The Last Three Days of January 2014: Treasury Notes, Gold Certificates, and the Federal Reserve

January 29-31, 2014 will witness three events bearing on the ascendance of "forward guidance" as the premier US macroeconomic policy instrument.

On January 29, the US Treasury will conduct its first Floating Rate Note (FRN) auction. The FRN will be the first new instrument issued by the Treasury in exactly 17 years—to the day—since the introduction of inflation-protected securities (TIPS).

January 30, 2014 will mark the 80th anniversary of the day Franklin Delano Roosevelt signed into law the Gold Reserve Act (GRA). This act, inter alia, compelled the legal transfer of all US gold coin and monetary gold from the Federal Reserve Banks (FR) to the US Treasury. President Roosevelt exercised the power granted him in that law to reduce the gold content of the dollar on the following day, January 31, 1934.

And of course, January 31, 2014 marks Ben Bernanke's last day in office as FR Chairman.

Let us take a look at these three events in reverse chronological order.

January 31, 2014

From most perspectives, the hand-over from Ben Bernanke to Janet Yellen should not result in major policy changes. We will lose someone who fortuitously was well versed in the history of the Great Depression and whose published research emphasized the role of financial disintermediation in propagating and deepening adverse economic shocks. This knowledge was both timely and important since most large-scale macroeconomic models circa 2007, including those used by the FR, completely ignored the role of the financial sector in the economy. With Ben out the door, my concerns relate to the notion that Chairman Yellen might be overly reliant on optimal control models or that she will make them an important part of forward guidance going forward.

There is nothing wrong with models, of course, nor do I wish to enter into discussions of specific models. My concern is more practical. Empirical macro models are based on parameters that are calibrated with real economic data. As time passes, they should simply get better and better as more data is accumulated. That is, the parameters become more and more refined. But that Panglossian view of the world assumes that the data is being generated from an underlying structural constellation of fundamental economic relations (the "true" model) that is stable over time and that the data being generated by the true model is the result of market clearing processes. Neither of those two assumptions can be accepted as valid in most of the advanced countries since 2007 and certainly not in the United States. Since the crisis there have been fundamental changes in the structure of the US economy in general and in the financial system in particular. Furthermore, and more important, the determination of key US interest rates has clearly not been the outcome of market forces.

Consequently, although there are initiatives under way to incorporate financial factors such as leverage into large-scale models, their calibration is hampered by the fact that we have been living with 5+ years of distorted interest rates and well-out-of-equilibrium financial markets. We might need another 20

years of data—once the situation has normalized—to obtain reliable correlations of the appropriate variables. “We” still have not completely figured out the Great Depression, 80 years later.

So I am making a very basic point, 2015-2019 is not the best time for heavy reliance on large-scale empirical macro models as the primary guide for policy. These are essentially the same models in use in 2007 with the added disadvantage of being updated/calibrated using 7 years of dodgy data. Not dodgy in the way Argentine inflation data is dodgy but dodgy in the way that correlations of money growth and inflation in Venezuela are made meaningless by various price controls.

Whatever the shade of dodgyness, the point remains the same, in an era when expectations about future policy are everything, it will take quite an extraordinary communications performance to pull off the “lower than longer” Jedi mind trick. Neither the market nor the FR should place too much emphasis on model-driven arguments. It is much too early to lift the curtain on Oz. Fortunately Chairman designate Yellen did express an appropriate degree of skepticism in her April 11, 2011 speech to the New York University Money Marketeers “I consider it essential…to recognize at the outset the limits of our understanding regarding the dynamics of the economy and the transmission of monetary policy.” Unfortunately, it is difficult to be creditable with model-driven forward guidance when you are admittedly shooting in the dark.

January 30, 2014

January 30, 2014 marks the 80th anniversary of the Gold Reserve Act. As noted above, the GRA transferred ownership of all gold coin and bullion from the FR to the Treasury: Upon the approval of this Act all right, title, and interest, and every claim of the Federal Reserve Board, of every Federal Reserve bank, and of every Federal Reserve agent, in and to any and all gold coin and gold bullion shall pass to and are hereby vested in the United States; and in payment therefor credits in equivalent amounts in dollars are hereby established in the Treasury in the accounts authorized under the sixteenth paragraph of section 16 of the Federal Reserve Act, as heretofore and by this Act amended (U.S.C., title 12, sec. 467). Balances in such accounts shall be payable in gold certificates, which shall be in such form and in such denominations as the Secretary of the Treasury may determine…. The Secretary of the Treasury is authorized to issue gold certificates in such form and in such denominations as he may determine, against any gold held by the Treasurer of the United States, except the gold fund held as a reserve for any United States notes and Treasury notes of 1890[1].

The key factor was not the—admittedly shrewd—move by Roosevelt to take ownership of the gold less than 24 hours before the 41 percent reduction in the gold content of the dollar, resulting in a “paper profit” for the Government of over US$ 2 billion, but the *unlimited* authority given to the Treasury to print gold certificates backed by gold. This meant that the Treasury could use the original profit, monetized by the FR[2], to purchase more gold in London, which in turn allowed the Treasury to print more certificates, which were then monetized by the FR thereby enabling the process to continue ad infinitum. Roosevelt’s objective was to force a depreciation of the dollar and an increase in prices—particularly agricultural prices—and in this he succeeded.

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[1] The source of these excerpts is the February 1934 Federal Reserve Bulletin, which contains the GRA, full text.

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[2] The US Treasury was given deposits at the FR equivalent to the difference in the dollar value of the gold transferred on January 30, 1934 and the dollar value (41 percent more) of gold as established by Roosevelt on January 31, 1934.

At the time, Roosevelt's policies were branded—even by those within his own administration—as experimentalist lunacy[3]. Naturally the central bankers at the FR were aghast at the thought of deliberately provoking inflation (and also rather sore about losing the gold). But if we understand now that expectations play such an important role in determining inflation, what made the policy ushered in by the GRA credible—given the obvious opposition from the very authorities supposedly in charge of monetary policy and the mercurial nature of Roosevelt's decisions?

Two factors were essential to the success of the GRA. One is that Roosevelt's advisors incorporated into the Law a mechanism that left the FR powerless to counter the monetary impact of gold purchases financed with certificates. Since April 5, 1933, nine months before the GRA, Roosevelt's Executive Order 6102 had prohibited all natural and legal US persons apart from the FR from holding gold coin, bullion and certificates. Such persons were ordered to turn over all such gold to the FR. Therefore, when the FR found itself in possession of billions of dollars worth of the newly printed 1934 certificates bearing the likeness of Woodrow Wilson, there was **no one** to whom they could be sold. That is, the certificates could not be sold to absorb the increase in the monetary base engendered by the Treasury. Indeed, *to this day*, those very same gold certificates are clearly visible on the FR balance sheet.

As the Bureau of Engraving printing press moved into high gear, and the Treasury carried on with gold purchases from US producers and the international bullion market, the FR eventually found the asset side of its balance sheet dominated by these non-interest bearing non-marketable pieces of paper. Although they did hold some conventional Treasury securities, selling them to absorb money would have left the FR banks devoid of income. The Treasury, in any event, could have simply undone the FR operation by buying more gold and monetizing more gold certificates. Which brings us to the second factor regarding credibility. The "end" of the policy regime was at the discretion of the Treasury, not the FR. The GRA gave the Secretary of the Treasury the power to determine the timing and conditions of the redemption of the notes—as of 2014 we are still waiting.

While few would have believed the Federal Reserve if they had simply said they were going to accept high inflation and refrain from sterilizing an enormous monetary expansion, the Treasury, under the control of the "lunatics" in the Administration were credible. In other words, only the insane can be counted on to carry out an insane policy. And this is the fundamental problem that the FR has in obtaining credibility now—when it counts—for the "rates lower than longer" and "balance sheet bigger for longer". This is, can a very wise and august institution be believed when they say they are going to act in a way inconsistent with past norms? The logic of the policy—which by the way is not insane at all—can be explained to some. But when it is not bought into—unanimously by the FOMC—and when the "market" is seemingly not sophisticated enough to understand the mechanics of modern monetary policy, the communications challenge is massive and, in my judgment probably insurmountable.

The GRA provides an interesting guide but it ended even the pretense of FR independence for 17 years, until the 1951 Treasury-Fed Accord. Consequently a similar scheme is not likely to be tried again.

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[3] For a recent discussion of Roosevelt's impact on expectations, see Gauti Eggertsson (2008) "Great Expectations and the End of the Great Depression" *American Economic Review* 98(4).

Were that the FR expected to keep its end-2014 Treasury and MBS securities on its balance sheet until 2094! I suspect it will, with suitable rollovers and conversion of the MBS at some stage into Treasuries, but surely I will not be around to collect on the bet. And since the market will not believe it we will live with higher-than-necessary interest rates.

January 29, 2014

The US Treasury will conduct its first auction of FRNs on January 29, 2014. This marks a key element in the reformulation of macro policy tools intended to soften the eventual rise in FR policy rates. It also marks a striking parallel with Treasury policy at the time of the Treasury-Fed Accord mentioned above, the last time US monetary policy exited from a sustained period of artificially suppressed interest rates.

Some historical background is needed to understand what happened in 1951. The FR and Treasury had agreed to fix interest rates on government debt throughout the Second World War and the practice continued into 1951. At the time, Treasury bonds were sold “on tap” not by auction. Investors could purchase bonds whenever they chose, at par with a fixed coupon. In order to guarantee the quantity of funding needed by the Treasury at posted/fixed rates, heavy marketing and moral suasion was sometimes needed including, naturally, appeals to patriotism. Similar challenges faced all the major combatants during that War as well as during the First World War. Central banks in extreme circumstances could buy treasury debt directly but they were generally reluctant to be seen to be doing so as that would have called their independence from the treasury into question. Treasuries, in turn, thought it would not be good for the “market” to know that they were having funding difficulties. The conventional way around this problem was to have the central bank lend to another arm of the public sector, or to banks, or even individuals and have them buy directly from the Treasury. In one case, discussed in R. S. Sayers’ *History of the Bank of England 1891-1944*, the Bank of England arranged a personal loan to its Chief Cashier who used the proceeds to subscribe to an enormous amount of UK Treasury bonds. More commonly, the central bank agreed to provide credit to financial institutions on the security of treasury bonds at rates below the rate paid on the bonds. While the maturity of the central bank loans was generally shorter than the corresponding Treasury bonds, the borrower would book profits on the transaction as long as the central bank did not raise its “discount” rate.

This was the situation the FR found itself in 1951. With nominal GDP growing rapidly, the FR wished to raise rates but this would have both crushed the bondholders who had been running a mismatched liquidity book for many years and killed demand for Treasury issues at current rates thereby forcing the Treasury to raise the coupon offered on new bonds. As a result, when the Treasury agreed to allow the FR to raise interest rates it also offered existing bondholders the option to exchange their bonds—at par—into new bonds with higher coupons. In part this was to avoid the bad will occasioned during the exit from the suppressed interest rates after the first World War, 30 years prior.

Fast forward to 2014. The US has experienced 5+ years of suppressed interest rates, bondholders are becoming very wary of what might happen to the market value of their bonds once the FR begins to withdraw support for the market. The market remembers, to an extent, the losses associated with the Greenspan “surprise” aggressive rate tightening that started in February 1994. It cannot remember the

last secular rise in bond yields as yields have been on a downward trend since 1981 but it can imagine that there is only one direction—up—once the FR begins to hike. Holding long duration assets today is a bit like picking up nickels in front of a runaway freight train. So how does the Treasury entice investors to continue to buy long term debt—and prevent prices from collapsing once the FR intimates rates are about to rise? Offer floating rate notes. Notes—unlike TIPS—that protect against an unexpected increase in *real* interest rates. And it is precisely a rise in real rates that should be expected once the FR begins to tighten owing to dynamic *real* growth. Hence the Treasury is offering a sweet option to those who do not believe the "rates for longer" story.

Be certain that one buyer of these bonds will not be the FR. Indeed, the FR will continue to hold its long-term Treasury and MBS debt throughout the interest rate cycle and suffer silently its losses. To do otherwise would simply contravene the policy message—"low for longer"—no need to worry about rising rates any time soon, but for the doubters the Treasury is glad to take the other side of the bet.

Forward guidance and expectations management has become a necessary supplement to a policy arsenal that has exhausted its short-term rate ammunition clip and recognized that the benefits to manipulating long rates are sliding below the value of the collateral damage. There is no binding solution on the horizon such as the Gold Reserve Act to convince markets that the FR will hold on to its balance sheet for 80 years although it in all likelihood will. Expect a select few at the FOMC to do their best to convince markets that rates will be low for longer and for the Treasury to do its part. We will all be better off if they succeed but they probably will not. So we will likely have rates low for longer as the result of a weaker-than-desired economy not as a brilliant innovation in policy.

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