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Statement of the Shadow Financial Regulatory Committee

Stress Testing the Fed

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The Federal Reserve has recently announced its intention to purchase an additional \$600 billion of securities as part of a second round of quantitative easing. In the past when the Fed typically held its portfolio of short-term Treasuries at book value until they matured. Today its assets may need to be sold before they mature to mop up the excess reserves that have been injected into the system before a bout of inflation breaks out. Security sales and other methods of generating increased interest rates entail significant interest rate risk for the Federal Reserve and could result in either economic or book value insolvency long before interest rates rise and return to normal.

The Fed now has a very large portfolio of mortgage-backed securities (MBS) and long term Treasury bonds that entail significant interest rate risk. When interest rates rise, security values fall. This will depress the market value of the Fed's net worth or reduce its book capital when securities are sold. In the case of private banks, financial economists worry that unrecognized insolvency could lead to excessive risk taking by "zombie" institutions. For the Fed, a hidden insolvency might lead to excessive risk taking through a different channel, namely, the avoidance of a contraction of its balance sheet, at the cost of rising inflation. The Shadow Financial Regulatory Committee believes that the reputational risks and political and international ramifications of a de-capitalized central bank are significant and pose threats both to the appropriate conduct of monetary policy and political independence of the Fed.

Prior to the financial crisis, the Fed's balance sheet did not contain significant exposures to interest rate risk, but the acquisitions of MBS and long-term Treasuries has put the Fed into a risky position. According to one market estimate, roughly 50 basis points of additional increases in medium- and long-term interest rates could render the Fed economically insolvent. Given current asset durations, the addition of an additional \$600 billion to its balance sheet would nearly halve the estimate of the increase in interest rates that would result in economic insolvency. With the continuing acquisitions of medium- and long-term Treasuries under QE II, the market has responded by increasing expected inflation and long-term bond yields significantly. Market rates could even rise significantly before the Fed begins asset sales.

The Fed is not obligated to mark its portfolio to market, and traditionally has not done so. Therefore, so long as the Fed does not sell assets with a market value below their face value, the Fed can avoid recognizing losses, and thus avoid recognizing insolvency even if it becomes market value insolvent.

Currently, money velocity and the money multiplier are at or near historic lows. But an increase in economic growth could prompt an abrupt expansion of lending and deposit creation. This would boost the money multiplier and require offsetting policy by the Fed including significant asset sales to prevent inflation. But if sales of assets forced a recognition of insolvency, the Fed might demur, thus fueling an acceleration of inflation.

Chairman Bernanke has recently discussed several possible alternative ways of responding to inflation risk, but all would carry significant costs or risks. First, in a rising interest rate environment, if the Fed sold long-term Treasuries or MBS at values below their market value, that could force the Fed to have to appeal to either the Treasury or Congress for recapitalization. While some might argue that this would not be significant, it definitely would fuel uncertainty in international markets and invite further politicization of monetary policy as a quid pro quo for additional capital. Moreover, it would undermine the Fed's moral authority as the chief supervisor of systemically important institutions.

A second possible policy response to inflation risk could be to engage in reverse repurchase agreements with MMMFs and other counterparties. But, reverse repos are only a temporary way of idling reserve balances, and furthermore, it is not clear that MMMFs or other counterparties would be willing or able to participate in a massive quantity of such trades, particularly if the Fed were regarded as insolvent on a market-value basis.

A third policy response would be to raise interest rates on excess reserves to discourage expansion of the money multiplier. But if loan supply and loan demand shifted positively, the amount by which interest rates on excess reserves would have to rise is uncertain, and a very large increase could create further economic losses for the Fed, and thus further strain its financial position.

A fourth possibility would be to raise reserve requirements. This would disadvantage U.S. banks relative to foreign competitors in loan and deposit markets.

The Shadow Financial Regulatory Committee believes that Fed insolvency is not necessarily a low-probability event, and therefore, its consequences for monetary policy and reputation of the Fed are potentially important and worthy of consideration. QE II only further adds to the risks associated with potential Fed insolvency.

The Committee believes that it would be desirable for the Fed to restore the historical maturity structure of its balance sheet, and remove the current interest rate and insolvency risk exposures that it is bearing at the earliest possible opportunity. One possible alternative would be for the Fed to swap its long term debt for short term Treasuries and its MBS with the housing GSEs for short-term Treasuries that the latter could finance with debt issued to the Treasury.