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FED SHADOW

Taking It Up A Notch

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TALF 2.0 makes the Fed's balance sheet both bigger and stickier.

Update to strategic view
US MACRO: The Fed's enlistment in the Treasury's toxic asset relief plan compounds the sizeable inflation risks already being courted in the present regime of extreme monetary ease, making the Fed's already enormous balance sheet more difficult to shrink as the economy recovers.
[see Investment Strategy Dashboard]

With the Fed committed to another step toward significantly expanding its balance sheet under the bank rescue plan announced this week by Treasury Secretary Tim Geithner, the bias toward an inflationary outcome of this crisis management exercise is becoming increasingly deeply embedded. Under the Treasury announcement, the recently instituted TALF program -- under which the Fed lends to support highly leveraged investment in asset-backed securities with the Treasury underwriting first-loss risk (see "TALF -- The Fed Gets One Right" March 6, 2009) -- will be expanded to take on some so-far unspecified amount of "toxic assets" clogging the balance sheet of the banking system (see "Geithner Gets A Do-Over" March 24, 2009). Originally, TALF would only facilitate the purchase of newly issued AAA-rated securities. But that is being subsumed under the Treasury Public Private Partnership Investment Program, and given the uncertainties surrounding much of the plan laid out by Geithner, the Fed is likely to shoulder the bulk of the legacy asset clean-up project.

In its joint statement with Treasury issued Monday following Geithner's announcement, the Fed was seeking to guard against the impression that its balance sheet was being commandeered by Treasury. While it "will continue to use all tools working closely and cooperatively with other agencies in efforts to preserve monetary stability," the Fed said "it alone is responsible for maintaining monetary stability." Further, it stated that "loans or securities purchases that influence the size of its balance sheet, must not constrain the exercise of monetary policy."

The Fed here is attempting to provide assurances that it would have the tools needed to "sterilize the effects of its lending or securities purchases on the supply of bank reserves." But that may be easier said than done. The Fed noted that Treasury "has in place a special financing mechanism called the 'Supplementary Financing Program,'" under which it has issued debt with the proceeds being deposited at the Fed, acting as a draining mechanism. But from over $550 billion in October, the SFP has settled in at about $200 billion, offsetting only a small part of the more than $1 trillion in liquidity that the Fed has added through its asset acquisitions.

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Even prior to this week's announcement of PPPIP, the Fed was committed to more than another $2 trillion in additional asset accumulation, between TALF, mortgage-backed and agency securities, and Treasuries. That will bring the asset side of its balance sheet to some $4 trillion, nearly quintuple its size at the outset of this exercise in mid-September. Ultimately, if the Fed steps in as the major facilitator of toxic asset relief, going well beyond the current scope of the TALF program, and acting to absorb a major share of the problem assets currently thought to be on the books, it could add as much as another $2 trillion to the total.

The Fed would like to be able to count on a significant expansion of the SFP to sterilize a good part of the enlargement of its balance sheet attributable to its Treasury-linked operations. But Treasury's capacity to continue issuing debt to fund the program may be limited. As it is, at this week's 5-year note auction, we saw the first signs of resistance to the massive borrowing requirements now being shouldered by the federal government. It's questionable whether Treasury will essentially want to compete against itself by floating a large amount of additional debt to fund the Fed. The Fed would have other sterilization options, including selling assets, conducting reverse repurchase agreements, or incentivizing the deposit of additional excess reserves -- but whether these could be done on the scale required to offset enough of the toxic asset acquisitions is debatable.

But beyond the issue of the Fed's involvement in Treasury operations, the Fed on its own account has done much to sow the seeds for sizeable inflationary fallout. Indeed, the Fed may find itself on the horns of a thorny dilemma, and sooner than it probably imagines. At this point, it is officially proceeding on the assumption that once the present credit crisis fades and the economy enters recovery, it can unwind the balance sheet expansion quickly enough, and combined with whatever sterilization measures are employed, avoid a significant inflation breakout. We think that's an assumption relying on premises that may prove faulty. For one thing, TALF loans presently are for three-year terms -- and loans against toxic assets are likely to have even longer terms -- so unless the Fed finds some way of sterilizing their impact, it will be impossible to withdraw or offset the liquidity being added to the system from that source until the loans come due. At the same time, the Fed is acquiring assets such as MBS that may prove difficult to unload when the time comes.

These technical questions about *how* the Fed will eventually reduce the size of its balance sheet leave aside the more important issue of whether it will have the good judgment to do so at the right time. The central bank has gone to unprecedented lengths in carrying out this exercise in extraordinary monetary ease, and the transition from its present deflation concern to unnerving inflation reality will probably entail more decision-risk than the Fed will want to tolerate. Just as it did in 2003 when it kept interest rates low for "a considerable period" even after the economy had visibly recovered, the Fed will probably opt for a "risk-control" solution in which it consciously tolerates a higher inflation environment for a while in the interest of market and economic stability.

On that score, we got a surprisingly honest acknowledgement of the potential quandary facing the Fed this week from Richmond Fed president Jeffrey Lacker. A noted hawk among FOMC members, Lacker told students at the College of Charleston that whether or not the Fed's actions have an inflationary impact "depends on our skill at the Federal Reserve in withdrawing the stimulus in a timely way. That is a very delicate, very hard policy," he said. "The economy when it recovers is spotty…Inevitably, we face this dilemma -- do we keep policy easy and stimulative because of the sectors that are lagging behind… or do we get ahead of the curve. It is going to be a tough call." For somebody with Lacker's anti-inflation credentials to describe that as a "tough call" provides compelling insight into the pressures being exerted on the Fed to accede to an inflationary outcome of this endeavor. His comments also get at the source of much of the Fed's problems over the years -- the complete discretion of policymakers to act as they see fit, unburdened by any objective standards for their actions. Lacker is sometimes viewed as a loose cannon for making statements that are less restrained than is the central baker norm. But here he should be praised for his truth-telling, sounding an alert to the real policy challenges lying ahead.

BOTTOM LINE: The Fed's enlistment in the Treasury's toxic asset relief plan compounds the sizeable inflation risks already being courted in the present regime of extreme monetary ease, making the Fed's already enormous balance sheet more difficult to shrink as the economy recovers.