A Short Law to Enhance the Efficiency and Stability of the US Financial System

An unintended consequence of the Fed's large scale asset purchases has been a stunning increase in bank reserves and an equivalent reduction in high quality liquid assets available to financial markets[1]*. Recent FOMC statements, and the tenor of some discussions at Jackson Hole this year, portend a large Fed balance sheet for an extended period as well as a continued surfeit of bank reserves and scarcity of HQLA. The problems occasioned by the way central bank LSAPs have been financed (with bank reserves) and their interaction with strengthened financial market regulations designed to reduce systemic risk have been discussed elsewhere*[2]*. In this note I propose a short law that would enable the US Treasury and Federal Reserve to remedy those problems emanating from the fact that bank reserves are available only to US banks while treasury bills are available to all global financial market participants. The proposed law is similar to arrangements currently in place in Singapore, Mexico and Israel and may be most simply understood as institutionalizing the US Supplementary Financing Program*[3] *that was successfully employed to assist the Fed to manage the balance sheet consequences of the financial interventions associated with the Lehman Brothers insolvency. This week's political developments may also provide an impetus to restructure expeditiously the Federal Reserve balance sheet.*

A Law to Enhance the Functioning and Stability of the US Financial System

1. Be it defined that "US Treasury Bills issued for monetary regulation purposes" (hereafter MTB) are those bills issued and redeemed solely for the purpose of enabling the Federal Reserve to regulate the quantity of reserves financial institutions hold with Federal Reserve Banks.
2. MTB shall be exempt from the Public Debt Limit established in 31 U.S. Code § 3101.
3. Federal Reserve Banks shall not issue own debt instruments so long as they are enabled, as agents of the US Treasury, to issue MTB for the purposes outlined in this Law.
4. Proceeds from the sale of MTB are to be deposited in a segregated account at the Federal Reserve Bank of New York denoted the "Monetary Regulation Account" (hereafter MRA).
5. US Treasury funds held in the MRA may be used only to redeem MTB.
6. The FRBNY shall accrue and pay interest on balances in the MRA at a rate equal to the equivalent interest rate implied by the discount at which MTB are sold.
7. The US Treasury shall include projections for the issuance and redemption of MTB in the Quarterly Refunding Statement and will separately identify, within each auction announcement, the amount of MTB being offered.
8. Apart from the requirement established in paragraph 7, MTB shall be identical to treasury bills not so identified.
9. Nothing in this Law shall be construed as limiting the ability of the United States Treasury and the Federal Reserve Banks to reach an agreement whereby the Treasury would engage in an early redemption of US Treasury securities currently held in the System Open Market Account so as to reduce the size of the balance sheet of the Consolidated Federal Reserve System.
10. The US Treasury and Federal Reserve shall closely coordinate the issuance of treasury bills.

The primary objectives of the law are to:

- Increase the supply of HQLA to the US and global financial system
- Allow US banks to shrink their balance sheets and exit the zero margin intermediation of nonbank credit to the Federal Reserve Banks (currently $ 2.5 trillion)
- Reduce the Federal Reserve footprint in financial markets
- Improve the capital efficiency of US regulatory requirements
- Reduce the taxpayer's cost to finance the consolidated US balance sheet (The Fed is currently paying 50 bps on excess reserves compared with 25 bps on 30-day US treasury bills)

References:

Kohn, Donald L. (2010), *The Federal Reserve's Policy Actions during the Financial Crisis and Lessons for the Future*, Speech at Carleton University, Ottawa, Canada May 13.

[1] See Kohn (2010) and Martin, McAndrews, and Skeie (2011).
[2] See Exiting Well (2015), elsewhere on this blog, and McCauley and McGuire (2014).
[3] See https://www.newyorkfed.org/markets/statement_091708.html

Martin, Antoine, McAndrews, James and David Skeie (2011) *A Note on Bank Lending in Times of Large Bank Reserves*, Federal Reserve Bank of New York Staff Reports no. 497, May.

McCauley, Robert and Patrick McGuire (2014) *Non-US Banks' Claims on the Federal Reserve* BIS Quarterly Review (March).

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