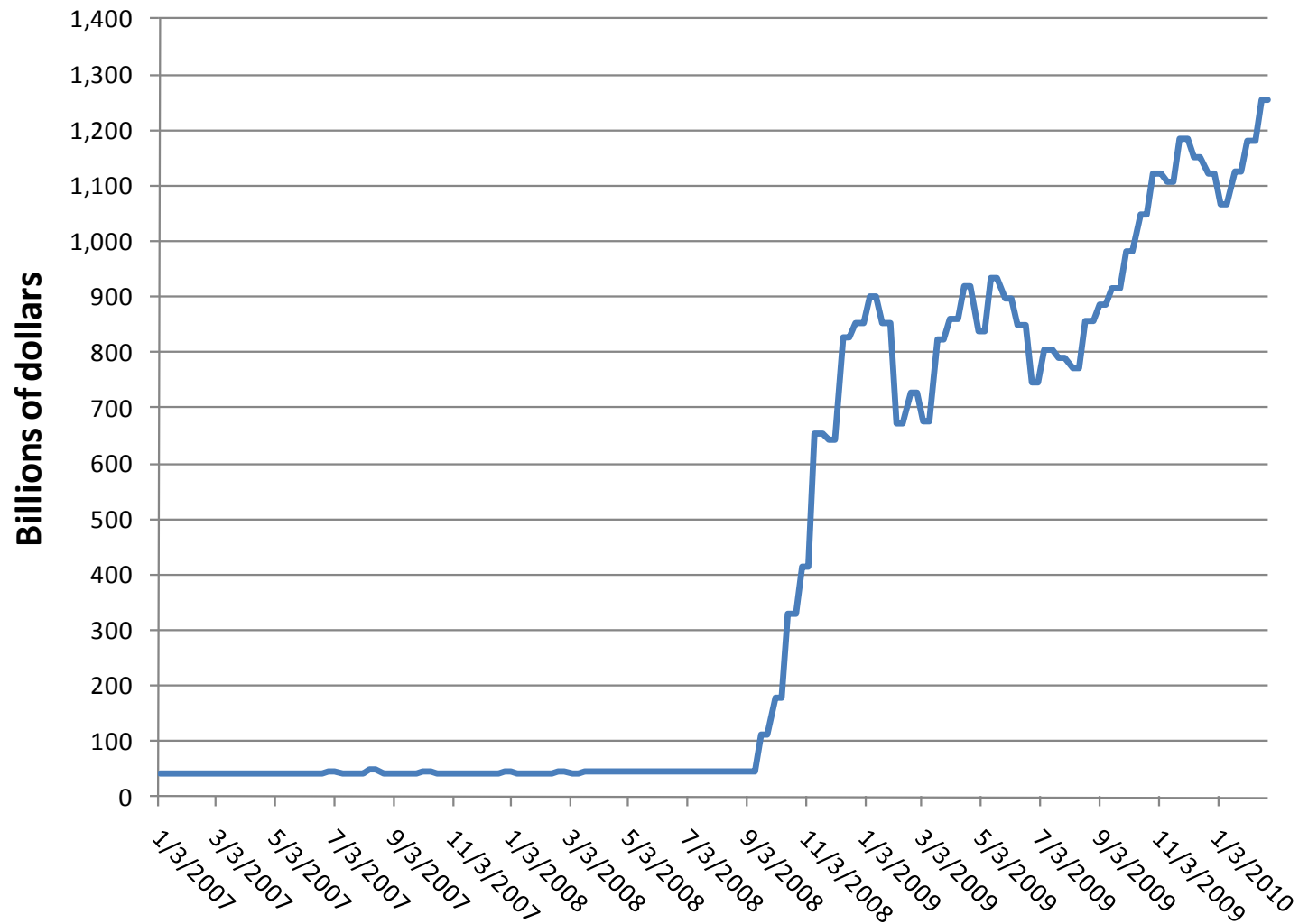


1. Phase out liquidity facilities ← gets for free
2. Normalize discount lending ← supplements 1
3. Passively shrink MBS/GSE debt ← gets for free
4. Increase interest rate on reserves ← novel
5. Offer banks “CDs” ← novel
6. Reverse repos ← conventional OMO, discretionary
7. Outright asset sales ← conventional OMO, discretionary

Offering banks CDs



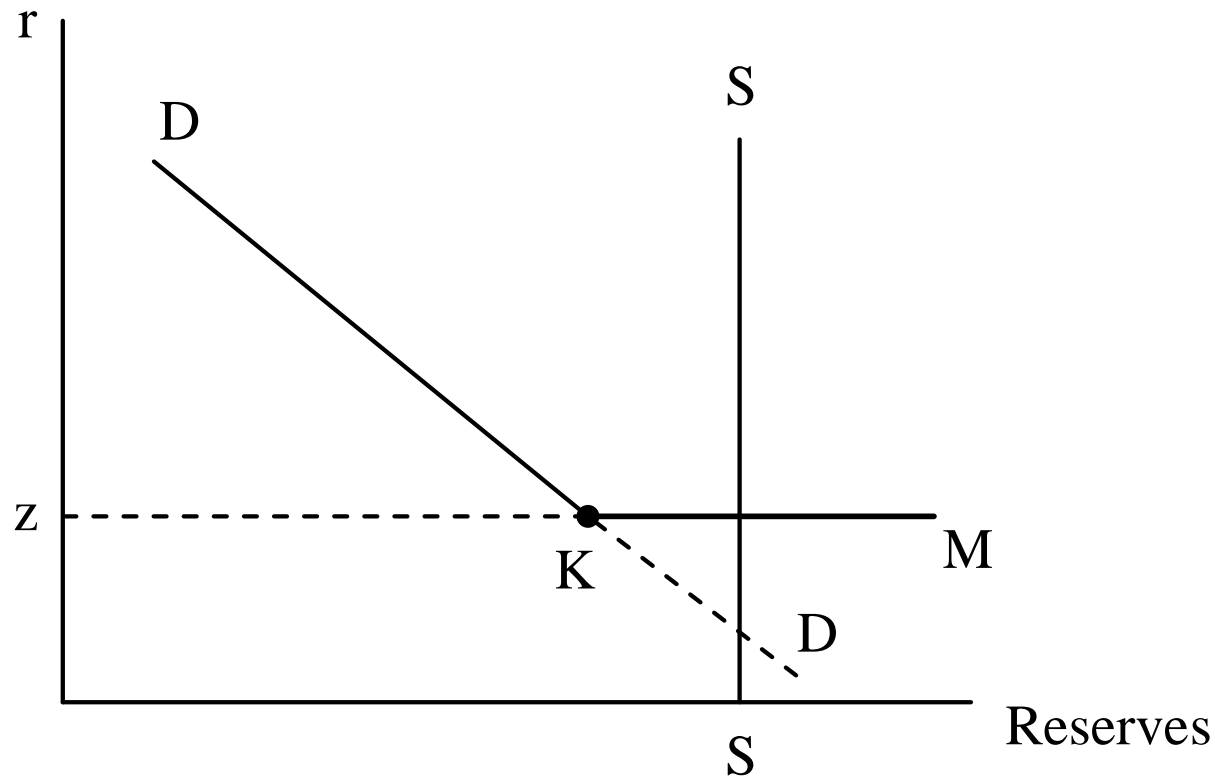
The mountain of reserves



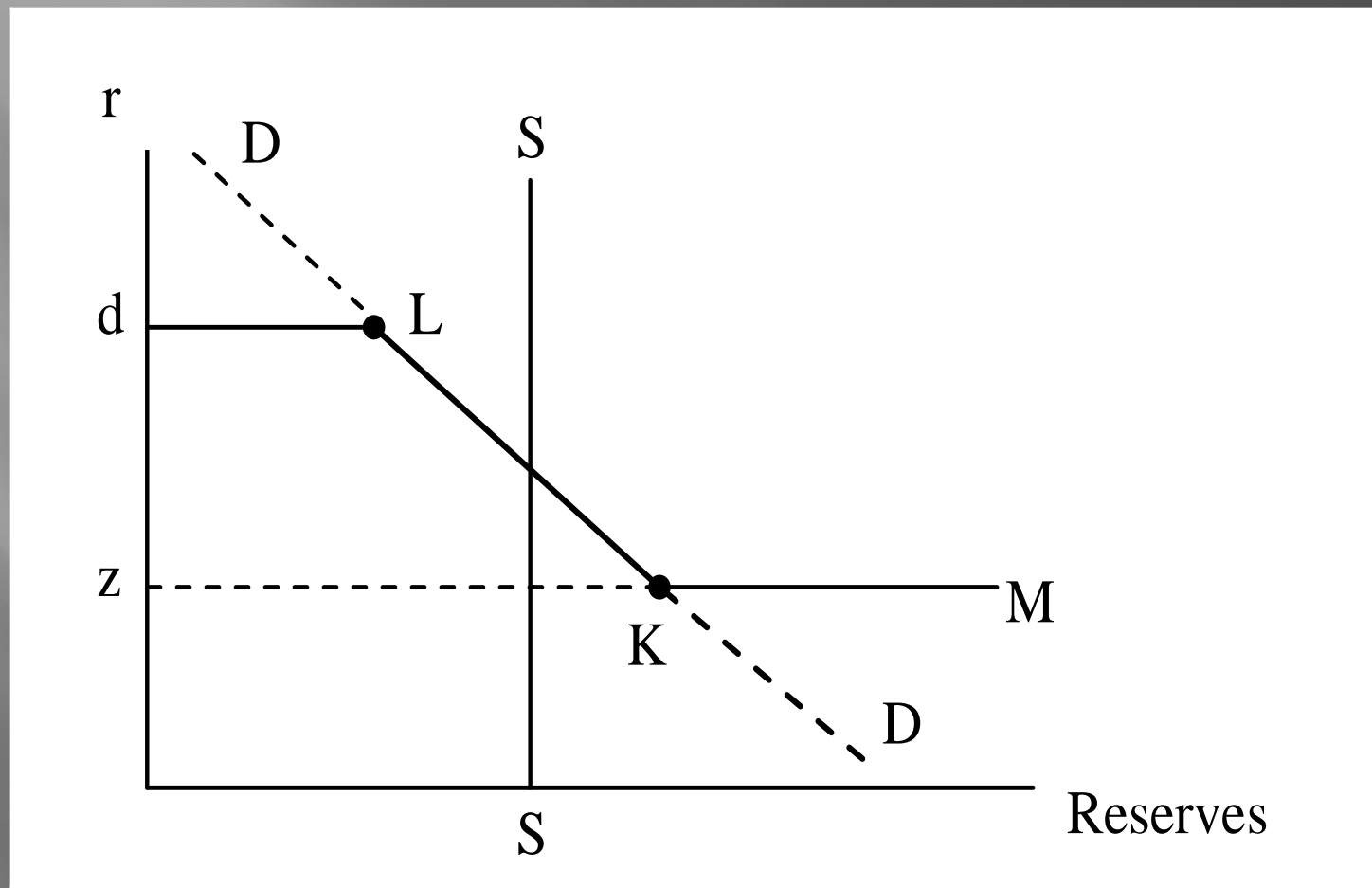
Simplified Fed balance sheet

ASSETS	LIABILITIES AND NET WORTH
Treasury securities	Currency
Less liquid assets ↓	Bank Reserves ↓
Loans ↓	Treasury deposits
	<hr/>
	Capital

The market for bank reserves with a floor



The market for bank reserves with a corridor



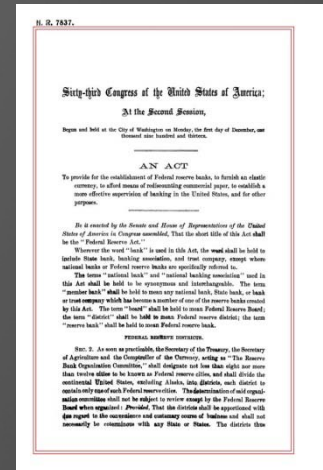
4. Quantitative easing and central bank independence



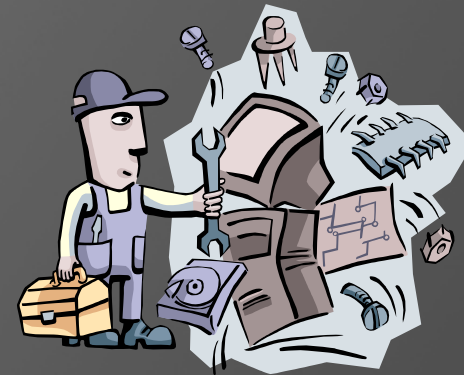
Quasi-fiscal operations

Section 13(3) of FRA:

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, ... to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank. (emphasis added)



Fixing Section 13(3)



- ▣ Require permission of the Secretary of the Treasury (or the FSOC)
- ▣ Require prompt reporting to the two banking committees (confidential for a while)
- ▣ These ideas are in both bills.

An important note— and a question



- ▣ The Fed has *never* had as much independence in the regulatory sphere as it has in monetary policy.
- ▣ What happens when Section 13(3) actions *are* the Fed's monetary policy?

5. Summing up

