June 3, 2009

Debt and money

If you are hunkered down on inflation watch, yesterday's news offered some soothing words. From Reuters:

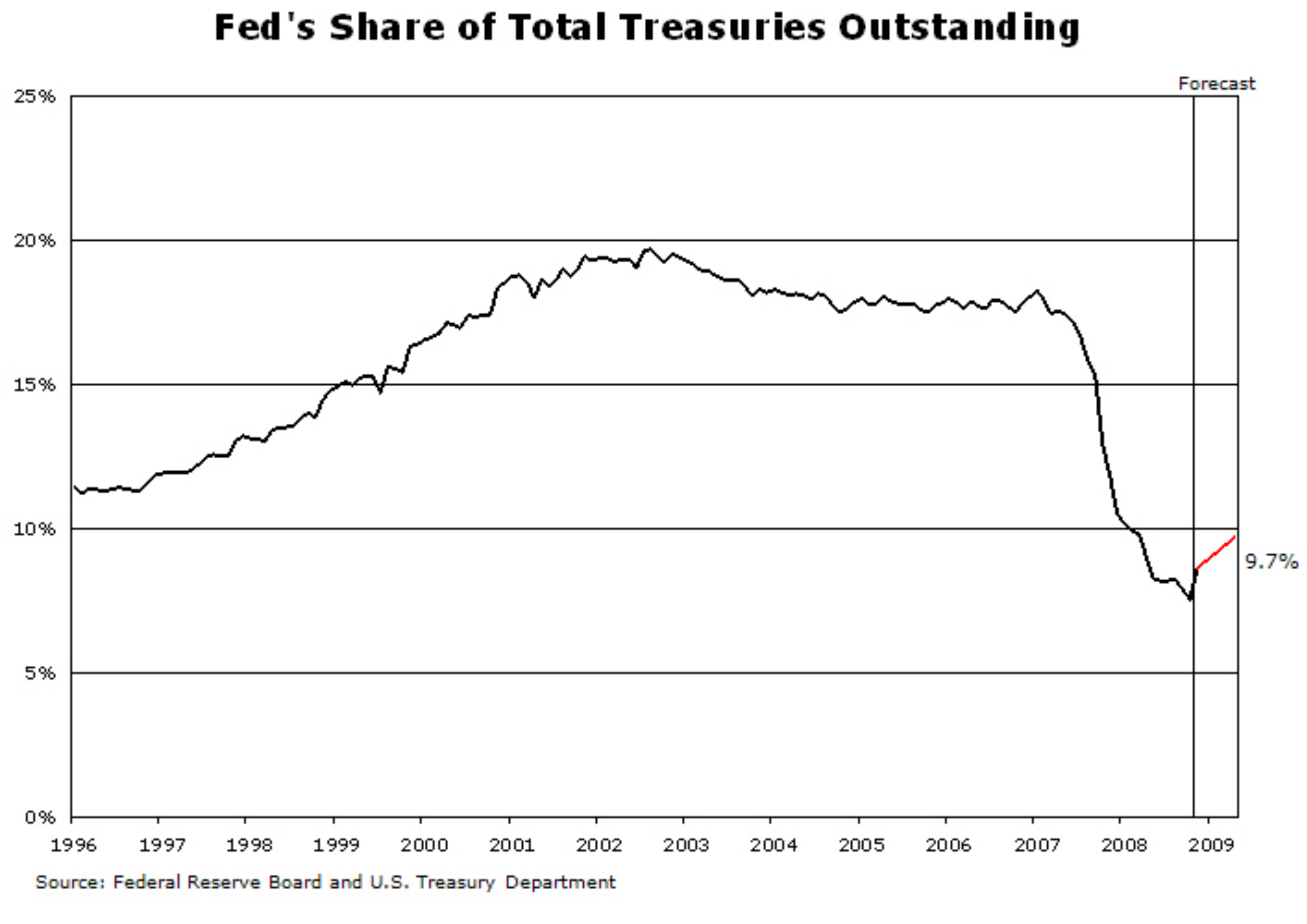
> "Chinese officials have expressed concern that heavy deficit spending and an ultra-loose monetary policy could spark inflation, eroding the value of China's U.S. bond holdings.
>
> "But [U.S. Treasury Secretary Timothy] Geithner said: 'We have a strong, independent Fed and I am completely confident they have the ability to do their job under the law, which is to keep inflation stable and low over time, and that they will be able to—and certainly intend to—unwind these exceptional measures as soon as they have served their purpose.' "

And from Bloomberg:

> "He said that there was 'no risk' of the U.S. monetizing its debt, a response to a question about whether the government would seek to finance the national debt by expanding the money supply and thus trigger a rise in inflation."

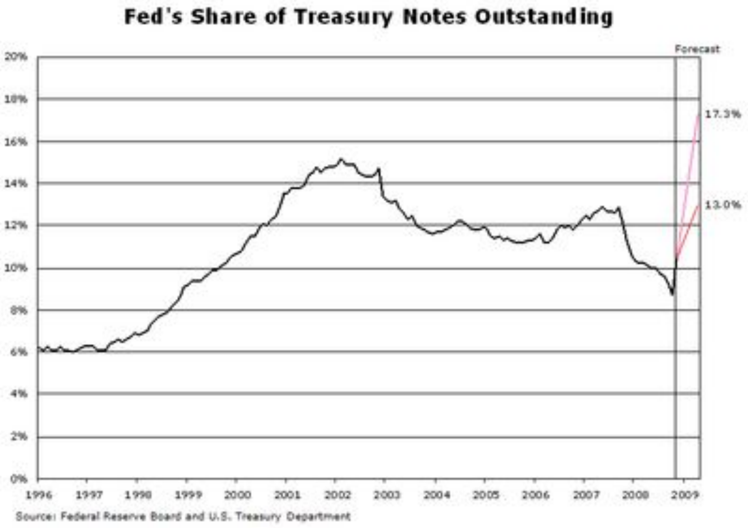
Concerns about such monetization arose in the wake of the FOMC's decision at its March meeting to purchase up to $300 billion of longer-term Treasury securities and that decision's coincidence with the very large fiscal deficits contemplated in President Obama's budget proposals. Those concerns have accelerated as longer-term Treasury yields have moved higher since.

There will, I trust, be plenty of opportunity to expand on these concerns as things develop, but for now I will offer just a little perspective in the form of the chart below, which shows the recent and (near-term) prospective shares of federal debt held by the Federal Reserve. The red line represents the share of debt that will be held by the Fed at the end of fiscal year 2009 if the $300 billion Treasury purchase program is completed and the federal deficit emerges as currently predicted by the Congressional Budget Office.



The financial crisis has, of course, borne witness to the shift in the Fed's balance sheet from Treasuries (which have been much in demand by the private sector) to a variety of loans and mortgage-backed securities. The consequence has been a sharp fall in the fraction of government debt held by the central bank, a fact that will be little changed under the current trajectory of Fed purchases and projected deficit spending.

A large decline in Fed holdings of Treasury bills—securities that mature in one year or less—drives much of the pattern seen in the chart above. The drop-off in share is not as large for Treasury *notes*—securities in the two- to ten-year maturity range, and some assumptions have to be made to get a picture of how the Fed's share might evolve over the near term. Without knowing how this evolution will occur, I developed two general assumptions for argument sake. *If* net new issues of Treasury debt follow historical averages, meaning just over half of net new debt is in the form of notes, and *if* the central bank applies the remainder of the $300 billion of longer-term Treasury purchases (about $170 billion at the end May) to notes, then the Fed would hold roughly 13 percent of the outstanding stock by the end of the year. If the Treasury were to issue nothing but bills or bonds, a $170 billion purchase of notes by the Fed would bring its share up to the neighborhood of 17 percent. Though these numbers are not as unusually low in historical context as is the case for total outstanding debt, neither would they jump off the page as an extreme aberration in the other direction.



Some might argue that "monetization" these days involves a whole lot more than government debt, but Chairman Bernanke has been pretty clear about [his intentions regarding the overall size of the Fed's balance sheet](). And, as I see it, so far allegations that extraordinary steps are being taken specifically to accommodate fiscal deficits are properly characterized as risk rather than fact.

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