Checklist for the January 24-25 FOMC Meeting - Continued

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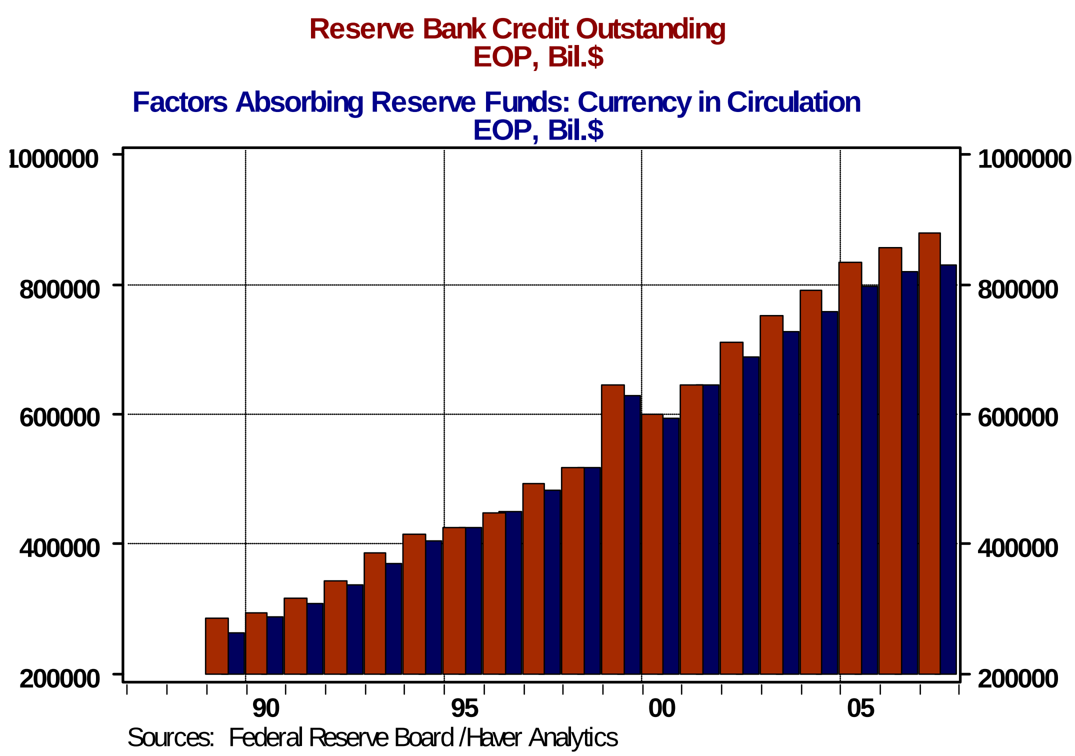
Yesterday's edition of the daily commentary listed three changes the Fed will incorporate in the manner in which it communicates with financial markets as of January 25. We had noted that additional comments about the Fed's balance sheet will be the topic of today's discussion. Picking up from yesterday's note, the Fed has indicated that the narrative will include "qualitative information" about the outlook for the Fed's balance sheet. The market consensus is that these details will be part of the minutes to be published on February 15. It is also likely that Chairman Bernanke would answer questions about this issue during the press conference. In any case, some background about the Fed's balance sheet is called for now.

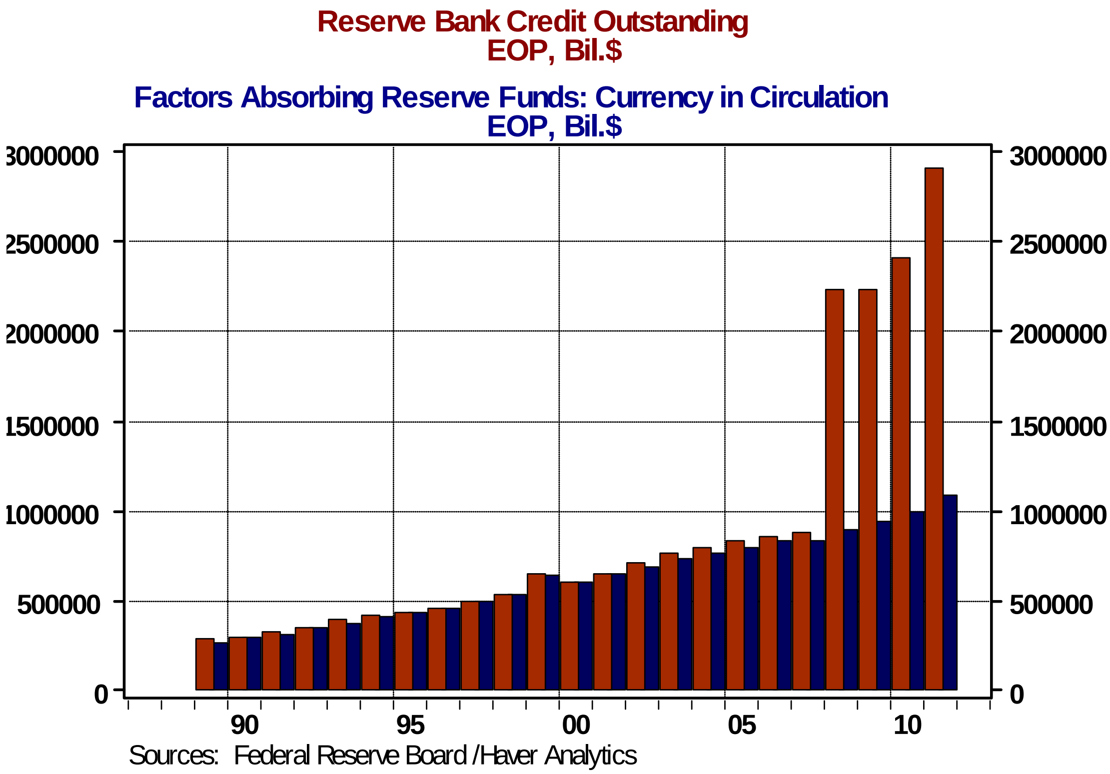
The Fed's balance sheet stood at $2.904 trillion as of January 19, 2011. In the current context, the Fed's balance sheet can be viewed in two parts – pre-2008 and post-2008. In the pre-2008 period, the balance sheet posted small and steady growth (1989-2007, see Chart 1). The only anomaly was in 1999 when special provisions were put in place to address the Y2K problem. Of the main components of the balance sheet, currency in circulation is the major factor accounting for the increase in the balance sheet over the course of this period.

Chart 1



The balance sheet shows a radical transformation commencing in 2008 to reflect the impact of the two quantitative easing programs put in place to stem the financial crisis and provide support to the economy (see Chart 2, which is an extension of Chart 1 including the period after 2007).

Chart 2



It is not clear as to how the Fed will present the "qualitative" outlook for the balance sheet. The Fed is currently engaged in maintaining the size of the balance sheet under the "Operation Twist" program which expires in June 2012. "Qualitative outlook" of the balance sheet would entail explaining circumstances that would compel an increase in the size of the balance sheet and describing the situation that would enable an exit strategy. The Fed is most likely to point out that if economic activity fades it would stand ready to provide additional accommodation through increased purchases of securities. At the same time, the Fed would have to indicate the circumstances under which it would shrink the balance sheet and how it plans to unwind its holdings – passive run-off or active sales of the securities it holds.

In addition to these changes, the policy statement could show a modification because the Fed is now publishing its own federal funds rate forecast. The policy statement since August 2011 contains the following remarks about the outlook for Fed policy:

> *"The Committee also decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions--including low*

> *rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels for the* ***federal funds rate at least through mid-2013****."*

In all, there are several unknowns that should be clarified tomorrow. The policy statement will be published at12:30 EST, while the Summary of Economic Projections will be available only at 2:00 EST. Market reaction could change as information seeps in by way of the policy statement, forecast, and the press conference.