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FED SHADOW

Treasury Won't Bail Out the Fed

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David Gitlitz

Their obscure partnership won't keep the Fed from having to inflate our way out of crisis.

It went virtually unnoticed by the media or analyst communities, but coincident with Treasury Secretary's Timothy Geithner's appearances last week presenting his financial rescue agenda came release of an inter-agency statement which included a section on "Additional tools for the Federal Reserve." That section stated,

> In order for the Federal Reserve to manage monetary policy over time in a way consistent with maximum sustainable employment and price stability, it must be able to manage its balance sheet, and in particular, to control the amount of reserves that the Fed provides to the banking system. The amount of reserves is the key determinant of the interest rate that the Federal Reserve uses to pursue it monetary policy objectives. Treasury and the Federal Reserve will seek legislation to give the Federal Reserve additional tools to enable it to manage more effectively the level of reserves.

Update to strategic view

GOLD: A Treasury/Fed partnership will corrupt the Fed's independence, but probably do little to fund the ongoing rapid growth of the Fed's assets. Gold will challenge its old highs as the Fed becomes increasingly compromised at the same time as it must continue to buy assets from distressed credit markets.

[see Investment Strategy Dashboard]

This statement struck us as being as opaque as the rest of Geithner's "plan" (see "Two Strikes for Tim" February 11, 2009). What might it mean? A Fed official told us the primary objective would be to allow the Treasury to continue issuing debt for the Fed account without it counting against the Treasury's debt limit. This would suggest that the Fed hasn't entirely lost sight of the need to fund the growth of the asset side of its balance sheet, even as it is committed to maintaining its open-spigot liquidity posture indefinitely. Through the yet to be initiated TALF and the Fed's mortgage securities purchase program, the Fed has already committed to provide at least another $1.6 trillion in fresh funds, which will show up as assets on its balance sheet. The Treasury so far is only committed to fund $200 million of that. Any "additional tools" that will be sought would not appear to be particularly significant in terms of shaping the overall outlook for the Fed's balance sheet, given the massive borrowing requirements the Treasury is now incurring.

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As we have observed on numerous occasions, since the Fed went into hyper-easing mode with the intensification of the credit market crisis last September, its liquidity additions have, on net, more than doubled the size of the asset side of its balance sheet, which now stands at more than $1.8 trillion. The Fed and Treasury instituted the Supplementary Financing Program, under which Treasury issued short-term bills and deposited the funds with the Fed, which had the effect of draining liquidity to offset some of the Fed's injections. At its height in late October, the program was drawing down as much as $560 billion cumulatively, although that wasn't enough to prevent the overall size of the balance sheet from continuing to grow at a prodigious pace. Treasury suspended the program in November, apparently out of concern that it could conflict with its rapidly expanding borrowing needs to fund the various financial rescues and economic recovery efforts. But by late December, Treasury had resumed selling bills for the Fed account, but previously issued debt was maturing at a faster rate, so the net effect has been to stabilize the drain at about $200 billion outstanding.

Gold -- the market's most sensitive barometer of the real value of the dollar -- does not seem to have been impressed with the inter-agency statement (see "What is Gold Trying to Tell Us?" February 3, 2009). Last Monday, the day before issuance of the statement, gold closed below $900. Today, it is trading around $970, in a seemingly inexorable march back above $1,000. We are struck again by the disparity seen in the dollar weakness indicated by gold -- which today alone is up by more than 3% -- versus the currency's apparent strength against foreign exchange, with the euro down by nearly 2% on the day. As we have pointed out, this is a reflection of the fact that, as weak as the dollar may look against gold, the other currencies are even weaker (see "The Dollar: The Tallest Pygmy" February 5, 2009).

Recommended reading
Late Change in Course Hobbled Rollout of Geithner's Bank Plan Neil Irwin and Binyamin Appelbaum *Washington Post* February 17, 2009 *How To Make TARP II Work* Lucian Arye Bebchuk Harvard University February 12, 2009
[Recommended Reading home]

This idea of the Treasury's continued or accelerated funding of the Fed is also troublesome from the perspective of the Fed maintaining its independence. The integration of Treasury debt issuance into the Fed's policy framework would effectively allow the Treasury to exert considerable control over monetary policy. For example, the Treasury could unilaterally cause the Fed to ease by withdrawing funding -- leaving the Fed no choice but to create money to support the assets on its balance sheet. Through history, giving that kind of leverage over central banking to a political branch of government has been a recipe for monetary disorder.

BOTTOM LINE: A Treasury/Fed partnership will corrupt the Fed's independence, but probably do little to fund the ongoing rapid growth of the Fed's assets. Gold will challenge its old highs as the Fed becomes increasingly compromised at the same time as it must continue to buy assets from distressed credit markets.