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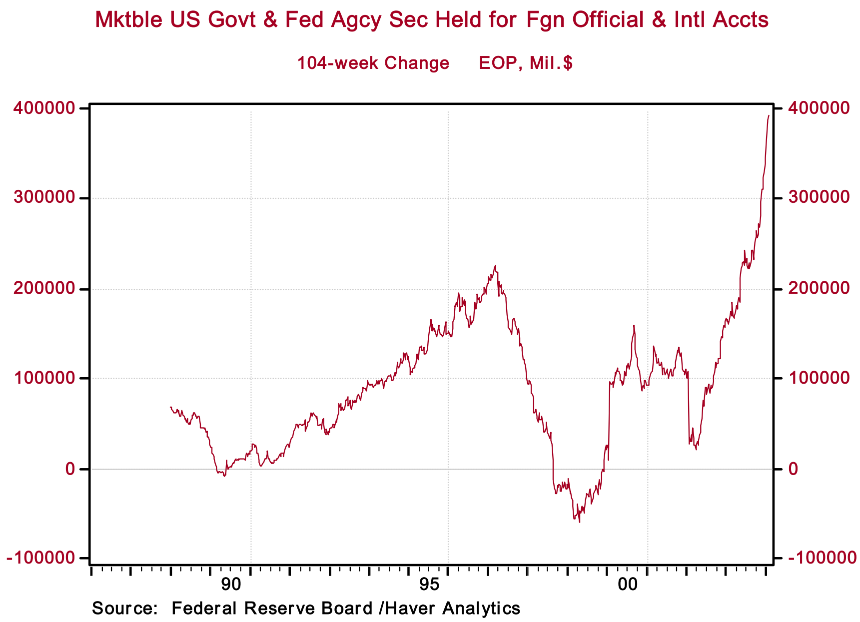
If Foreign Central Banks Were To Sell Treasuries, Fed Would Probably Buy Them

The chart below shows the 104-week (two-year) increase in U.S. government and agency securities held in custody at the New York Fed on behalf of primarily foreign central banks. In the 104 weeks ended February 4, 2004, these custody holdings have increased a whopping $392 billion. In a hearing before a House committee today, Fed Chairman Greenspan was asked whether foreign central bank sales of these securities would push U.S. interest rates up. Greenspan replied that he did not think there would be much impact on U.S. interest rates in the event. The reason Greenspan gave for his lack of concern about this is that the bulk of the securities owned by foreign central banks are of short maturity and the Fed largely dictates the behavior of short-maturity U.S. interest rates. Greenspan is correct on both counts.

But how does the Fed dictate the level of short-maturity interest rates? By creating, figuratively out of thin air, credit, or, on very rare occasions, extinguishing credit. If foreign central banks were to go on selling spree of U.S. government securities, this would put upward pressure on short-maturity U.S. interest rates, including the fed funds rate. But if the Fed did not want the funds rate to rise, it would purchase enough of the securities being sold by foreign central banks to bring the funds rate back down to its desired level. In effect, the Fed would monetize the U.S. government securities being sold by foreign central banks. Although this would prevent short-maturity interest rates from rising, it might actually lead to higher longer-maturity interest rates. Why? Because the Fed's monetizing of debt has future inflationary implications. Rising inflation expectations would drive up the nominal interest rates on longer-maturity debt. So, Greenspan is only partially correct about the effect of foreign central bank sales of U.S. government securities. These sales would not necessarily drive up short-term interest rates, but would probably drive up long-term interest rates.

By the way, what might prompt foreign central banks to sell U.S. government securities? Rising inflation in their home economies. Foreign central banks are buying U.S. securities with the U.S. dollars they have bought in the foreign exchange market in order to cushion the appreciation of their home currencies. With what do they purchase these dollars? With freshly "printed" (by them) home currencies. This tends to inflate their home economies. If this process goes on long enough, these foreign central banks will reverse their U.S. government securities transactions in order to strengthen their home currencies to combat higher inflation. Is there any reason to think that foreign central bank selling of U.S. government securities might lie on the not-too-distant horizon? Well, for starters, the second biggest buyer, China, entered 2003 with moderate deflation in its CPI and exited 2003 with moderate inflation. Japan, the biggest buyer, entered 2003 with modest CPI-ex-food deflation and exited 2003 with price stability. If the central banks of these two countries continue to reflate in 2004 because of their currency-intervention operations, they may find their economies overheated in 2005.



Fed's Forecast Implies FOMC on Hold

Chairman Greenspan presented the semi-annual testimony to Congress this morning. This testimony includes the Fed's economic projections for 2004. Greenspan indicated that the "prospects are good for sustained expansion of the U.S. economy." He also noted that the current "accommodative posture is appropriate" for the present time and added that eventually the federal funds rate will have to rise. "However, with inflation very low and substantial slack in the economy, the Federal Reserve can be patient in removing its current policy accommodation." Financial markets translated this to imply that the FOMC is in no rush to raise the federal funds rate and both the bond and equity markets rallied following this testimony.

The Fed's real GDP projection for 2004 is higher (see table below) than the July 2003 prediction. Real GDP is expected to grow at 4.5% - 5.0% in 2004 vs. the July forecast of 3.75% - 4.75%. At the same time, the Fed has lowered the inflation forecast to 1.0-1-1/4% from 1.0-1-1/2%, indicating that it expects inflation to remain contained despite the projected sharp growth in real GDP. The forecast indicates that the Fed firmly believes that growth well above trend is feasible without exerting inflationary pressures. In other words, the FOMC is not anxious to pull the tightening trigger in the near term.

Economic Projections for 2004 (central tendency)

	Feb-04	**Jul-03**
Percent change Q4/Q4		
Nominal GDP	5.5 - 6.25	5.25 - 6.25
Real GDP	4.5 - 5.0	3.75 - 4.75
PCE chain-type price index	1.0 - 1.25	1.0 - 1.5
Average level Q4		
Civilian unemployment rate	5.25 - 5.5	5.5 - 6.0

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