

# A View from the Trenches

Toronto, Wednesday, June 17<sup>th</sup>, 2009

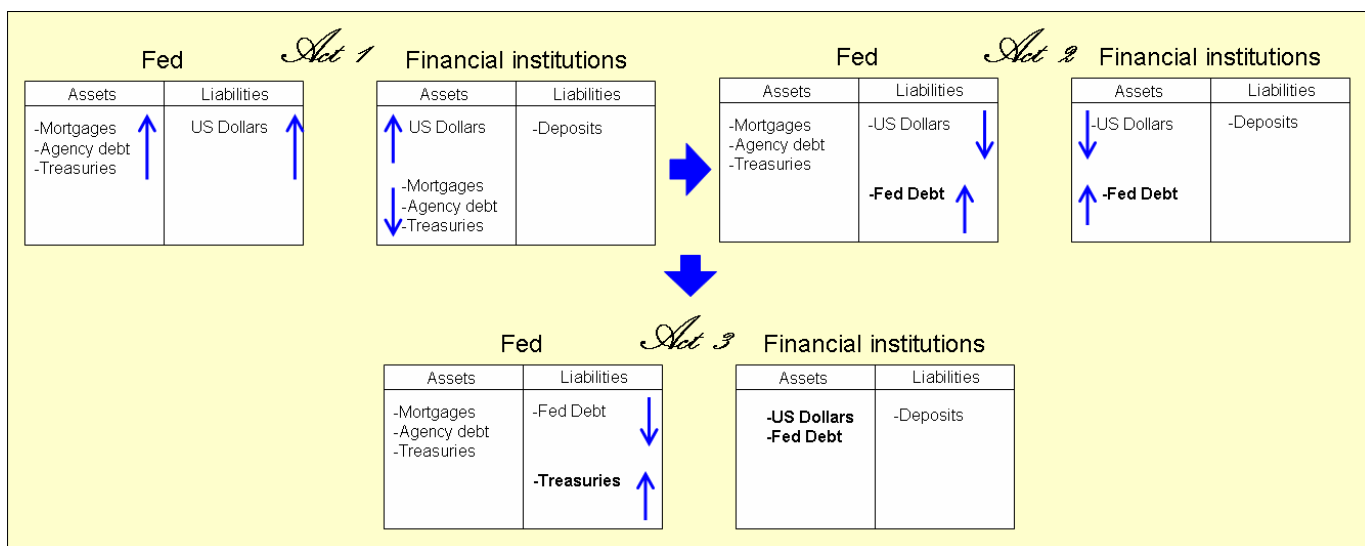
Good morning,

Last Friday, June 12<sup>th</sup>, Barclays Capital's "Global Weekly Rates" report suggested that a possible exit strategy for the Fed may consist in the Fed's issuance of debt. The hypothesis is not new. But from all the publications I read, this one seemed to me the most optimistic on this alternative. As I have not yet read any other work discussing the implications of the alternative, I will give it a try myself. To understand this process, I divided it in three "acts". Let's see...

**-Act 1:** We're still in Act 1. The Fed is buying mortgages, agency debt and Treasuries. (In total, including the Term Asset Backed Lending facility (TALF), it will have bought \$3 trillions by the end of 2009) In exchange, the Fed gives liquidity, US dollars (a liability for the Fed) to the sellers of the assets (the Treasury, agencies, financial institutions). This liquidity is inflationary. This liquidity, instead of distressed assets, is now backing deposits.

**-Act 2:** After obtaining congressional approval, the Fed issues its own debt, changing the composition of its liabilities: Less USD, more Fed certificates. **Who buys these certificates?** Holders of US dollars. Will they do so willingly? **(Perhaps, Obama's announcements today on financial markets supervision will open the door to allow the Fed to "direct" USD deposits).** This could have a **counterintuitive impact**. The reduction in US dollars would tend to appreciate the USD and weaken Treasuries, because every US dollar that buys Fed debt is a US dollar that doesn't buy Treasuries. **Will Gresham's law apply and further boost the value of the USD?** What about interest rates? There would be a crowding-out effect here: Every US dollar that buys Fed debt is a US dollar that doesn't buy corporate debt. **Credit spreads should widen**, as higher rates push leveraged players closer to default. If banks are forced to buy Fed debt, should their equity prices not fall? Who is going to fund US banks from overseas? **Should Libor fall**, as USD overseas become abundant, because foreign investors don't want to invest their USD in the US jurisdiction? These are some of the numerous questions that would arise, if the Fed issued its own debt.

**-Act 3:** The Fed could finally exchange its debt for Treasuries (with congressional approval). **But the final picture is that of US banks backing their USD deposits with Fed debt, not US dollars. Should this not trigger another sort of Creditanstalt collapse? Should gold not reach \$2,000/oz?**



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