Discussion of "Government and Central Bank Balance Sheets, Inflation and Monetary Policy" by Christopher A. Sims

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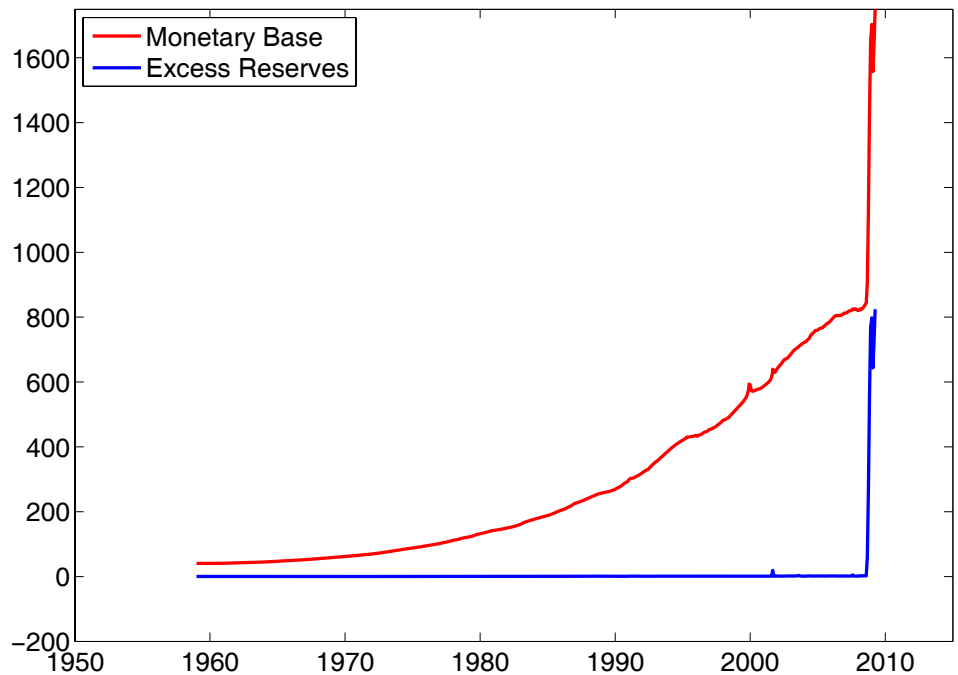
Questions about the Fed's Balance Sheet

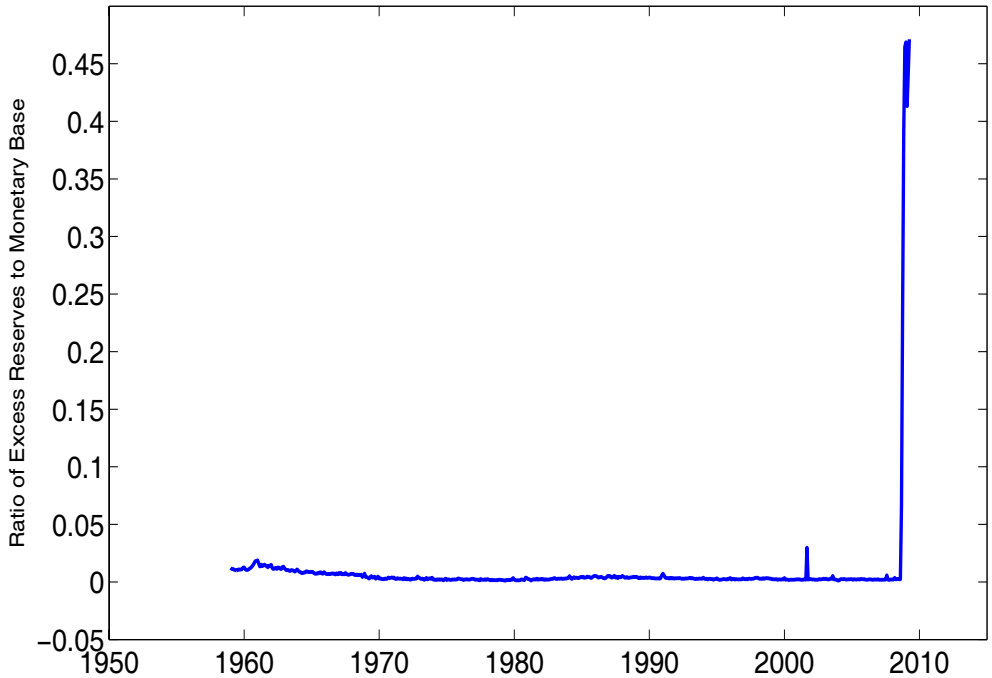
- Does the vast expansion of reserves pose an inflationary threat?
- Could the Fed have trouble unwinding its balance sheet fast enough to control inflation?
- Should the Fed be allowed to issue debt on its own account?
- Would an injection of capital from the Treasury be helpful?

An inflationary threat?



There is no immediate threat because most of the increase in high-powered money is being held as excess reserves.

What if excess reserves returned to 'normal'?



Fed would have to drain approximately $820 billion in reserves.

Unwinding the balance sheet: a reason to worry?

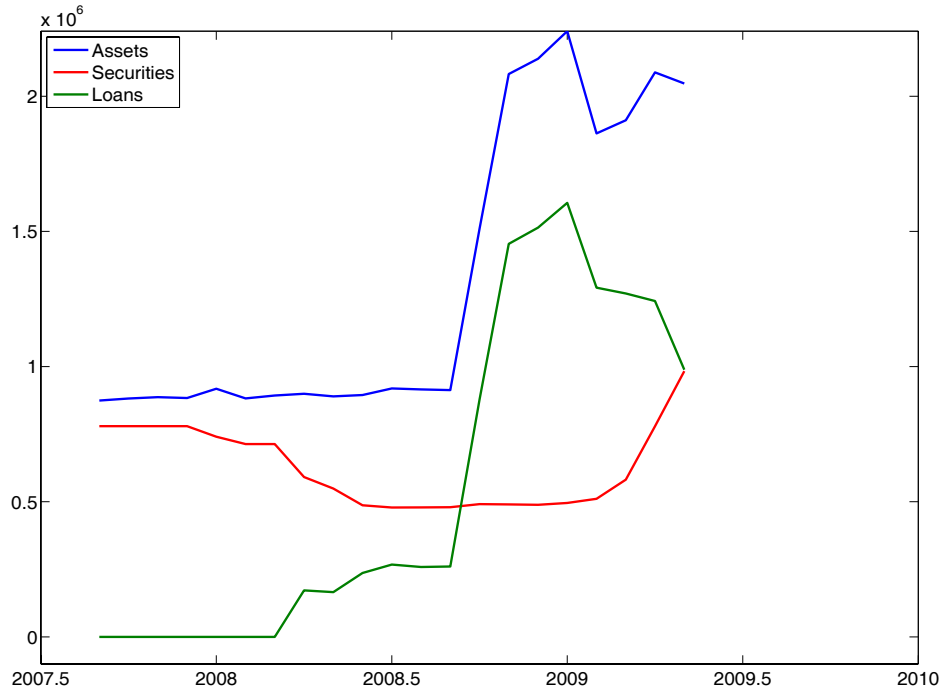
Fed currently holds $550 billion in Treasury securities, hence cannot drain the required amount solely by selling Treasuries.

Also, much of their Treasury portfolio is long term ($450 billion more than 1 year), hence subject to interest-rate risk.

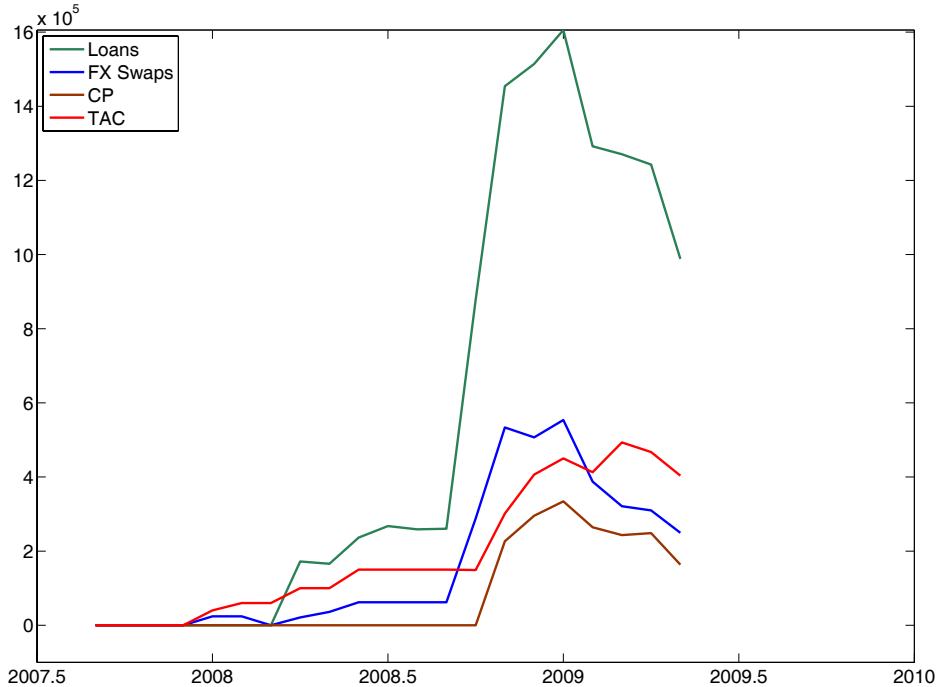
Treasury yields are likely to rise as the crisis abates, exposing Fed to capital losses.

Reasons not to worry

- A large proportion of the increase in high-powered money is in the form of short-term loans, many of which will run off on their own as the crisis subsides.



Federal Reserve Assets



Federal Reserve Loans

CP + FX swaps = \$413 billion, half the required drainage.

Already beginning to decline.

Commercial Paper: $164 billion

- Less than 3 months
- Only highly-rated borrowers
- Fees charged to make this a backup facility

Central Bank FX Swaps: $249 billion

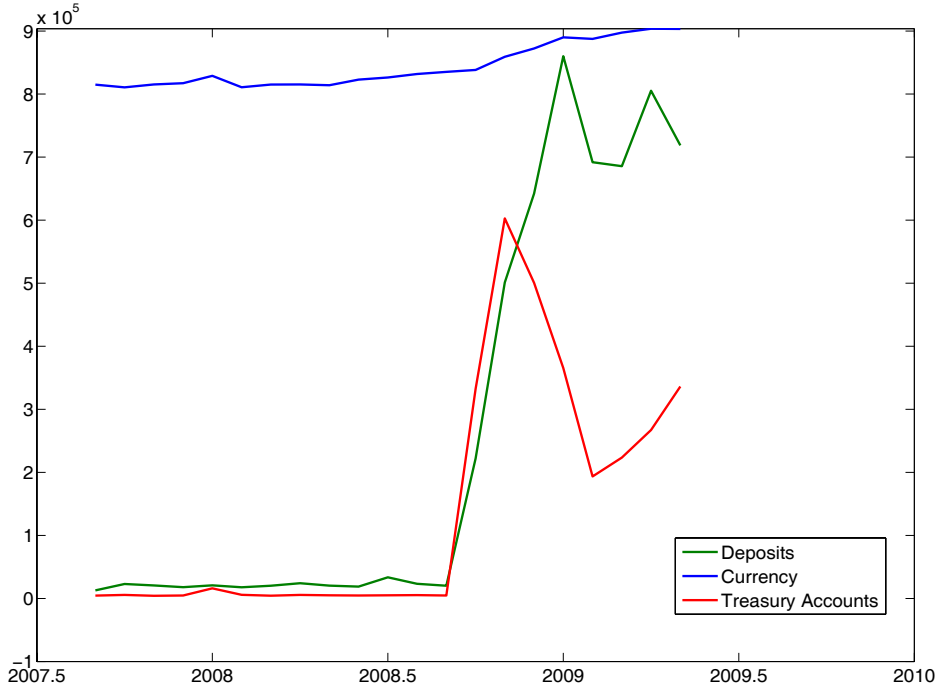
- Counterparties are foreign central banks

Term Auction Facility: $403 billion

- Essentially discount window loans, but w/out the stigma.
- Since borrowers are commercial banks, less clear how quickly this will unwind.

Reasons not to worry (con't)

There has been a big increase in the Treasury account at the Fed, draining funds that would otherwise appear in commercial banks.



Federal Reserve Liabilities

Presumably the Treasury balance could be increased if an inflationary threat were to emerge, but ...

- This would add to the interest burden of the Federal debt.

- And would make Treasury a partner in controlling inflation.

Reasons not to worry (con't)

Fed now pays interest on reserves, so the ratio of excess returns to the monetary base is unlikely to return to 'normal.'

Hence the figure of $820 billion cited above overstates the amount the Fed will need to drain.

Although this ratio is likely to fall, by how much is hard to say.

Should the Fed issue debt on its own account?

To increase the Treasury balance, the Treasury sells bills and places the proceeds with the Fed.

The Fed could achieve the same end w/out coordinating with Treasury if it could sell debt on its own account. This would streamline the process.

But Fed debt would have to be backed by taxes, so perhaps it would be better for Treasury to inject capital (give the Fed T-bills), which the Fed could then sell.

Summary of an exit strategy

1. Allow loans to run off.

2. Sell some Treasuries and other securities.

3. Adjust interest on reserves so that banks continue to hold them.

4. Increase balance in the Treasury account (not a Fed instrument).

Another reason to worry?

Over the coming months, the Fed plans to purchase

- \$1.25 trillion of mortgage-backed securities, raising MBS holdings to more than \$1.5 trillion
- \$500 billion of long-term Treasuries and agency-backed debt

The plan is to hold them long term (Bernanke April 3, 2009, BoG web page).

Unless this is accompanied by an injection of capital from Treasury, this would swamp the first two items in the exit strategy.

This would make the adjustment of interest on reserves and manipulation of Treasury balances key parts of the Fed's operating procedure.

The crisis is due largely to a regulatory breakdown that needs to be fixed.

The Fed has done a good job adjusting interest rates, however, and has a well-understood set of procedures for implementing an interest-rate rule.

But the Fed's balance sheet is changing in ways that require new procedures.

I would be reluctant to replace a good policy and well-understood procedures with new procedures that are less well understood and involve a partner whose commitment to price stability is questionable.

An injection of capital from Treasury would go a long way toward repairing the Fed's balance sheet and obviating the need for new operating procedures.