



We think the Fed is taking powerful steps to reopen credit markets closed by the Lehman bankruptcy. This will cause an economic recovery over time. The key variable in the outlook is the Fed's pace – with jobless claims likely to rise back toward 600,000 per week, is the Fed buying assets or planning to buy assets fast enough to catch up with the economic free fall?

In today's London speech, Fed Chairman Ben Bernanke gave what we think is a very clear explanation of what the Fed is doing and how it will work.

- Bernanke emphasized the breadth of the Fed's policy toolkit in avoiding deflations and inflations and the importance of rebuilding investor and consumer confidence. He put the monetary stimulus in clear perspective with the proposed fiscal stimulus: "Fiscal actions are unlikely to promote a lasting recovery unless they are accompanied by strong measures to further stabilize and strengthen the financial system."
- **To counteract deflation risk**, Bernanke explained in very clear language the difference between the Japan's quantitative easing using the liability side of the balance sheet and targets for bank reserves (a dead end for Japan) and the Fed's "credit easing". "The Federal Reserve's approach to supporting credit markets is conceptually distinct from quantitative easing (QE), the policy approach used by the Bank of Japan from 2001 to 2006... The Federal Reserve's credit easing approach focuses on the mix of loans and securities that it holds and on how this composition of assets affects credit conditions for households and businesses... Credit spreads are much wider and credit markets more dysfunctional in the United States today than was the case during the Japanese experiment with quantitative easing. To stimulate aggregate demand in the current environment, the Federal Reserve must focus its policies on reducing those spreads and improving the functioning of private credit markets more generally.... The stimulative effect of the Federal Reserve's credit easing policies depends sensitively on the particular mix of lending programs and securities purchases that it undertakes (WE WOULD ADD "AND THE PACE OF ACQUISITION"). When markets are illiquid and private arbitrage is impaired by balance sheet constraints and other factors, as at present, one dollar of longer-term securities purchases is unlikely to have the same impact on financial markets and the economy as a dollar of lending to banks, which has in turn a different effect than a dollar of lending to support the commercial paper market."

- **To counteract inflation risk**, Bernanke explained in detail that he is not “printing money” and has a clear exit strategy for the Fed’s balance sheet expansion. “Some observers have expressed the concern that, by expanding its balance sheet, the Federal Reserve is effectively printing money, an action that will ultimately be inflationary. The Fed’s lending activities have indeed resulted in a large increase in the excess reserves held by banks. Bank reserves, together with currency, make up the narrowest definition of money, the monetary base; as you would expect, this measure of money has risen significantly as the Fed’s balance sheet has expanded. However, **banks are choosing to leave the great bulk of their excess reserves idle...** At some point, **when credit markets and the economy have begun to recover, the Federal Reserve will have to unwind its various lending programs.** To some extent, this unwinding will happen automatically, as improvements in credit markets should reduce the need to use Fed facilities....”
- Bernanke briefly addressed what we think is a major problem in the financial system – the continuing drain on regulatory capital from banks and insurance companies caused by the harmful interaction between the CDS market, mark-to-market accounting rules, bond raters and regulatory capital calculations. Bernanke said: **“We should revisit capital regulations, accounting rules, and other aspects of the regulatory regime to ensure that they do not induce excessive procyclicality in the financial system and the economy. (OUR QUESTION IS HOW FAST WILL THIS BE DONE, SINCE THE REGULATORY CAPITAL DRAIN IS STILL FAST.)”**

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