

Little Thoughts on Economic Issues

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Understanding the Federal Reserve²

Fes is not part of the government. It is controlled by a 7 member board of governors, nominated by the president and confirmed by the Senate. One of the governors will be selected by the president as the chairman of the Fed. FOMC meets 8 times a year to set monetary goals and objective. By adjusting the monetary supply, the Fed controls the cost of capital and interest rate (Addiss, 2015).

The Fed fund rate is the rate set by FOMC, at which banks can borrow funds from other banks³; the discount rate is the rate at which the bank can borrow from the Fed (a.k.a. the Window). Since 2010, the Fed fund rate has been down to 0 and the discount rate is about 50 bps. This means that the Fed is encouraging banks to borrow funds from each other.

On a daily basis, the Fed injects or controls liquidity through the repo and reverse repo operations with major Treasury deals. Repo can be viewed as a one day collateralized loan (using bonds as collateral) that reverse itself the next day between treasury dealers and the customers. With the help of a tri-party custodian, no fund is actually wired during the process and money are still kept in the custodian bank. As repo can be made at the Fed fund rate, it is very low (close to 0.15%), treasury dealers use it as a way to fund capitals. Since mutual funds and money market funds rarely make their cash fully invested, they often use their idle cash for repo as a sweep account.

Since 2010, the Fed started three rounds of unprecedented monetary policy- Quantitative Easing- to stimulate the economy when standard monetary policy has become ineffective due to the close to zero Fed fund rate. By buying totaling 3 trillion treasuries with cash, the Fed injects liquidity into market that push down the yield on the Treasury notes. In the third round (QE3), the Fed changed one time purchase into monthly purchase, and gradually applied tapering on the amount of liquidity injected based on improved economic conditions. On October 2014, the QE3 ended. Surprisingly, QE did not cause two much inflationary fears. The market expects the Fed to gradually increase the interest rate as the economy stabilizes.

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² The main contents of this section is based on an online course of the same name offered by New York Institute of Finance, taught by William Addiss.

³ Another similar term is the LIBOR rate, which is the 90 day floating rate at which banks borrow fund from each other in London. However, Fed fund rate is in USD, while LIBOR can be in each currencies such as yen, dollar and ponds etc.

How Government deals with inflationary fears

When inflationary fears arise, government has usually two forms of macroeconomic policy to employ: monetary and fiscal policy.

Monetary policy achieve the objective of inflation control through control of the monetary system by operating on the supply of money, supply of credit and structure of interest rates (Crack, 2014, p. 227). With monetary policy, the Fed reduces liquidity by selling bonds (a.k.a. Open Market Operation). This leads to less supply of money, higher interest and cost of borrowing, and makes capital expenditure more costly. This monetary operation slows down economy and cools down the inflationary fears. Besides, the Fed controls the cost of money through the adjustment of the discount rate (the rate Fed charges banks for loans), Fed fund rate (the rate banks charge each other), bank reserve requirements (the proportion of bank asset required to be held in Treasury securities) and operations on government repo market.

Fiscal policy achieves the objective of inflation control through taxation and government expenditures to control the aggregate level of economic activity. Increasing taxation and government spending fights inflationary fears.

Economic release and the market reaction

Every month U.S. Bureau of Labor will release current non-farm payroll figure that represents the total paid U.S. workers of business excluding farm employees, private household employees, or non-profit organization employees. This is an influential figure as part of a comprehensive report of the state of the labor market, which will be read by policy makers to determine the state of the market and its future development.

Many people believe that a less-than-expected reading will cause equity market to react negatively. However, it is not always true. If the job number is bad, this may give the policy makers more incentive to keep a relaxed and encouraging fiscal and monetary policy (such as low interest rate and more quantitative easing, etc.), which will actually benefit the equity market. In contrast, a better-than-average reading shows strength of the economy, and may give the policy makers (such as the Fed) more incentive to initiate a rate hike or tightening of funds, which can be bearish for equity market.