Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

The Fed's New New Facility

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Donald Luskin

Just when the Fed got things figured out, it's poking the hornet's nest with a new policy tool.

Update to strategic view
GOLD, US DOLLAR: Inflation-sensitive markets are building in a risk premium the Fed's new initiative to pay interest on reserves is evaluated. They've been due for a substantial correction anyway, resting a bit in the sudden trend-shift that set in at mid-March when infinitely dovish Fed expectations began to moderate and reverse. As the Fed's initiative becomes better understood, we expect this correction will play itself out.
[see Investment Strategy Dashboard]

The rally in gold, taking it to above 900 this morning from its lows two weeks ago at 845, has corresponded with the emergence of a new idea for the operation of Fed monetary policy -- the payment of interest on bank reserves held at the Fed. This isn't exactly a new idea. Under a 2006 law, the Fed would start paying interest on reserves starting in 2011. But in the last two weeks there have been leaks to the effect that Ben Bernanke wants congressional approval to move that date forward. Today it was reported that the Fed has formally sought this approval, and that House Financial Services Committee chair Barney Frank has signaled his acquiescence. Is the sharp move higher in gold -- and in most other commodities and foreign currencies -- a signal that this policy initiative amplifies inflation risk?

There's no question that inflation *risk* -- that is, *uncertainty* -- is amplified here, as it is whenever there is a fundamental change in the Fed's operating framework. Much -- in fact, nearly all -- remains unknown about how an interest-on-reserves regime would work in practice. No doubt at the point of eventual implementation it will require some on-the-job learning to get it to work. And if history has taught us anything about central banks, it's that if there is a mistake to be made they will make it. So it makes sense that inflation-sensitive markets such as gold should perk up here, impounding some degree of an *inflation risk premium*, even if not an *actual forecast* that this policy change is necessarily inflationary.

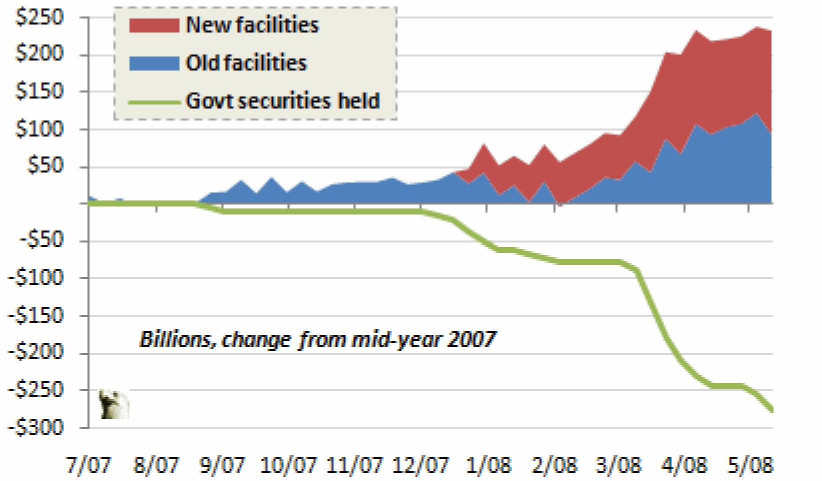
Paying interest on reserves gives the Fed a tool with which it can expand its balance sheet by means not currently available. If the Fed wants more reserves, all it has to do is raise the interest rate it offers on those reserves, and it will get them. Some commentators have opined that this gives the Fed expanded powers to carry out inflationary "helicopter drops" of money, suggesting that the scope of possible inflationary error has commensurably expanded. There is still much to be learned here, but we doubt this is the right take. If the Fed offers an interest incentive for banks to keep more money on deposit at the Fed in the form of reserves, that does

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

not *create* reserves, instead it *attracts* them -- it causes *pre-existing money* to be voluntarily *moved* from elsewhere in the economy into banks' reserve accounts at the Fed. In such a case the Fed's balance sheet will have expanded, but the Fed will *not* have *created* money to accomplish it -- there is simply a deposit and an offsetting commitment to repay it someday, and no securities will have been purchased in open market operations with newly printed money.



Why does the Fed want to move forward the date on which it will pay interest on reserves? Because this will give the Fed the means to expand, if necessary, its new targeted liquidity facilities such as the Term Securities Lending Facility, Term Auction Facility, and the Primary Dealer Credit Facility (as well as what they call "other credit," to describe their acquisition of Bear Stearns' portfolio of risky asset-backed securities). TAF was introduced late last year, and the PDCF in March, and as of now these two facilities have together cumulatively lent $139 billion. The Fed has sterilized every dollar of that by selling Treasury securities it already held, or letting those securities mature without replacing them. More Treasuries have been sold or redeemed to offset the Fed's lending by its traditional means, reducing the Fed's Treasury portfolio from $754 billion at year-end to $516 billion today. Of that, $137 billion is on loan in connection with TSLF. So that leaves only $378 billion in Treasuries. If further disruption in credit markets were to demand expanded use of the new liquidity facilities, the Fed could run out of liquidity to supply and be forced to print money to create it.

The Fed might be more concerned about being *perceived* as running short of needed liquidity, than it is of *actually* doing so at this late stage in the credit crisis. A perception that the Fed has "run out of bullets" could *itself* could trigger another round of credit market instability, as market participants become excessively risk averse out of a belief that the Fed backstop so effective last March were no longer in place.

Either way, paying interest on reserves potentially relieves the concern. If the bank needs more Treasury securities in its stockpile to lend under TSLF, it can raise the rate on reserves to attract more reserves, and then use those reserves to buy Treasuries. If it needs money to lend under TSLF or TAF and has insufficient Treasuries to sell or redeem, it can raise the rate on reserves to attract more reserves, and then lend those reserves.

Note that in order to attract additional reserves the Fed would have to *raise* the interest rate it is willing to pay on them. It seems to us that, perforce, this would entail raising the fed funds rate as well. That's because if the rate paid on reserves were higher than the funds rate, banks could game the Fed through arbitrage, simultaneously lending at the higher reserve rate and borrowing at the lower fed funds rate. So whatever else it may do, the new power to pay interest on reserves would seem, at least at the margin, to militate against responding to banking crises by cutting interest rates, as the Fed did in the present crisis. This notion is affirmed to some extent by a speech by Ben Bernanke this week. He spoke of the work of 19th century economist Walter Bagehot, citing his belief that banking crises should be handled by central banks' freely lending to troubled institutions, but at high interest rates.

So based on our present understanding, we don't think that the initiative to pay interest on reserves is necessarily a prelude to a new inflationary error by the Fed. To be sure, it introduces risk simply by changing the way the Fed operates, requiring some potentially costly learning-by-doing. It's ironic, because the Fed has already done a *lot* of learning-by-doing under the *force majeure* of the credit crisis -- and it was just getting to where markets seemed to be finding comfort that the Fed had finally figured things out. And now *this*.

BOTTOM LINE: So it makes sense that inflation-sensitive markets would build in a risk premium while the Fed's initiative to pay interest on reserves gets processed. They've been due for a substantial correction anyway, resting a bit in the declines (other than in oil) that set in at mid-March when infinitely dovish Fed expectations began to moderate and reverse (see "Inflation Inflection" March 25, 2008). As the Fed's new initiative becomes better understood, we expect this correction will play itself out.