

# **IMPLICATIONS OF THE TREASURY DEBT PAYDOWN FOR FEDERAL RESERVE OPEN MARKET OPERATIONS**

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## **Declining Treasury Debt**

In 2000, in 20 buyback operations, the Treasury purchased a total of \$30 billion of par value marketable debt that it had previously issued, with maturities ranging from 12 to 27 years. In each of the first two quarters of 2001, it will purchase, in two buyback operations per month, about \$9 billion par value of outstanding Treasury debt. In line with the buybacks, the Treasury has reduced its issues of new securities, but it has scheduled regular reopenings of auctions of additional amounts of a previously issued security (instead of issuing a new one) in order to maintain adequate sizes of individual maturities. The reopening of every other auction of five-, ten-, and thirty-year maturities is smaller than the previously auctioned security. In addition, the Treasury has reduced the issue sizes of two-year notes and inflation-indexed securities. It has eliminated the April auction of the thirty-year inflation-indexed bond, and one-year bills following the February 2001 auction.

## **Modifications of Federal Reserve Operations**

Reductions in Treasury debt that are forecast will require a shift in the Fed's portfolio. By reason of the volume of that debt, its default-free status, and liquidity, it has come to be preeminently the trading vehicle of choice and market benchmark. The liquidity of Treasury securities enables the Fed to provide or withdraw reserves rapidly at minimum cost and minimum disruption to the market. In question is whether substitutes with comparable attributes can be found.

The usual financial assets that are mentioned as alternatives to Treasury securities are obligations of federal government agencies or government-sponsored enterprises (Fannie Mae, Freddie Mac, the Federal Home Loan Banks, the farm credit banks, Sallie Mae, the Tennessee Valley Authority); corporate debt securities; interest rate swaps. Agency securities have an implicit line of credit with the Treasury. Interest rate swaps and corporate securities are private market instruments with some credit risk. Offered in large and liquid issues, these alternatives may assume some of the roles of Treasury securities.

In light of actual and potential declines in Treasury debt, the FOMC has had to determine what its reaction should be were the amounts available to fall short of its portfolio needs. In March 2000 it arranged for a study of possible alternative financial assets and the criteria for their selection. One alternative to purchases of Treasury debt would be to expand the use of the discount window. This is not a likely solution. Pending completion of the study, the Fed has taken some interim measures. To add or withdraw reserves, instead of outright purchases of Treasury securities, it already uses short-term repurchase agreements and matched sale-purchase transactions. It has recently increased its use of longer-term repurchase agreements, typically with 28-day maturities. Contributing to increased use of short-term operations in repurchase agreements has been the Fed's approval of a broader range of eligible collateral including the extension of temporary authority to the New York Fed trading desk to accept mortgage-based securities of government-sponsored enterprises.<sup>1</sup>

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<sup>1</sup> Agency issuers have initiated auctions in all maturities, imitating the size and regularity of Treasury issues. Congressional legislation, however, has created some uncertainty about using agency issues. The proposed bill would eliminate the \$2.25 billion Treasury credit lines available to Fannie Mae and Freddie Mac, and a \$4 billion Treasury credit line available to the Federal Home Loan Bank System. The Fed also seems unwilling to give benchmark status to issues of government-sponsored enterprises. Chairman Greenspan has indicated that he expected the private sector capital markets would create benchmarks to replace Treasury securities. The private sector's dollar swap market has been used by Ford Motor, General Motors, and Wells Fargo as the benchmark for pricing their debt issues. Dollar swap turnover is higher than in agency coupon securities though less than in Treasury securities.

The Fed now holds more than 15% of marketable Treasury debt and, on present trends in growth of reserve needs and the Treasury paydown, it is estimated that its holdings would grow to 25% in 2002 and 50% in 2005. To avoid acquiring disruptive levels of individual Treasury securities, the Federal Reserve Bank of New York announced on July 5, 2000, percentage limits on System holdings of outstanding amounts, ranging from 35% for Treasury bills to 15% for longer-term bonds. These limits required the System to redeem some of its holdings when the amount of maturing holdings exceeded the amount that could be rolled over into newly issued Treasury securities. More than \$24 billion in bills were redeemed, about \$4 billion in other maturities.

### **Does the Fed Have a Problem?**

The Federal Reserve Act authorizes the System to buy agency securities, certain direct obligations of state and local governments, foreign exchange, and foreign sovereign debt. The Fed could request authority to acquire a wider range of assets. However, there may be a political fallout for the Fed from such diversification. A preference for the obligations of certain issuers rather than others may suggest to some observers partiality in its decision-making rather than impartiality. In addition, the Fed's portfolio would bear greater credit risk.

Whether these alternatives would provide the same liquidity services as do Treasury securities remains to be seen. The efficiency not only of the Fed but also of financial markets in general would be affected should the available market instruments be less liquid than Treasury securities.

In the near term, the paydown of Treasury debt will continue. The marketable publicly held debt will not be eliminated over the longer term because some debt will not be callable except at a premium, and because the projected surplus probably will not materialize. The conclusion that

the debt paydown should not pose a problem for Fed monetary policy operations does not address the costs the economy will bear in greater credit risk and less liquidity.