Notes from the Economics Desk

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Sterilized Bond Buying

Jon Hilsenrath came through for the second time this week with some juicy scoop on the Fed. The latest article suggests that if the FOMC does decide that yet another round of stimulus is warranted, then there would be three options:

1) Straight QE. Buy securities (presumably MBS) and add cash to the system.
2) Operation Twist II. Alternatively, the FOMC could extend Operation Twist. The problem with this option is that by June 30 (when Operation Twist is currently scheduled to end) the Fed will own very few Treasury securities with three years or less remaining to maturity. To "pay for" another proper round of long-end purchases (the current OT program is $400 billion), the Fed would probably have to liquidate nearly everything out to about five years.
3) "Sterilized" QE. In this case, the Fed would buy long-term securities but prevent the cash it creates from entering the economy by locking up the money with reverse RPs (it would lend out some of its portfolio, holding market players' cash for the term of the RP, say 28 days).

Of course, the "new news" in the article is Option #3, as it has been widely understood for a long time that either of the first two options were open to policymakers. We've tossed the sterilized QE idea around internally here, but today's article is the first public acknowledgement that Fed officials are actively considering it.

The more I think about this idea, the sillier it seems. I think the absurdity of the proposal, which I hope to flesh out for you below, indicates just how much the Fed has played out its options. The doves at the Fed have run of good ideas, and they have become desperate, and are now entertaining bad ones. The fact that this is under active consideration should tell you we are nearing the end in the Fed's unprecedented policy easing campaign (akin to when the cafeteria manager in our building in the late-1990s left to be a tech stock day trader or when the guy who detailed cars in our garage became a real estate agent/home flipper in the mid-2000s).

Do we need stimulus or not? The first and most obvious objection to "sterilized QE" is to ask why it needs to be sterilized. Does the economy need stimulus or not? If it does, just do QE3. If it doesn't, then, for goodness sake, put the shovel down and stop digging. One could object to this argument on the grounds that the Fed is already doing a faux QE in the form of Operation Twist. Exactly. What has that gotten us? Long-term Treasury rates may be 10 or 20 BPs lower than they would otherwise be. But there is no new liquidity added to the economy, and there is little or no evidence that the purported modest decline in long rates is generating added activity. What it has done is satisfy two of the fixations of the activists/doves at the Fed: the urge to be always and everywhere doing something and the obsessive desire to manipulate markets to achieve some contrived result. Good luck to

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Chairman Bernanke attempting to explain this policy in a coherent way to your average legislator or financial press reporter. That would be impossible, because the policy itself is clearly incoherent.

Sterilized QE is not like Operation Twist. Operation Twist is a balance sheet neutral effort to bring long rates down. The Fed buys one security and sells another in an equal amount. The only change is that the average duration of the Fed's holdings extend (or, to put it another way, the Fed takes duration out of the market), which the Fed believes provides stimulus via the portfolio balance channel. In contrast, sterilized QE blows up both sides of the Fed's balance sheet to bring long rates down. The Fed's purchases of long-term securities would expand the asset side of the balance sheet, and the Fed would create an offsetting liability to temporarily tie up the extra cash that QE is pumping into the financial system. The "sterilized" part of sterilized QE is really just a fig leaf. If the ECB's 3-year LTRO is QE in a poor disguise, so is this.

Sterilized QE will not assuage inflation concerns. The argument is that the Fed can permanently add cash to the economy by buying a 10-year or 30-year Treasury, but market players worried that the Fed is laying the groundwork for future inflation will be comforted by the existence of a 28-day reverse RP that keeps the money from being deployed for a month. Seriously? In the article, the sources that Hilsenrath cites go to great pains to argue that Fed officials (at least the majority of them) think that these concerns about inflation are entirely misguided. The implication is that sterilizing QE is really about placating the irrational inflation fearers, not because there is a true need to protect against a future acceleration in price hikes. This is unbelievably weak. Either there is an inflation threat or there isn't. If there is, yet another dollop of stimulus should be out of the question (this would certainly be my view!). If inflation is not a threat, then man (and woman) up and convince these poor misguided souls of the error of their ways rather than patronizing them by offering reverse RPs. If these inflation fearers are as misinformed as Fed officials seem to suggest, then they should be easily disabused of their erroneous inflation fears by some reasoned discourse from Chairman Bernanke and others on the FOMC. In reality, anyone who is already concerned that the Fed is in the process of unleashing the inflation beast is only going to be **more** worried if the Fed embarks on another round of QE, whether there is a 28-day fig leaf offsetting the transaction or not.

Cutting off the exits. As the Fed has gotten more and more extreme with its policies over the last year or two, it has systematically destroyed the easiest pieces of the exit strategy devised in 2010. Locking in (even conditionally) zero rates for three years has prevented a quiet or graceful retreat on rates. Operation Twist has led to the liquidation of all those short Treasury securities that were going to roll off, allowing the Fed to reduce its balance sheet without having to resort to outright asset sales. And now, the Fed proposes to use reverse RPs, which were going to be the lead dog in neutralizing the size of the balance sheet when that became necessary, to "pay for" yet another round of QE. Of course, there is only so much in reverse RPs that market players will be able to support, and sterilized QE would eat up much of that capacity (no official speculation on size, but Twist is $400 billion). I realize that Fed officials will be happy when they are able to start implementing an exit strategy because that will mean

the economy is strong enough to support a more normal policy stance. However, the short-sightedness of the FOMC is becoming increasingly evident in that they continually to eviscerate their options for exit in the process of piling on more and more easing now. The odds that the Fed can gracefully transition to removing accommodation have waned considerably, and the chances of a disruptive train wreck in the markets when the inevitable turn takes place have grown considerably. Sterilized QE would only add to the headaches for the next Fed chairman (or Bernanke himself if things turn more quickly).

Fed working against itself. On a more practical level, what might the Fed hope to achieve with sterilized QE? With Twist, the policy works against itself to some degree, but there is in theory an unambiguous result of downward pressure on long rates and curve flattening. If the Fed "offsets" QE via the RP market, then repo rates will rise. Let's say that the Fed buys agency MBS and then executes reverse 28-day RPs as an offset. Repo rates will rise, including for the very MBS that the Fed is buying. Financing becomes more expensive, which at the margin diminishes the demand for the paper. It is tough to say whether the net result would be higher or lower yields for MBS, but I think we can be fairly confident that the net impact would, at a minimum, be substantially muted relative to an "unsterilized" QE program.

Arbitrage problems. I do not have a precise feel for how deep the term RP market is. Perhaps the Fed could do several hundred billion dollars worth of reverse RPs without driving financing rates substantially higher. I doubt it. Besides, banks will not even consider a 28-day RP that is less lucrative than the 25 BPs on offer for holding excess reserves at the Fed overnight. Of course, if the term RP rate moves well above 25 BPs, then there will be no one other than the Fed on that side of the market. There will be an endless stream of cash holders willing to earn, say, 30 or 40 BPs on their cash, but who in their right mind would pay so much in the financing market when the funds rate and interest on reserves are at or below 25 BPs. When I try to fully explore all of the potential arbitrage constraints, my head starts to spin, but I am fairly comfortable with the notion that the Fed airdropping hundreds of billions of dollars worth of action into the RP term market is going to create ripples. I am also extremely confident that the Fed will not relax its policy stance (i.e. the 0 to 0.25% range for the funds rate or a 25 BP IOER rate) due to dislocations caused by the reverse RP program. As a result, the Fed is likely either going to run into serious arbitrage restraints on what it can do in reverse RPs or it is going to cause troublesome dislocations in financing markets.

Conclusion

I could go on for pages and pages, but you get the picture. With every step in the easing process, the Fed has upped the degree of complication, and sterilized QE would reach a level of convolution that would make Rube Goldberg proud. Clearly, sterilizing QE is not being trial ballooned because it has substantive merits. It is a vehicle to provide the Fed with political cover to do something that most everyone agrees is unnecessary, if not harmful. The radicalization of the FOMC continues apace, and the scorched Earth nature of the easing campaign, systematically closing off the paths of retreat, is only

going to make the inevitable return to normal more painful when inflation forces the current FOMC's hands or a different leadership takes over and returns the Fed to a more conventional policy framework.

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