

Market Monitor

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The Fed Giveth and The Fed Taketh Away

Lately, there have been several references to the Fed (or the Federal Reserve Board) “loosening” and “tightening” and one may wonder what it means. Today we’ll focus on the following themes:

- The Fed changes certain interest rates to regulate the economy and combat inflation.
- The Fed can raise and lower short-term interest rates to add or subtract reserves to the banking system.
- Recently the Fed has been “tightening” by raising interest rates to prevent a possible rise in inflation, while still keeping an eye on employment and the economy.

The Fed “loosening” means it is lowering short-term interest rates. “Tightening” means the Fed is raising rates. Fed Chairman Ben Bernanke and his fellow Fed governors meet as a committee eight times a year to regulate U.S. economic growth and to combat unacceptable inflation. At these meetings they can vote to raise or lower short-term interest rates or keep them the same based on current information and their collective judgment.

Interest rate movements can stimulate or dampen economic growth. Therefore, an *increase* in interest rates tends to dampen demand for goods and services and reduce

inflationary pressures. A *decrease* in interest rates tends to increase demand and stimulate inflation. For instance, people who buy (or demand) a car on credit or lease the car using credit are less likely to do so when interest rates are rising than when interest rates are declining. And, by raising interest rates and dampening economic growth, the Fed can try to prevent a rise in inflation, particularly when the economy is near or at full employment.

The Fed can “tighten” or “loosen” monetary pressure by using one of three tools. It almost always uses the open market operations tool, which is based upon the current **supply** and **demand** for money in the market place.

If the Fed wishes to “tighten” policy and raise interest rates it starts by selling its own short-term bonds or bills to banks. These are government securities that it holds in its own investment portfolio. The banks pay for those securities by writing checks to the Fed. As the banks pay the Fed, their checks reduce the supply of money that the banks use as reserves. These reserves are in excess of what banks are required to hold when they make loans. And as we know from economic theory, when the supply of something diminishes relative to the demand, the price of that something tends to rise (be it apples, oranges, or bank reserves). The relevant price in this case is what we call the market interest rate for borrowing and lending the excess bank reserves or “Fed funds rate”. By buying and selling government securities on the open market, the Fed can regulate or target the Fed funds rate. In other words, the Fed giveth and taketh away excess reserves to set a desired Fed funds rate. So, when we talk about Fed “loosening” or “tightening”, we are talking about the Fed expanding or contracting excess bank reserves. This is the same thing as raising or lowering short-term interest rates.

While the Fed uses open market operations almost exclusively for controlling short-term interest rates, there are, technically, two other tools: changes in reserve requirements and direct lending to banks through the “discount window”. However, they are rarely used.

Why do we care about all this? Most other short-term interest rates move in tandem with the Fed funds rate. When short-term interest rates fall, economic demand and growth tend to increase and vice versa. Beyond that, Fed interest rate changes can affect other asset classes, such as long-term bonds and equities. The overall prices for those asset classes also depend heavily on the economy's current position in the business cycle. For example, if the economy is close to full employment and has grown strongly for quite some time, a Fed "loosening" would likely cause short-term interest rates to fall, but longer-term interest rates to rise. In that situation, bond buyers would probably become more concerned about inflation and they would demand higher bond yields as compensation for the loss of purchasing power arising from higher expected inflation. This is in spite of shorter-term rates being lower. But if there is plenty of slack in the economy and inflation fears remain virtually nonexistent, long-term bond yields may decline as the Fed "loosens". This is what happened in 2002 through 2005, when the Fed lowered short-term interest rates down to 1%.

Equities are also affected by Fed funds rate movements, but mainly by how such movements affect the economy. Equity markets may benefit from a Fed "loosening" that causes a stronger economy and improvements in corporate earnings. So the Fed not only giveth and taketh away with respect to short-term interest rates, but to varying degrees, other financial asset markets.

To put these things into practice, we can see that because the economy has grown over the past four years and because of large energy and commodity price increases, the Fed has been aggressively "tightening" by quintupling the Fed funds rate through its open-market operations to prevent an incipient rise in inflation. And lately the Fed has signaled that it will likely continue to tighten at least through early August.

Short-term bond rates are, of course, rising due directly to Fed actions. Longer-term bond rates have risen a lot less than shorter rates because investors may believe that the U.S. economy is in a fairly gentle downward glide path, thus relaxing any upward pressure on long-term rates. As for equities, as we explained last week, the domestic and international markets were probably due for a break because equity prices had risen since 2003 and in some cases had grown more than the prospect for future dividends could support. Beyond the underlying fundamentals, the break in the equity markets may have been triggered by Chairman Bernanke's concerned comments about inflation, which he later partly retracted.

So we can see that the Fed has a limited but powerful tool to directly affect bank reserves and short-term interest rates. This tool, as well as the Fed's ability to command public attention, can indirectly affect other parts of the financial markets, such as longer-term bond rates and equities.

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