

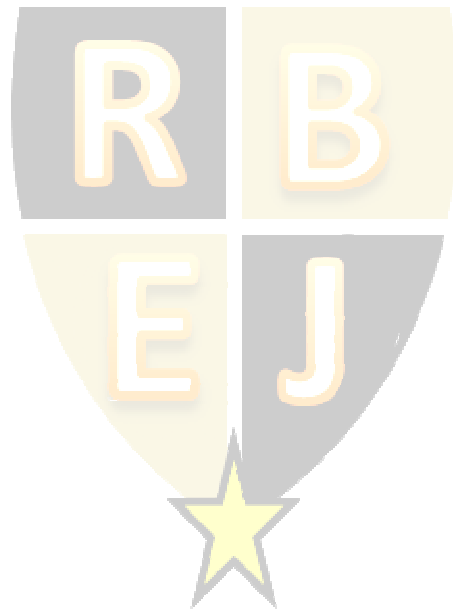
Credit easing and the recession of 2007 -2009 - Was it worth it?

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ABSTRACT:

This paper investigates the results of the Quantitative/Credit Easing policy adopted by the Federal Reserve in response to the most recent recession. This paper also explores credit easing and the history of the recession in the U.S. and the reactions on the price of oil and gold, the monetary base, the Dow-Jones, unemployment and GDP.

Keywords: Quantitative Easing, Credit Easing, Recession



INTRODUCTION

Today the concept of Quantitative Easing is invoked in all major financial newspapers and business news. Quantitative easing, according to a Bank of England pamphlet (2011), is conducted by Central Banks buying “assets from private sector institutions – that could be insurance companies, pension funds, banks or non-financial firms – and credits the seller’s bank account.” However, in the United States the policy adopted by the Federal Reserve is one of Credit Easing. According to Bernanke, Credit Easing is similar to Quantitative Easing. The main difference according to the staff of The Wall Street Journal (2009) is that Quantitative easing focuses on the liabilities of the central bank balance sheet, while Credit Easing focuses on the assets of the balance sheet. Bernanke, during a speech in 2009, at the London Business School of Economics specified that “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.” According to Wheelock (2010), “the Fed’s credit-easing policy was at least as much concerned with the allocation of credit supplied by the Fed to the financial system as with the quantity.” Therefore, the Federal Reserve was concerned mainly with long term but also with short term credit instruments and mortgage backed securities.

HISTORY OF THE RECESSION

According to the National Bureau of Economic Research ([NBER], 2010) the United States entered the last recession in December, 2007. The recession lasted 18 months and ended in June, 2009. It was the longest Recession since WWII. The following conditions were in place December, 2007:

- Unemployment rate: 5% (Bureau of Labor Statistics [BLS], 2011)
- Dow Jones: closed the month of December at 13,265 points (Yahoo Finance [^DJI], 2011)
- 4th trimester GDP: growing at 2.9% (Bureau of Economic Analysis [BEA], 2011)
- Price of gold: \$800 an ounce (USAAGOLD, 2011)
- A barrel of oil: \$95.95 (U.S. Energy Information Administration [EIA], 2011)
- The Monetary Base seasonally adjusted (M2): 7,494.7 Billion (Federal Reserve, 2011)
- 10-year benchmark Treasury yield: 4.03% (Yahoo Finance [^TNXI], 2011)

According to Anderson, Gasco and Liu (2010), the recession was brought about by the decline on the residential real estate market and the subsequent losses by financial institutions in subprime mortgages.

The following are the main events and policy actions adopted by the Federal Reserve and the Treasury Department in response of the economic downturn according to the Time Line at the Federal Reserve of St. Louis and other sources.

- In December 2007 the Federal Reserve created the Term Auction Facility (TAF). According to the Board of Governors’ press release (BOG, 2007) “the Federal Reserve will auction term funds to depository institutions against the wide variety of collateral that can be used to secure loans at the discount window.”
- In January 2008 the Federal Open Market Committee, FOMC, reduced its target for the federal funds rate to 3.5 percent (Board of Governors [BOG], 2008b).

- In March 2008 the Federal Reserve created the Term Security Lending Facility (TSFL) and the Primary Dealer Credit Facility (PDCF). These facilities provided loans to primary dealers. Also in March, FOMC reduced its target for the federal funds rate to 2.25 percent.
- In April 2008 the FOMC reduced its target for the federal funds rate to 2 percent.
- In October 2008 the Federal Reserve started to pay interest on banks' holdings of reserves (thanks to the Emergency Economic Stabilization Act of 2008) and the U.S. Treasury Department announced the creation of the Troubled Asset Relief Program (TARP). Federal Open Market Committee reduced its target for the Federal funds rate to 1%.
- In November 2008 we have the beginning of Credit Easing. The Federal Reserve Board creates TALF, the Term-Asset-Backed Securities Lending Facility. The Federal Reserve Bank of New York was authorized to lend \$200 billion to owners of asset-backed securities guaranteed by small business loans. Also, The Federal Reserve started a program to buy \$100 billion "in direct obligations of housing-related government-sponsored enterprises (GSEs) - Fannie Mae, Freddie Mac, and the Federal Home Loan Banks" and \$500 billion in "mortgage-backed securities (MBS) backed by Fannie Mae, Freddie Mac, and Ginnie Mae."

According to Blinder (2010) the Federal Open Market Committee on December 16, 2008 pushed the federal funds rate to nearly zero. According to Bernanke's own testimony to Congress during his Semiannual Monetary Policy Report in July 2009 Bernanke stated that "since December, the targeted funds rate has been effectively at its zero lower bound (more precisely, in a range between 0 and 25 basis points), eliminating the possibility of further stimulating the economy through cuts in the target rate." In the same speech, Bernanke continues to say the nonconventional tools of credit easing was full and center now at the Federal Reserve because of "substantial economic slack and limited inflation pressures, monetary policy remains focused on fostering economic recovering. Accordingly, as I mentioned earlier, the FOMC believes that a highly accommodative stance on monetary policy will be appropriate for an extended period." (Bernanke, 2009a)

- In February 2009 the Federal Reserve Board expands the TALF to \$1 trillion (BOG, 2009).
- By June 2009, M2 reached 8454.4 Billion, an increment of 12.8% from the beginning of the recession (Federal Reserve, 2011).
- In June 2009 the recession ended according to the National Bureau of Economic Activities (NBER, 2010).
- In November 2010 Annalyn Censky reported from the online page of CNN that the Federal Reserve was inputting additional Billions into the economy with Quantitative Easing 2 which will end in June 2011.

EMPIRICAL RECESSION RESULTS

At the end of the recession in July, 2009, the following conditions were in place:

- Unemployment rate: 9.5% (BLS, 2011)
- Dow Jones: closed at 8,447 (^DJI, 2011)

- GDP: -0.7% for the 2nd quarter 2009 (BEA, 2011)
- Gold: \$934.50 an ounce (USAAGOLD, 2011)
- A barrel of oil: \$69.26 (EIA, 2011)
- The Monetary Base: 8,454.5 Billion M2 (Federal Reserve, 2011)
- 10-year benchmark Treasury yield: 3.5 (TNX, 2011)

The level of unemployment during the recession passed from 5% in December 2007 to 9.5% in July 2009 (Table 4 Appendix). Comparing these numbers to the previous two recessions, the impact on unemployment was immense. The recession of July 1990 – to March 1991, unemployment went from 5.5% to 6.8%. This was an increase of 1.3 percentage points – a 23% increase. The next recession from March 2001 to November 2001, unemployment went from 4.3% to 5.5% - 1.2 points or 28% increase (BLS, 2011). In this most recent recession, unemployment went from 5% to 9.5%, up 4.5% which is a 90% increase (BLS, 2011). This further illustrates the magnitude of this recession.

The Dow Jones closed the month of December 2007 at 13,264.82 points (Table 5 Appendix). The last day of trading in June 2009 it closed at 8,447 points; a reduction of almost 37% (^DJI, 2011).

In the second trimester of 2009 GDP was decreasing at 0.7% (Table 6 Appendix). In their analysis of the last 11 recessions, Iqbal and Vintner (2011) reached the conclusion that “the 2007 recession is the deepest”, and according to the study conducted by Chowdhury and Manzoor (2010) “has been the worst since the Great Depression”.

The GDP went from 2.9% growth to -0.7% decline (BEA, 2011).

The price of an ounce of gold in the December 2007 was \$833.75. At the end of June 2009 the price was \$934.50, an increase of 12% (Table 2 Appendix) almost as much as the increase in the Money Supply. This seems to be a contradiction of the findings of Coudert and Raymond in which they state that gold on average in the short-run is a “weak safe haven.” (Coudert, Raymond, 2010)

The price of a barrel of oil at the end of December 2007 was \$95.95 and on July 2009 was \$69.26 a reduction of 27% (Table 3 Appendix). This result seems to confirm the study conducted by Evans and Fisher in which they conclude that there is a “modest dependence of policy on energy and other commodity prices.” (Evans, Fisher, 2011)

The money supply (measured using M2) grew from 7,494.7 Billion in December 2007 to 8,454.5 Billion in June 2009 - an increase of 12.8% (Table 1 Appendix). In the two previous recessions without the use of the unconventional method of Credit Easing money supply grew by 3% from July 1990 to March 1991 and by 6% March 2001 to November 2001 (BLS, 2011).

The 10-year Treasury yield went from 4.03% in December 2007 to 3.5% at the end of June, 2009 (^TNX, 2011).

SINCE THE RECESSION

The improvements in the economy since the recession ended seem to justify the policies adopted by the Federal Reserve. As Blinder (2011) put it “It was a wonderful example of learning by doing” by Bernanke. It appears that as of July 2011, the economy is back from the brink of a second great depression. Quantitative/Credit easing efforts ended June, 2011.

As of July 8, 2011:

- Unemployment rate: 9.2% (BLS, 2011)

- Dow Jones: closed at 12,717 on July 8th (^DJI, 2011)
- GDP: 1.9% for the 1st quarter 2011 (BEA, 2011)
- Gold: \$1,541.50 an ounce (USAAGOLD, 2011)
- A barrel of oil: \$96.52 (EIA, 2011)
- The Monetary Base: 9,144 Billion M2 (reported June 27, 2011) (Federal Reserve, 2011)
- 10-year benchmark Treasury yield: 3.02 (TNX, 2011)

NOTEWORTHY TRENDS AND CONCLUSIONS:

The unemployment rate trend confirms Knotek and Tesrly (2009) findings that concluded that “evidence suggests that banking crises are associated with large and persistent increases in the unemployment rate. Banking crises that coincide with recessions are associated with even worse outcomes for unemployment.” In the testimony offered to the Committee on the Budget for the US House of Representatives, in February 2011 Bernanke stated that “the unemployment rate probably will remain elevated for some time.” Though unemployment is still relatively high (Table A), one might be able to make the conclusion that the effect of Quantitative/Credit Easing on unemployment was still a positive one. In looking back further in history to the Great Depression, though the Federal Reserve lowered interest rates, no Quantitative/Credit Easing policies were enacted and unemployment went from 3% to 25%.

Over the course of the recession, Gold and the Monetary Base (Table B and Table C) increased at the same percentage rate, 12% for both. However, since the end of the recession, the Monetary Base increased only 8% while the price of Gold increased 65%. Traditionally, the price of Gold increases when confidence in the economy decreases. This shows that consumer confidence is still low.

The goal of Quantitative/Credit Easing was “to inject money into the economy in order to revive nominal spending” according to Bendford, Nikolov, Young and Robson (2009) and to lower long-term interest rates. Those goals were accomplished (Table C and Table D).

Overall, the results of the Federal Reserve’s use of Quantitative Easing seem to be a mixed bag. Interest rates are low, the stock market has rebounded and there is more money in the economy. However, unemployment rates are still relatively high, consumer confidence is still low (as evidenced by the high price of gold) and the GDP is also growing at a relatively low rate.

Appendix

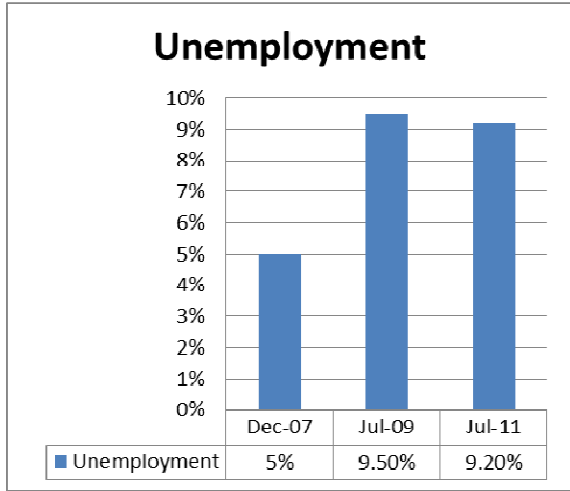


Table A

SOURCE: Bureau of Labor Statistics

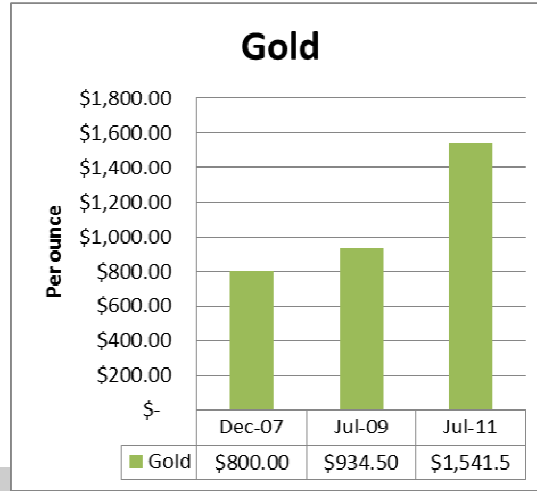


Table B

SOURCE: USAGOLD Centennial Precious Metals. Daily Gold Price History

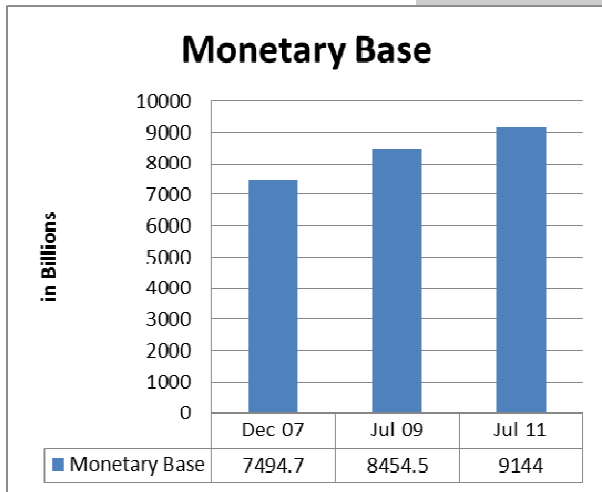


Table C

SOURCE: Federal Reserve H.6 Money Stock Measures

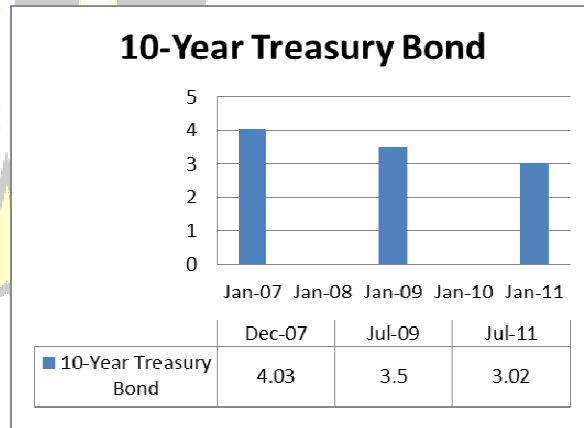
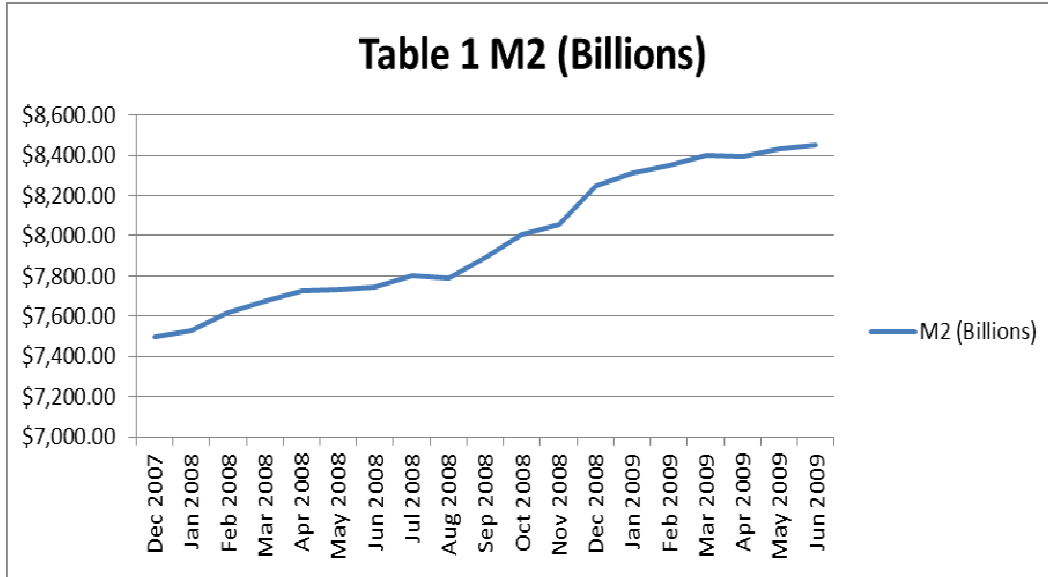
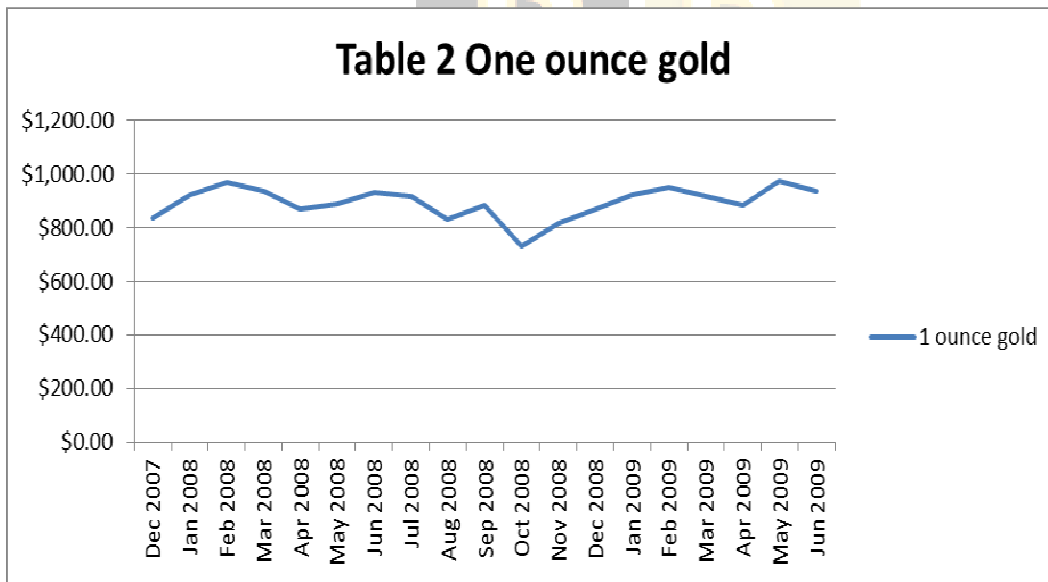


Table D

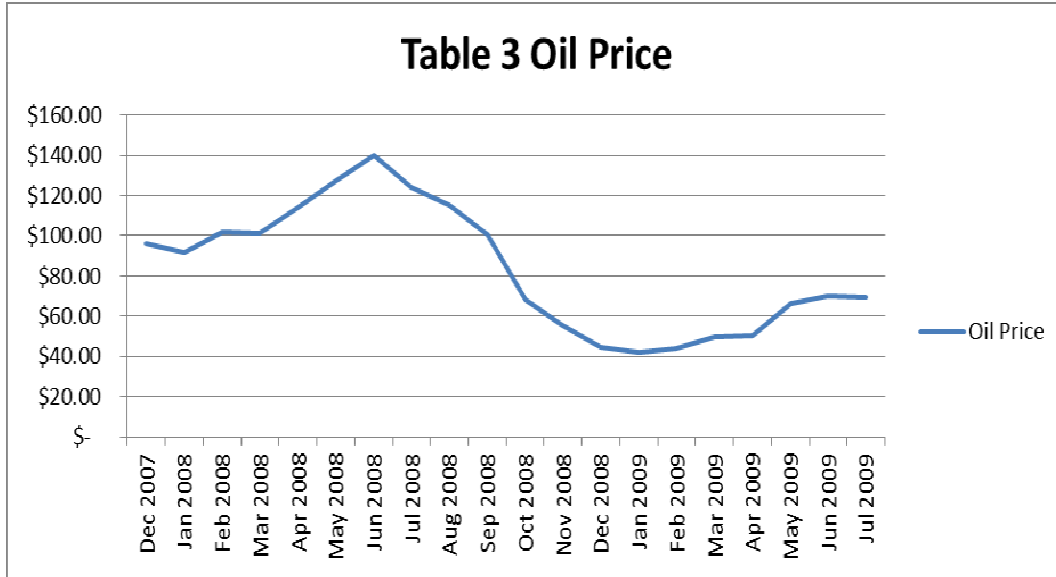
SOURCE Yahoo Finance. CBOE Interest Rate 10-Year T-No (^TNX)



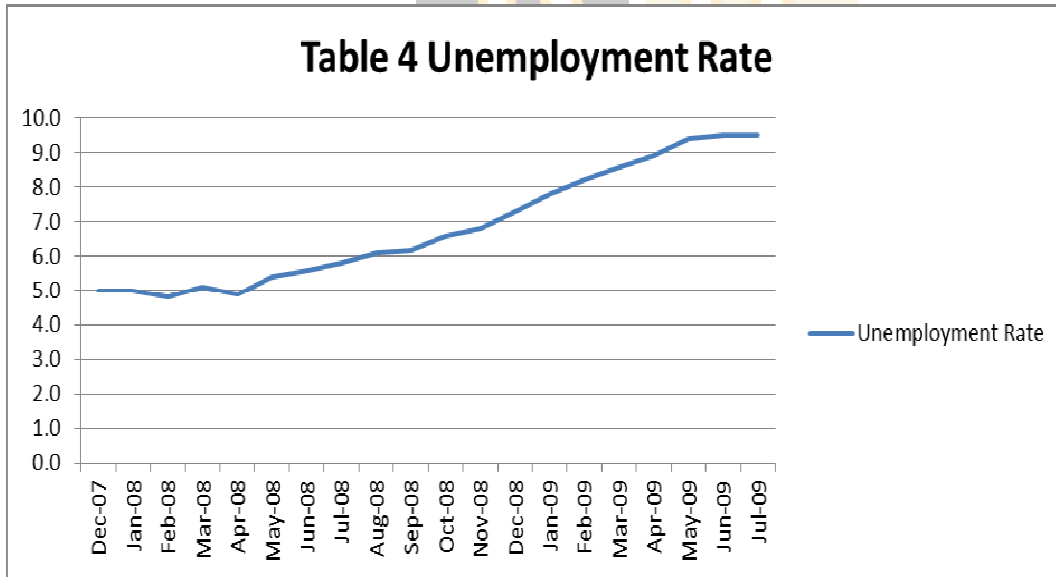
SOURCE: Federal Reserve H.6 Money Stock Measures



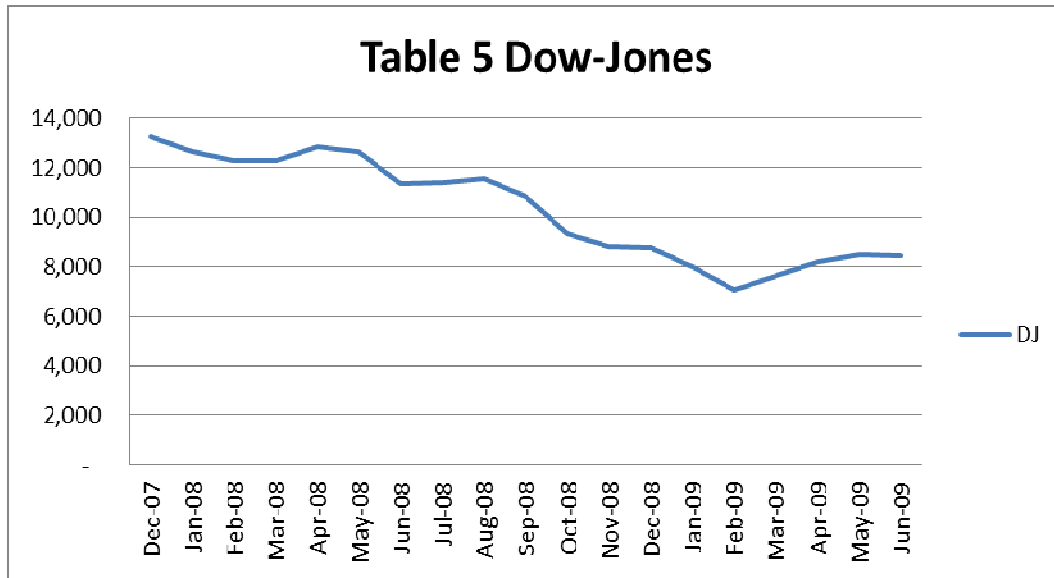
SOURCE: USAGOLD Centennial Precious Metals. Daily Gold Price History



SOURCE: U.S. Energy Information Administration



SOURCE: Bureau of Labor Statistics



SOURCE: Yahoo Finance. (2011). Dow Jones Industrial Average (^DJI)



SOURCE: Bureau of Economic Analysis

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