Box 2.1

Unconventional monetary policy and its exit strategy in the United States

After the outbreak of the sub-prime mortgage crisis in mid-2007 in the United States, the Federal Reserve (the Fed) had been easing its monetary policy aggressively, through successive cuts in the Fed Fund Target Rate. By the end of April 2008, the Target Rate was cut cumulatively by 325 basis points(1). However, the abrupt escalation of the financial crisis in the latter part of 2008 prompted the Fed to step up its pursuit of unconventional monetary policy, on top of further cuts in the Fed Fund Target Rate to 0-0.25% by mid-December 2008.

Unconventional monetary policy refers to the means through which a central bank can provide additional monetary stimulus when its policy rates are close to the zero bound. Broadly speaking, the Fed carried out unconventional measures through four approaches. First, the Fed explicitly committed to keep short-term interest rates low in order to anchor market expectations, as enshrined in the statements by the Federal Open Market Committee (FOMC) since the latter part of 2008 and by the Fed officials on various public occasions. Second, the Fed provided extraordinary amounts of low-cost, short-term financing to financial institutions through existing or new facilities(2). Third, the Fed purchased longer-term government securities such as the US Treasuries and government-sponsored enterprise (GSE) debt with a view to reduce long-term private borrowing rates. Fourth, the Fed provided liquidity direct to borrowers and investors in key credit markets that saw dislocations(3). The latter three approaches share the common feature of making use of the asset side of the Fed's balance sheet (i.e. involve lending or purchase of securities).

By now, the Fed's extraordinary policy actions, many of which were unprecedented, have brought down the systemic risk in the financial markets significantly, and eased the liquidity risk through increased availability of short-term financing. However, the large expansion in the Fed's balance sheet has also led to concerns that the excess liquidity could transform into rapid credit growth and thus inflation.

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(1) Also, the spread between the primary discount window rate and the policy rate was cut to 25 basis points from the usual 100 basis points within this time period.

(2) For example, the term of the discount window loans was increased from overnight to 90 days; and new facilities such as Term Auction Facility, Term Securities Lending Facility, and Primary Dealer Credit Facility were created to allow the Fed to provide liquidity to financial institutions based on collaterals which saw sharp decline in liquidity during the crisis time.

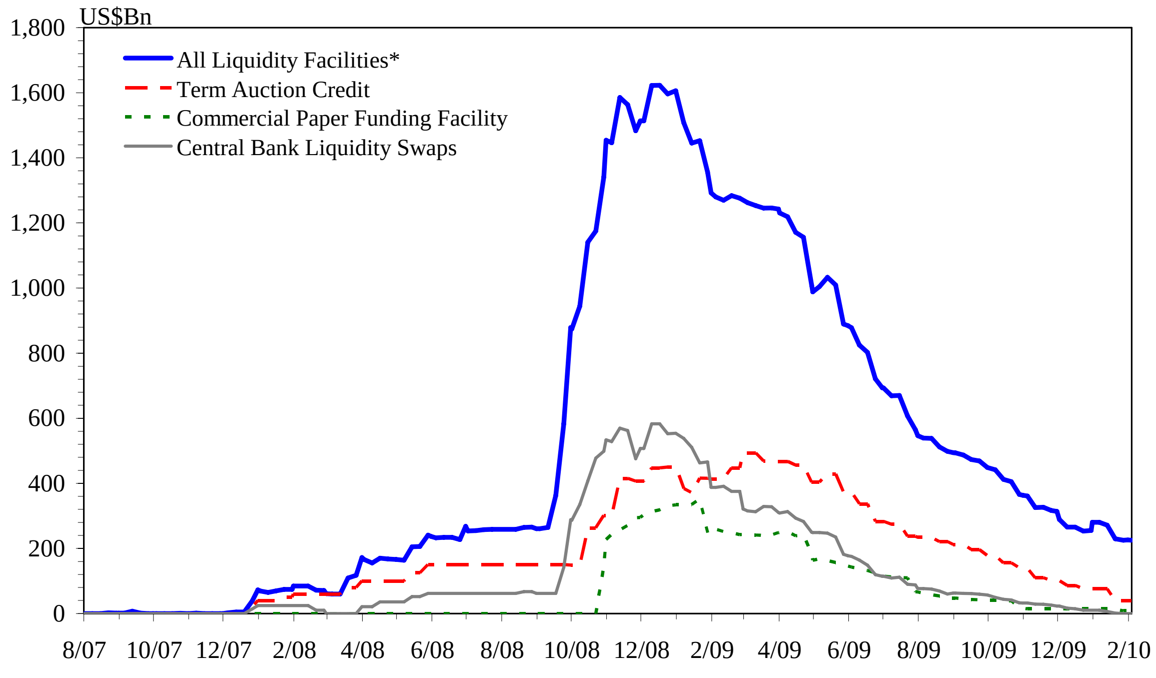
(3) These included the Asset-backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility, the Money Market Investor Funding Facility, and the Term Asset-backed Securities Loan Facility.

Box 2.1 (Cont'd)

To address the issue, Fed Chairman Bernanke acknowledged publicly at the relatively early stage of the financial tsunami that the Fed will have to unwind its various lending programs at some point to be consistent with the Fed's obligation to foster full employment and price stability[(4)]. On various occasions later last year, specific ways were outlined through which the Fed could actively drain liquidity in the markets when the economic outlook allows them to do so. They are as followed: 1) the Fed could arrange large-scale reverse repurchase agreements (reverse repos) with financial market participants, involving the sale by the Fed of securities from its portfolio with an agreement to buy the securities back at a slightly higher price at a later date. In fact, the Fed confirmed that it had been conducting tests of reverse repos as announced in mid-October last year; 2) the Treasury could sell bills and then deposit the proceeds with the Federal Reserve; 3) the Fed could pay interest on the balances held by banks at the Fed, using the authority delegated by the Congress in the fall of 2008. On 28 December 2009, the Fed issued a consultation paper for changing its rules to enable the Fed to offer interest-bearing term deposits to eligible institutions through an auction mechanism; 4) the Fed could reduce reserves by selling a portion of its holdings of long-term securities in the open market.

In fact, the size of the Fed's balance sheet can contract automatically, as improving financial conditions lead to reduced use of the Fed's liquidity facilities. As shown in ***Chart 1***, most of the liquidity facilities by the Fed wound down significantly over 2009. Nevertheless, the size of the Fed's balance sheet stayed broadly steady in 2009 (see ***Chart 2***). The winding down of the liquidity facilities was offset by the significant increase in the level of securities held by the Fed over the course of the year, principally reflecting purchases of Treasury, agency, and agency-guaranteed mortgage-backed securities under the large scale asset purchase program announced by the FOMC.

Chart 1 The usage of liquidity facilities provided by the Fed saw decline over time as financial conditions improved



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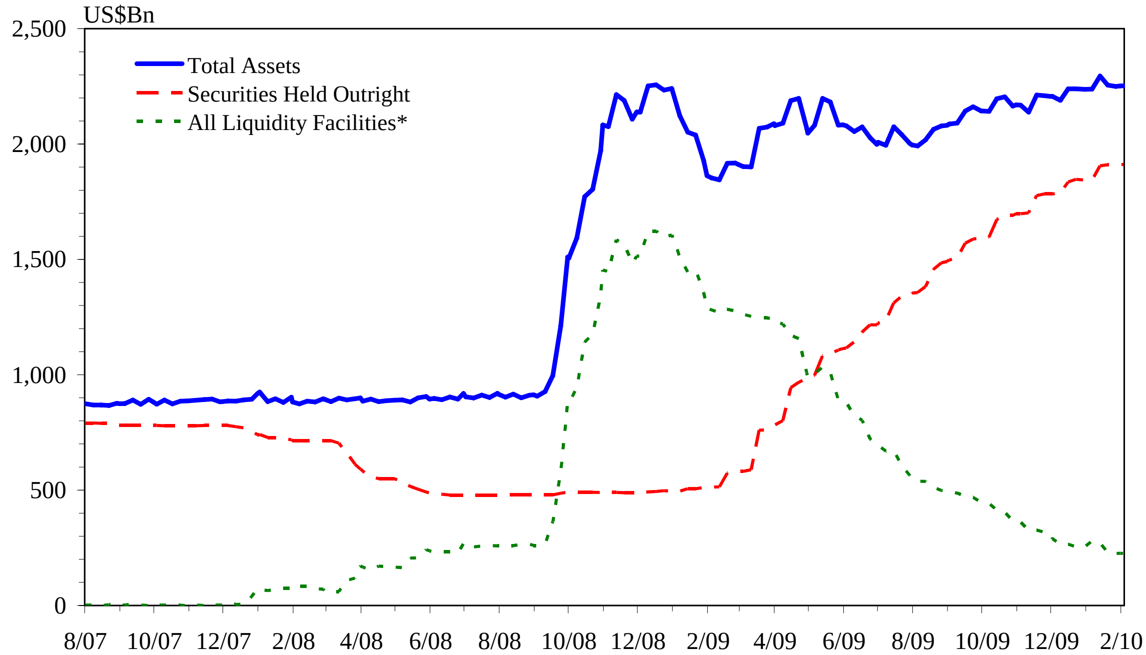
(4) Fed Chairman Bernanke's speech at the London School of Economics on 13 January 2009. (http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm)

Box 2.1 (Cont'd)

Chart 2 The composition of the balance sheet of the Federal Reserve changed as the situation in the financial markets evolved



Note: (*) All Liquidity Facilities include: Term Auction credit; primary credit; secondary credit; seasonal credit; Primary Dealer Credit Facility; Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility; Term Asset-Backed Securities Loan Facility; Commercial Paper Funding Facility; outstanding principal amount of loans to American International Group, Maiden Lane LLC, Maiden Lane II LLC, Maiden Lane III LLC, and TALF LLC; and central bank liquidity swaps.

Summarized as "credit easing" policy approach, the Fed had adopted a varying mix of policy actions as the economic crisis evolved since mid-2007 or so. Similarly, the central banks of other major economies also adopted extraordinary policy actions, though the exact measures undertaken could be different depending on the institutional arrangements, to ease the monetary conditions in their economies. These measures made their mark in stabilising the overall economic situation as the global economy reversed to expansion since the latter half of 2009. While the recent situation of the US economy "are likely to warrant exceptionally low rates of an extended period", as highlighted by the FOMC 's statement in late January this year, several of the Fed's special liquidity facilities were already closed and most of the others would not be extended upon expiry in the coming months(5). Later, in his testimony to the Congress in mid-February, Fed Chairman Bernanke outlined a possible sequencing of steps and combination of tools to be deployed by the Fed in its exit strategy(6). The timing and the pace that the Fed is going to unwind its unconventional measures will bear important implication to the global economy in the period ahead. A premature withdrawal could risk a relapse to recession, while delayed action could inflict high inflation. The development in the Fed's exit strategy has to be closely watched over as one of the key determinants of the global economic performance this year, and hence the performance of the Hong Kong economy, given its high degree of external orientation.

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(5) FOMC's statement on 27 January 2010. (http://www.federalreserve.gov/newsevents/press/monetary/20100127a.htm)

(6) Bernanke's testimony on the Fed's exit strategy before the US House of Representatives. (http://www.federalreserve.gov/newsevents/testimony/bernanke20100210a.htm)