

DAILY GLOBAL
COMMENTARY

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Chairman Bernanke on Fed's Exit Strategy

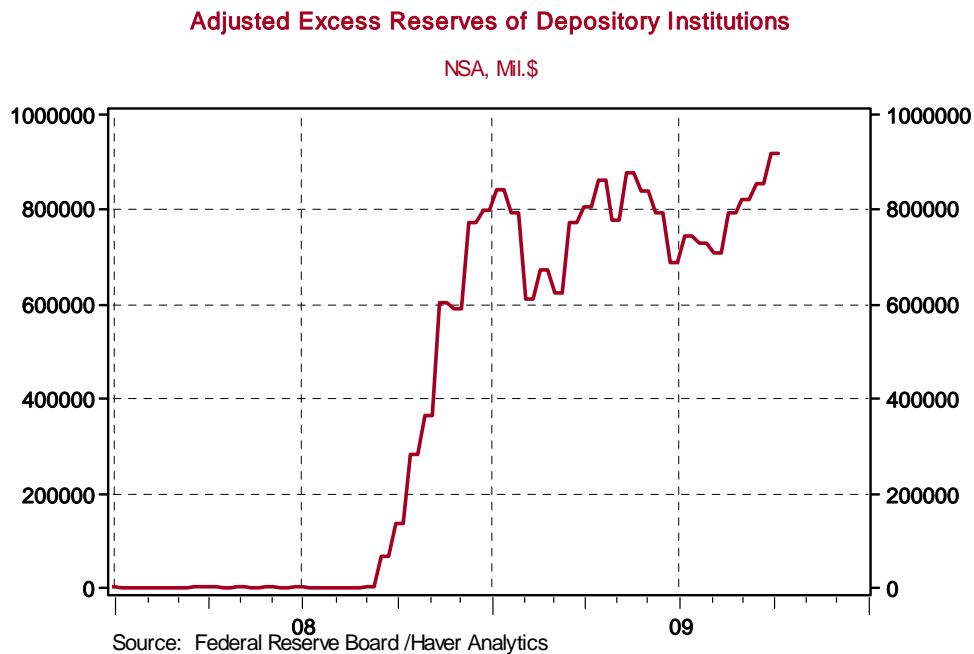
October 9, 2009

The Chairman Bernanke presented a detailed explanation of the Fed's balance sheet and exit strategy at yesterday's Federal Reserve Board Conference on Key Developments in Monetary Policy in Washington.

Bernanke noted that "accommodative policies will likely be warranted for an extended period. At some point, however, as economic recovery takes hold, we will need to tighten monetary policy to prevent the emergence of an inflation problem down the road." This observation largely matches market expectations about the course of monetary policy.

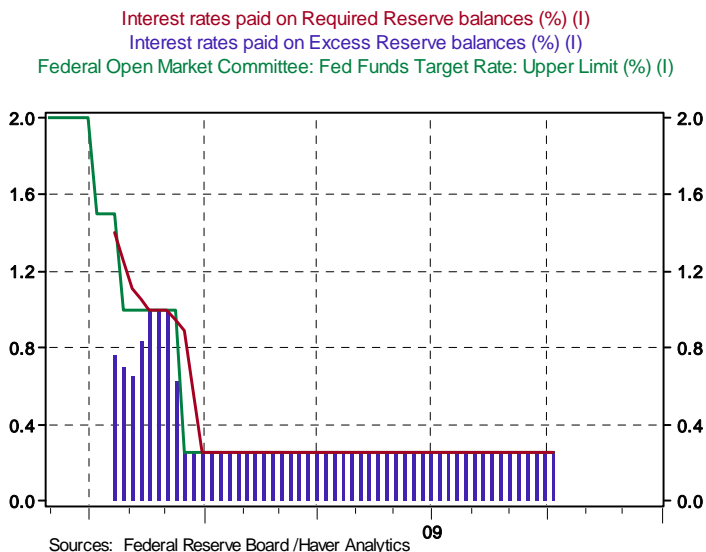
The exit strategy of the Fed is tied to the large accumulation of excess reserves at depository financial institutions which grew as the Fed extended extraordinary monetary accommodation to stabilize the financial system.

Chart 1



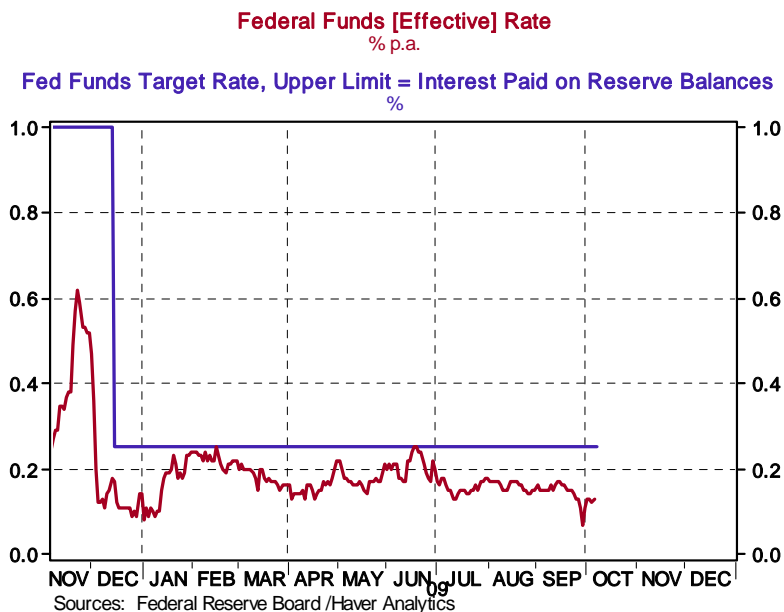
The Fed started compensating reserves of depository institutions with interest payments from October 22, 2008. The Fed differentiated between required and excess reserves by paying a higher rate on required reserves compared with excess reserves and both rates were set lower than the target federal funds rate (see chart 2).

Chart 2



These differences were phased out on November 19, 2008, with the target federal funds rate and interest rates on required and excess reserves becoming identical (chart 3). But, the effective federal funds rate continues to hold below the target rate (see chart 3).

Chart 3



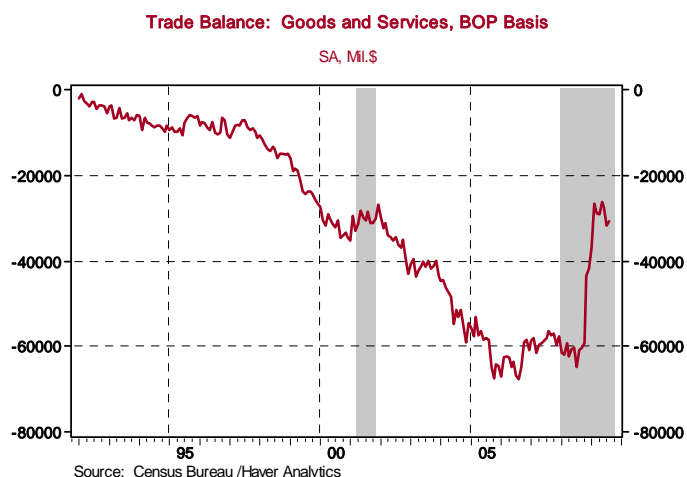
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The Fed's exit strategy consists of (1) paying interest on reserve balances and (2) taking steps to reduce the stock of reserves. Paying interest on reserve balances would establish a floor for interest rates in the short-term market. Bernanke's speech did not include whether the target federal funds rate will be different or the same as interest rate paid on reserve balance. As mentioned earlier, as of November 19, 2008, the target federal funds rate and interest paid on reserve balances are identical. The reduction of excess reserves would involve carrying out the following three options in isolation or as a combined operation: (a) conduct large reverse repurchase agreements with financial market participants inclusive of banks, GSE's and other institutions; (b). offer term deposits to banks; and (c). sell a portion of the Fed's holdings of long term securities. The main outcomes of these actions would be to raise interest rates and reduce the growth of money and credit. The challenge will be the timing of the reduction in accommodation and the quantity by which reserves are reduced. There is no historical blueprint for these actions. In other words, the Fed is mapping out a new course to some degree.

A Smaller Trade Deficit Reflects Decline in Real Exports and Imports of Goods

The trade deficit of the U.S. narrowed to \$30.7 billion in August from \$31.85 billion in July. Exports of goods and services increased 0.2% while imports of goods and service fell 0.6%. However, after adjusting for inflation, both exports (-1.5%) and imports (-1.9%) of goods declined in August. The trade deficit of goods narrowed in August compared with the July reading (\$-37.7 billion vs. \$38.8 billion in July). The narrowing of the trade gap is positive for real GDP growth in the third quarter. The petroleum-related deficit was noticeably smaller in August (-\$16.5 billion vs. -\$17.8 billion) compared with the prior month reflecting lower prices and a smaller quantity of imported oil.

Chart 4



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In August, the trade deficit narrowed vis-à-vis China (\$20.2 billion vs. \$20.4 billion in July), Canada ((\$1.5 billion vs. \$2.1 billion in July), and European Union ((\$5.4 billion vs. \$8.0 billion in July) but was wider vis-à-vis Mexico ((\$3.9 billion vs. \$2.9 billion in July) and Japan ((\$4.3 billion vs. \$3.9 billion in July).

International Trade – August 2009

	Trade Balance (billions)			Exports (m-o-m % change)		Imports (m-o-m % change)	
	Goods & Services	Goods	Goods - 2000\$	Goods & Services	Goods - 2000\$	Goods & Services	Goods - 2000\$
Mar-09	-28.9	-39.2	-40.3	-1.9	-0.8	0.0	0.2
Apr-09	-29.1	-39.9	-40.1	-1.9	-4.1	-1.3	-2.9
May-09	-26.4	-37.2	-36.3	1.4	1.9	-0.7	-2.1
Jun-09	-27.5	-38.3	-35.8	2.1	0.9	2.5	0.2
Jul-09	-31.9	-42.8	-38.8	2.5	4.1	4.9	5.4
Aug-09	-30.7	-41.9	-37.7	0.2	-1.5	-0.6	-1.9

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