Five Questions: The Fed Proposes to Sell Debt

Posted by David Gaffen

One can criticize the Federal Reserve for a number of its actions in this 2007-2008 credit crisis, but it has not lacked for creativity. The most recent possibility that is being broached would be the sale of its own debt, in order to raise money so it can continue to support troubled credit markets, which are basically stuck.

Funding rates have declined over the last few months, but riskier credit markets remain essentially shut, and Treasury bill yields have recently plunged into negative territory due to year-end funding concerns. The idea of the Federal Reserve competing with the Treasury Department in the government-debt world seems strange, but it could happen. MarketBeat has a few questions about this, however.

- Why is the Federal Reserve considering this? The Fed is engaged in a massive effort to re-introduce liquidity to the various credit markets — to support these markets with the eventual hope of getting those markets to function normally. They’ve used tons of money through interventions in the commercial paper and short-term borrowing markets already, and that has worked, to a point, in lowering rates. But many markets remain essentially shut, and the original plan to address this — the Treasury’s TARP facility — isn’t being utilized. “They really need to get hands on the troubled assets,” says Campbell Harvey, professor of finance at Duke University. The problem is that in order to keep financing these operations, the Fed believes it is necessary to do something other than what is has been doing: Increasing the level of excess reserves that commercial banks are holding at the Fed, because of the constraints it puts on banking balance sheets.

- What’s the problem with those balance sheets? Why not keep doing what it’s doing? The Fed has increased the level of excess reserves dramatically, something it can continue to do until the end of time. But it’s not great for the nation’s banks, says Lou Crandall, economist at Wrightson ICAP, because the banks receive a very low interest rate in exchange, and their balance sheets are being constrained. They’re getting 0.5 percentage point right now (the expected federal-funds target as of next week), but in the open market, the federal-funds rate was lately trading at 0.06 percentage point — so the banks are essentially saying they’ll hold this paper if they can buy it for almost nothing. “A lot of banks would prefer to have a tidier balance sheet and not have it bloated with assets that earn next to nothing,” Mr. Crandall says. “Behaviorally, the Fed is surprised that this is the case. They underestimate the extent to which banks are still conservative and don’t like blowing up their balance sheet at will.”

- Ok, so what are the other options? The first option is one that has been used — having the Treasury department sell debt, with the money then deposited at the Federal Reserve. The Treasury has decided to scale back that effort, however. This leaves the Fed with the possibility of selling its own debt. That’s an attractive possibility for this reason: Whereas the commercial banks are worried about their balance sheets, outside of the banking system, among regular investors, there’s clearly massive demand for short-term debt, as Treasury bills have fallen into negative-yield territory. If the Fed were to issue debt that was considered on a par with the Treasury’s debt, it would presumably attract tons of buyers.

- So why not just go ahead with this plan? That’s the thing — this isn’t legal. Not yet, anyway. The Federal Reserve Act doesn’t explicitly permit the Fed to issue...
notes beyond currency. The Fed could try some kind of end-around using a special-purpose vehicle, but it is more than likely to try to get something like this through Congress.

Will this happen? With a new administration coming into office in a bit more than a month, it may not. The new Treasury Secretary, Tim Geithner, was the head of the New York branch of the Federal Reserve, and his involvement in these issues might result in the Treasury attempting to sell debt. The Treasury is getting close to a debt ceiling, but that has been expanded before, and might be politically easier than the Fed attempting to garner new authority to issue debt.

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