

Disunity at the Fed

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- As universally expected, the Federal Open Market Committee stuck with their policy of unlimited monetary accommodation at a near-zero fed funds rate.
- The policy statement released after the meeting made it clear that officials are predicting a mild recovery in H2 2009 but concede downside risks to growth still exist. They also believe inflation is too low and needs to be higher for sustainable growth.
- The FOMC statement listed the various ways it is aiding the financial system, with special emphasis on the new program for buying “large quantities of agency debt and mortgage-backed securities” to support the mortgage market and housing.
- It also reiterated the Fed is prepared to buy longer-term Treasury securities. Indeed, one member, Richmond Fed president Jeffrey Lacker, dissented from the FOMC decision, asserting that he “preferred to expand the monetary base at this time by purchasing US Treasury securities rather than through targeted credit programs.” The message is that at least one and maybe more FOMC members oppose the program instituted under Chairman Bernanke in the past year and a half.

What the Fed has been doing

The Fed has lived up to its promise to use “all available tools” to support the functioning of the financial markets, especially those that are under extraordinary distress, and thus to allow credit channels to revive and help promote economic recovery. Some of these programs were launched a little more than a year ago, notably the Term Auction Credit facility that allows all member banks, not just primary dealers, to bid for funding directly from the Fed, without the stigma of applying at the discount window. Since the traumatic events in the markets largely associated with the forced bankruptcy of Lehman on September 15, 2008, the Fed has established several new programs to deal with chaotic conditions in the commercial paper market, with the near panic outflows from many money market mutual funds, and with the ongoing strains in the mortgage securities markets. In all, the Fed has put over USD1 trillion of assets on its balance sheet in that three-month period, more than doubling its size.

Much of what has been happening has reflected the ongoing lack of trust in the interbank market whereby banks fear the insolvency of counterparties and are not willing to take that risk even on overnight loans in the fed funds market. The Fed has in fact made it even easier for banks with excess liquidity to warehouse those funds at the Fed, because it started paying interest on excess reserve balances last fall. So there is really no opportunity cost for banks to avoid the federal funds market. Excess reserves have swelled from USD 25 billion just before the Lehman bankruptcy to over USD 800 bn as of January 22, 2009.

As a result, the Fed has been compelled to take on the role of financial intermediary, supplanting normal market relationships. That has been strikingly evident especially in the commercial paper market, where within a matter of days the Federal Reserve became the largest single owner of commercial paper – and thus a substantial direct lender to US corporations and non-bank financial

institutions. By doing this, the Fed has clearly prevented massive dislocations and a far greater financial meltdown than the already horrendous one that has been experienced.

FED'S TARGETED SUPPORT OF INSTITUTIONS & MARKETS

Program, USD billions	Current, 22Jan 09	10Sep08, Prior to Lehman bankruptcy
US Treasuries	475.4	479.8
Federal agency debt securities	24.2	0
Mortgage-backed securities	6.0	0
Term Auction Credit	416.0	150.0
Maiden Lane (Bear Stearns)	27.2	29.3
Primary Dealer Credit Facility	33.3	0
ABS money market funds	14.8	0
Commercial paper facility	350.5	0
AIG + Maiden Lane II&III	85.1	0
Total Federal Reserve Assets	2074.6	961.7

Source: Federal Reserve System H.4.1, UniCredit Research

Why US Treasuries?

The idea that the Fed is considering purchasing longer-term US Treasuries first surfaced at December's FOMC meeting. It is frankly puzzling and has certainly confused a number of financial market participants not normally historians of Fed operations. The fact is that the Fed has been buying longer-term US Treasuries for decades. Here is some background:

During World War II, the Fed and the US Treasury reached an agreement, under which the Fed promised to support the Treasury bond market in order to lower the cost to the taxpayer of financing war-related government expenditures. For several years after the end of the war, the agreement remained in place, until William McChesney Martin, then Treasury assistant secretary negotiated its termination in 1951. (He was rewarded by being appointed Fed chairman a few weeks later.) This is commonly called The Treasury-Fed Accord or Accord, for short. The argument for ending central bank support for the Treasury market was simple: it was distorting market mechanisms and threatening to cause higher inflation.

But that did not mean the end of Fed purchases of longer-term Treasuries (also called “coupon securities”). They have usually been acquired through pre-announced “coupon passes” in which the Fed essentially enters bids with the primary dealers for a specified amount of bonds. The purpose has usually been to inject permanent reserves into the banking system over and above the temporary reserves injected through purchases of US Treasury bills or even more temporary reserves injected through day-to-day or week-to-week repurchase agreements.

Once, however, back in the early 1960s, the Fed, in coordination with the US Treasury under President Kennedy, undertook a set of operations that eventually acquired the name “Operation Twist.” It was a time when short-term interest rates were low, while longer-term interest rates were deemed to be undesirably high. The judgment was made (by Fed officials in conjunction with Treasury Undersecretary for Monetary Affairs Bob Roosa) for the Fed’s open market desk to switch from buying Treasury bills to buying coupon issues with the goal of “twisting” or more accurately “flattening” the yield curve. Academic economists have long debated whether the program was effective, and a couple of generations of PhD students have written dissertations purporting to resolve the question once and for all. Alas, no one ever has been able to.

But even after that Operation Twist was abandoned, the Fed has routinely gone into the market to buy longer-term US Treasuries. It has continued to do so even during the traumatic financial market conditions of the past year. The following table shows that holdings have increased markedly over the past year and half, while Treasury bill holdings have virtually disappeared: Operation Twist in all but the name.

LONGER-TERM US TREASURIES HELD BY THE FED ALREADY RISING SHARE

<i>Longer-term securities, 5yr – 30yr USD billion</i>	Total holdings of US Treasuries	% held in longer-term securities
Pre-crisis, June 2007	790.5	19.8%
Pre-Lehman bankruptcy, Sept 2008	479.8	40.3%
January 22, 2009	475.4	41.8%

Source: Federal Reserve System, UniCredit Research

So why has the FOMC at two successive meetings, and Chairman Bernanke at his widely read speech at the LSE in London earlier this month, told the markets it is considering buying longer-term Treasuries when it has been doing so all along? The explanatory statement this week gave the following rationale: The Fed is prepared to buy longer-term US Treasuries “if evolving circumstances indicate that such transactions would be particularly effective in improving conditions in private credit markets.” What the statement does not say is that the Fed has shifted from short to longer-term Treasuries over the past year or so, without any evidence of improving conditions in private credit markets. That’s why they have been introducing all these new facilities, instead. Bizarre language and bound to confuse financial markets.

What the Lacker dissent might signify

A week ago, Jeffrey Lacker, president of the Federal Reserve Bank of Richmond, gave a long speech about the economic and financial situation. Tucked in the middle was a passage that indicated he was not happy with what the Fed was doing in supporting segments of the financial markets. Here is his key point: "The critical policy question of our time is where to establish the boundaries around the public-sector safety net provided to financial market participants, now that the old boundaries are gone. In doing so, the prime directive should be that the extent of regulatory and supervisory oversight should match the extent of access to central bank credit in order to contain moral hazard effectively. The dramatic recent expansion in Federal Reserve lending, and government support more broadly, has extended public sector support beyond existing supervisory reach, and thus could destabilize the financial system, if no corrective action is taken." He sees only two ways out of the problem. The first, which he rejects because it would create moral hazard, is to adapt the regulatory regime to the new scope of government lending support. The second is to roll back the financial safety net.

His dissent to the FOMC's policy decision this week was not, however, explained in these terms. To the contrary, he merely stated that he preferred expanding the monetary base through purchases of US Treasury securities rather than through targeted credit programs of the type that the Fed has been deploying in recent months. That is a judgment based on technical criteria, rather than the sharp differences in economic philosophy as expressed in the speech. Our suspicion is that there is more to the dissent than the statement reveals. It is most likely about the broader themes that Lacker developed, and that other Fed officials may well share Lacker's distaste for government intrusion in the markets, including the exceptional measures adopted by the Fed. Bernanke, Kohn, and now Bill Dudley, former head of open market operations and Geithner's successor as president of the NY Fed, are unlikely to back down. But they can live with a sentence that says the FOMC is considering buying longer-term Treasuries, a conciliatory gesture no doubt.

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