Central Bank Exit Strategies – The Process Begins

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Exit Strategies in focus – Is now the time?

- Libor-OIS Spreads – Close to pre-crisis levels
- VIX Index – Substantial declines but still higher than pre-crisis levels
- Sovereign CDS Spreads – Recent rise starting to reverse
Federal Reserve Exit Strategy

The 5 probable stages

Stage 1.
**Emergency Liquidity Programs terminated.**
- Term Auction Facility – final auction on 8th March 2010
- Term Asset-backed Securities Loan Facility – to terminate on 31st March.
- CMBS TALF to terminate on 30th June.
- Primary Credit (Discount) rate spread over federal funds rate is gradually normalised.

Stage 2.
**Quantitative Easing terminated.**
- Federal Reserve scheduled to reach USD 1.725 trillion worth of asset purchases by end of March 2010 with an intention to then terminate purchases. Supplementary Financing Bills issued over the next 8 weeks to drain USD 195 billion.

Stage 3.
**"Extended period" wording removed from FOMC statement.**
- This will probably coincide with a notable pick-up in the “Testing Stage” – testing tools used to drain liquidity like reverse repurchase operations and the creation of term deposits.

Stage 4.
**Substantial draining of excess reserves.**
- Reverse repurchase operations and term deposits now utilised to potentially drain “hundreds of billions of dollars” of reserves from the system.

Stage 5.
**The interest rate paid on reserve balances is increased.**
- This rate becomes the effective key monetary policy rate of the FOMC.
- The FOMC reverts to the federal funds rate as the effective policy rate and its holdings of MBS, Agency debt and US Treasury securities are gradually reduced through maturing holdings and/or outright sales depending on economic conditions.
Reserves may have peaked as Fed shifts from Stage 2 to Stage 3

- Balance sheet size not necessarily an indication of monetary stance
- Reserve balance at the Fed declined in the week to 5th March to USD 1,197 billion, the first drop this year
MBS yields to move higher on Fed absence but no outright sales planned

As of 3rd March 2010

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BOJ caution will continue with protracted exit strategy

- **Stage 1** – Outright purchases of CP and corporate bonds expired at the end of 2009
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- **Stage 2** – Gradual termination of temporary support for special fund-supplying operations
  
  JPY 19.8 trillion outstanding
  To expire between March 2010-end 2010
  JPY 10 trn lending facility to end in March

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**BOJ Commercial Bank Balances vs Overnight Call Rate**

- Current account balances, JPY 100mn (Left)
- Overnight call money rate (Right)
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- **Stage 2** – Gradual termination of temporary support for special fund-supplying operations
  
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- **Stage 3** – Overnight call money rate increased, but probably not before H1 2012 – consistent with “Understanding of Medium – to – Long-term Price Stability”

  Outright purchases of JGBs likely to be maintained at JPY 21.6 trillion per year
BOE QE ends but outright sales or CB bill issuance a long way off

- **Stage 1**
  - Asset Purchase Facility is halted at GBP 200bn
  - Special Liquidity Scheme closed on 30th January
  - Dollar swap agreement with Fed ends Feb 2010

![BOE Reserve Balance](chart.png)

*BOE, reserve balance liabilities, weekly amount outstanding, GBP - United Kingdom*
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- **Stage 3**
  - Bank Rate and Interest paid on reserves are increased. As of yet no plans on draining liquidity apart from asset sales or central bank bill issuance as and when economic conditions warrant it

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**BOE Reserve Balance**

![BOE Reserve Balance Chart](chart.png)

- BOE, reserve balance liabilities, weekly amount outstanding, GBP - United Kingdom
Phasing out of non-standard operations will allow for an orderly exit strategy

- Long-term refinancing operations to be phased out. 3-month LTRO to return to variable rate tender on 28th April. Covered bond purchases to be completed by early July 2010

- A gradual return of confidence and a contraction in liquidity will see the EONIA rate drift back toward the MRO minimum bid rate
Fundamentals Mean Differentiated Exit Strategies
Speed of exit strategies dependent on money supply constraints
Inflation expectations most responsive in QE countries – US & UK

Japan - Breakeven Inflation

US - Breakeven Inflation

Germany & Euro-zone - Breakeven Inflation

UK - Breakeven Inflation
More rapid, aggressive policy response in US & UK could mean more rapid exit

- US GDP now just 1.9% below Q2 2008 peak, but Japan, UK and euro-zone are 6.1%, 6.0% and 4.7% below respectively
- Real 2-year yields in US and UK most conducive to supporting growth – little change in Japan
Exit Strategy Implications For Foreign Exchange
AUD, NZD & CAD the main beneficiaries of QE since March 2009

- GBP has gained 2.3% since QE announcement in March 2009 despite asset purchases amounting to 14% of GDP

- USD the clear under-performer. But QE not the only focus in FX with EUR 2nd worst performer since QE announcements last March
Exit by Fed will have positive impact on USD

- Fed-ECB policy divergence will break the Dollar/Equity correlation just like in 2005
- 10-year US-EZ government bond yield spread is signalling lower EUR/USD
BOJ policy exit well behind Fed exit – USD/JPY to move sharply higher

- Real 2-year US-Japan yield spread to spike sharply higher this year, potentially fuelling USD/JPY back above 100.00 by year-end

- Carry appeal will only slowly return. 3-month LIBOR spread moving back in favour of USD
Correlation shift in foreign exchange already underway

For the first time since the onset of the financial crisis in 2007 short-term yield differentials are the single most important correlation for EUR/USD and GBP/USD. For USD/JPY it has happened before but not on as sustained a basis as now.
QE has distorted FX valuations – distortion to unwind as exit strategies proceed

AUD, CAD, EUR & NZD all recovered close to pre-crisis highs after the introduction of QE by Fed and BOE in March 2009. Early stages of renewed declines are underway
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