

**Fed's quantitative easing – any credit due?**

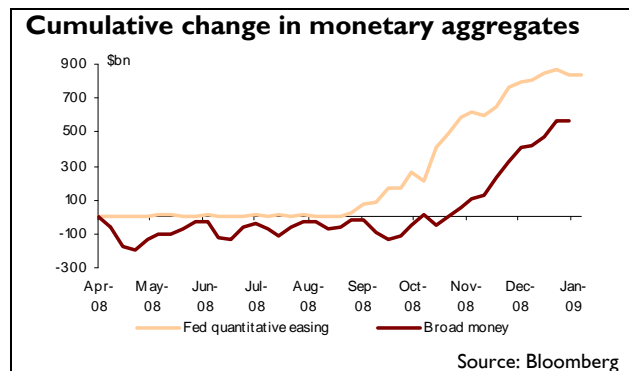
The Federal Reserve (Fed) has committed itself to 'unconventional' monetary policy – quantitative easing, buying credit risk with its balance sheet, printing money – in order to ease the credit crunch and support a return to growth for the US economy. But, with few useful precedents, how can we tell the policy is working? Even conventional monetary policy works with long and variable lags, so the evidence is necessarily tentative at this stage. Yet we see early signs that the current measures are working.

The Fed seems to have started printing money – or at least the modern equivalent in these days of electronic banking – as far back as April, partly as a result of the severe dislocation in money markets which made it wary of draining 'excess' liquidity out of the markets. It was only at the end of September that quantitative easing was adopted as a major policy instrument, when a raft of new programmes to support the financial system were funded from the Federal Reserve's balance sheet (i.e., by creating money), rather than from the Treasury (i.e., with the proceeds of selling Treasury bills and bonds).

This quantitative easing is designed to offset the current credit crunch. The process whereby losses lead to de-leveraging and forced selling and hence further losses is effectively destroying money. It's difficult to measure the process, given that traditional banking accounts for only around a third of the credit within the financial system. However, we still have figures from the traditional banking sector, and we can see the effects of the liquidity crunch. As a result, we can gain a qualitative view of the intensity of the liquidity crisis, even if we can't get timely quantitative data.

One of the measures we have been monitoring is the changes in the money supply. We look at the data provided by the St Louis Fed on Money at

Zero Maturity, which includes cash and retail deposits. This measure peaked in mid-April and, as the graph shows, didn't break through this level again until November.



That the money supply started rising again after the Fed started major quantitative easing in September is unlikely to be coincidental. But, before we declare victory, it should be noted that, initially, the Fed was pumping in money and there was no response from broad money. The Fed's actions were merely offsetting the decline in the money supply.

Since November, however, the total money supply has been rising faster than the amount of money supplied from the Fed's balance sheet. This implies that we are once again seeing credit creation within the economy, and this has been corroborated by other measures, such as the fall in LIBOR rates and a pick-up in re-mortgaging. Apparently, the Fed also believes that it has achieved some success, because it is considering withdrawing support from the commercial paper market, in the hope that it can now function without direct assistance.

So we would conclude that quantitative easing can work and is working. And work it must, because there is plenty more to do if, as we forecast, the US economy is to recover in the third quarter.

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