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

FED SHADOW

Some Tightening!

Wednesday, February 24, 2010

Donald Luskin

When the SFP is complete at $200 billion, excess reserves will top today's $1.137 trillion.

We've been surprised by the large number of inquiries from clients about the Treasury's announcement yesterday that it will expand to $200 billion its Supplemental Financing Program for the Fed (we mentioned it only briefly in yesterday's report, "Real Deflation" February 23, 2010). Most of the questions have centered around whether the SFP "mops up liquidity" or "drains reserves," and therefore constitutes tightening, as it has been portrayed in many media accounts.

It does *not* constitute tightening. It merely *sterilizes* the Fed's balance sheet against the inadvertent easing effects of the Fed's subsidies of AIG, Fannie Mae and Freddie Mac. These are investments undertaken by the Fed on behalf of the Treasury in the first place. These subsidies have a current aggregate value of $191.1 billion on the asset side of the Fed's balance sheet, so the $200 SFP is simply the Treasury funding its own rescue initiatives, treating the Fed as the neutral intermediary that it is (please see the chart on the following page. This level of funding was in place once before, as recently as last September. But it drifted down to as

Update to strategic view

FED FUNDS: An enlarged SFP will not drain reserves or mop up liquidity. When it is complete, we expect excess reserves to be greater than they are today. Nothing about it leads us to expect any hawkish surprises from this morning's House testimony from Bernanke.

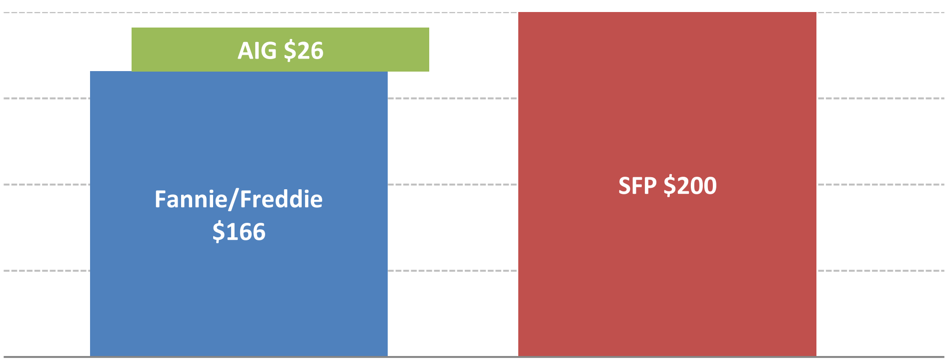
[Strategy Dashboard home]

low as $5 billion as the Treasury had to cope with its funding challenges while Congress dragged its feet on expanding the statutory debt ceiling. That's resolved now, so the SFP can go back to the $200 billion level where it was intended to be all along (please see the charts below).

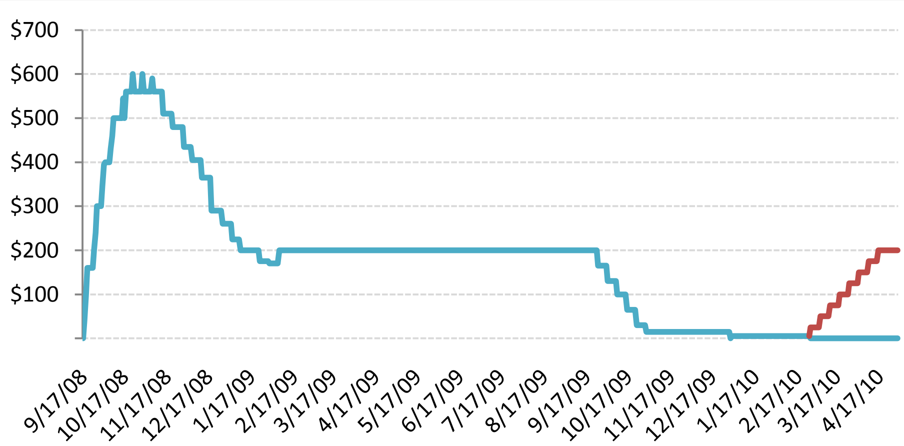
But doesn't the SFP take the place of bank excess reserves on deposit with the Fed? Yes, but that doesn't imply tightening. We would argue that it is immaterial to policy one way or the other, because those excess reserves are interest-bearing deposits parked at the Fed -- they are not money. But that's beside the point at this current juncture. As the $200 billion in SFP gets built up on the Fed's balance sheet $25 billion at a time over the coming eight weeks, more than all of it will be consumed by $149.0 billion of pending net settlements of mortgage-backed securities the Fed has already purchased, and another $75.4 billion it has yet to purchase. In other words, *when the SFP is completed, we expect the excess reserves parked on the Fed's balance sheet to be even greater than today's $1.137 trillion.* Some tightening!

If you want to understand the monetary impact of SFP from first principles, conduct a simple thought experiment. Consider these two alternative

Fed initiatives for Treasury, versus Supplemental Financing Program
USD billions, as of February 17, 2010; SFP projected total



Supplemental Financing Program — historical, and — projected
USD billions, as of February 24, 2010



Source: Federal Reserve, US Treasury, TrendMacro calculations

Contact TrendMacro

On the web at
www.trendmacro.com

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

[About us]

scenarios:

- The Treasury announces a program of weekly issuance of cash management bills, with a maximum of $200 billion outstanding at any one time. Banks, savers and investors buy the bills as they are issued. The federal government spends the money.
- Alternatively, the Treasury announces a program of weekly issuance of cash management bills, with a maximum of $200 billion outstanding at any one time. Banks, savers and investors buy the bills as they are issued. The Treasury deposits the money with the Fed. The Fed uses the money to buy Treasury bills. The federal government spends the money.

How are the two scenarios different? They are not. In neither one is money created or destroyed by the Fed. That's why the SFP is neutral with respect to monetary policy. At least it's neutral if you agree that issuing government debt is neutral. Many people believe that debt is not neutral, but rather is inflationary. But if that is so, then how could SFP represent tightening? Wouldn't it represent *easing*?

How is the thought experiment different from today's situation? It is not, though some institutional details would have to be colored in.

- The Treasury announces a program of weekly issuance of cash management bills, with a maximum of $200 billion outstanding at any one time. Banks, savers and investors buy the bills as they are issued. The Treasury deposits the money with the Fed. The Fed uses the money to buy mortgage-backed securities. The sellers of the MBS use the money to buy Treasury bills. The federal government spends the money.

Enlarging the SFP does not cause the Fed to create or destroy money. It is neutral.

Bottom line

An enlarged SFP will not drain reserves or mop up liquidity. When it is complete, we expect excess reserves to be greater than they are today. Nothing about it leads us to expect any hawkish surprises from this morning's House testimony from Bernanke.