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Aug 10, 2010 Economic Commentary

The Fed Gives the Treasury a Gift

Timothy Geithner, and the rest of the Obama Team, should send a thank you note to Ben Bernanke at the Federal Reserve. Thanks to today's announcement from the Fed, the US Treasury will pay even lower interest rates to finance its burgeoning debt levels.

The Federal Open Market Committee (FOMC) bowed to unwarranted fears of a double-dip recession. Rather than allowing its balance sheet to shrink, it agreed to buy longer-term Treasury bonds with any principal payments it receives from its vast holdings of mortgage backed securities. At the same time, the Fed announced that it will roll over any current holdings of Treasury securities as they mature.

The 2-year Treasury yield fell roughly 2 basis points (to, 0.52%), the 5-year fell 8 bps (to, 1.45%), and the 10-year fell 6 bps (to, 2.77%). The 30-year Treasury bond barely moved, but is yielding just 4.0%, one of the lowest yields on record – outside of the panic lows of late 2008 and early 2009.

With rates so low, the US Treasury is paying $230 billion less in interest per year than it would pay if rates were at levels that existed back in 2007 – just three years ago. Because the Fed has once again stated that it will hold the federal funds rate near zero for an "extended period" and because the Fed will step up its purchases of Treasury bonds, yields will likely remain near record lows. This masks the real cost of government debt.

For the fifth consecutive meeting, Thomas Hoenig, President of the Kansas City Federal Reserve Bank, dissented from both decisions of the FOMC. He believes that the "extended period" language is "no longer warranted." At the same time, he did not believe that maintaining the Fed's balance sheet at the current level was "required to support a return to Committee's policy objectives."

We agree with Thomas Hoenig. In fact, he is our hero. The odds of a double dip recession are extremely low. The risk of inflation is rising. And, the Federal Reserve should not be monetizing the debt of the US Treasury. The Federal Reserve cannot prop up the economy using money without causing long-term damage to the value of the dollar and US purchasing power.

What the Fed should do and what the Fed will do are two different things. First Trust models suggest that the natural rate of interest – the level of the federal funds rate that would not boost inflation, or hurt growth – is roughly 1% and rising. A perfect policy would be pushing rates to that level right now. However, it is clear that the Fed is in no mood to lift rates and will likely hold them steady well into 2011.

Holding rates steady means that the Fed will become more accommodative as the year progresses. As a result, Fed policy will cause both growth and inflation to accelerate throughout 2010 and into 2011. The bond market is stuck between a rock and a hard place. Fed policy on one hand is pulling rates down, while growth and inflation will push rates up. In the end, the Fed will lose this battle. Easy monetary policy eventually results in higher interest rates down the road.

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Robert Stein, *Senior Economist*

Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in June indicates that the pace of recovery in output and employment has slowed in recent months. Household spending is increasing gradually, but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software is rising; however, investment in nonresidential structures continues to be weak and employers remain reluctant to add to payrolls. Housing starts remain at a depressed level. Bank lending has continued to contract. Nonetheless, the Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability, although the pace of economic recovery is likely to be more modest in the near term than had been anticipated.

Measures of underlying inflation have trended lower in recent quarters and, with substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to be subdued for some time.

The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation

expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period.
To help support the economic recovery in a context of price stability, the Committee will keep constant the Federal Reserve's holdings of securities at their current level by reinvesting principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities.[1] *The Committee will continue to roll over the Federal Reserve's holdings of Treasury securities as they mature.*

The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to promote economic recovery and price stability.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; James Bullard; Elizabeth A. Duke; Donald L. Kohn; Sandra Pianalto; Eric S. Rosengren; Daniel K. Tarullo; and Kevin M. Warsh.

Voting against the policy was Thomas M. Hoenig, who judges that the economy is recovering modestly, as projected. Accordingly, he believed that continuing to express the expectation of exceptionally low levels of the federal funds rate for an extended period was no longer warranted and limits the Committee's ability to adjust policy when needed. In addition, given economic and financial conditions, Mr. Hoenig did not believe that keeping constant the size of the Federal Reserve's holdings of longer-term securities at their current level was required to support a return to the Committee's policy objectives.