The Fed Is Looking Like a Sovereign Wealth Fund

Instead of tackling a complex new investment mission, the Fed should establish a clear portfolio wind-down process.

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The Federal Reserve recently made clear it is planning to maintain its enormous balance sheet—roughly $4.5 trillion in Treasurys and mortgage-backed securities—for many years, while keeping interest rates near zero at least into 2015.

Far from being neutral or stimulative, these policies have caused huge distortions in financial markets, contributing to slow growth and falling median incomes. Given the tendency of government programs to expand and become permanent, the risk now is that the Fed's large pool of assets and liabilities evolves into a semi-permanent government-controlled investment fund, a U.S. version of the sovereign-wealth funds created by other governments.

The concept of a sovereign-wealth fund inside the Fed sounds farfetched, but the Fed's megaportfolio already looks like one in many respects. It is one of the world's largest and most leveraged bond portfolios, taking massive interest-rate risks. Just to maintain the Fed's assets as bonds mature will require the Fed to make at least $1 trillion in bond buying decisions over the next five years.

The longer the Fed holds its portfolio, the greater the danger that political forces will nudge its investments away from Treasury securities. The Fed already owns bonds created by Fannie Mae and Freddie Mac, helping them take market share in the mortgage market from the private sector. There have been many proposals in recent years to set up infrastructure banks, for example. Perhaps the Environmental Protection Agency could set up an environment fund that issues bonds for the Fed to buy as a creative way to finance the fight against global warming. Japan, China and others own large holdings of dollar-denominated bonds, and it's easy to see a future Fed edging its portfolio into euro- and yen-denominated bonds to manipulate the value of the dollar.

Maintaining the large Fed balance sheet raises a host of other concerns too. These include conflicts of interest among the Fed's monetary, regulatory and investment roles, and the risk of distracting the Fed from its crucial lender-of-last-resort responsibility. Major new problems are inevitable regarding investment transparency and political decisions on the appropriate levels of Fed payments to the Treasury Department and banks.

The Fed currently pays banks an interest rate of 0.25% a year on their reserves, and these reserves are the funding source for its purchases of Treasurys and mortgage bonds. When the Fed buys a bond, it pays for it with an IOU called excess reserves. It's a liability of the Fed and an asset of the...
bank. Beginning in 2013, the Fed built systems that would replace some of its bank funding with lower-rate collateralized repo borrowing—akin to replacing a personal loan with an adjustable-rate mortgage.

However, the Fed reversed course in the second quarter, apparently after signs that its repo borrowing plans were disrupting important private repo borrowers. This leaves the Fed dependent on bank funding and creates a complex equation for the Fed: To maintain its bond holdings, how much is it willing to pay banks for their deposits, over half of which are from U.S. branches of foreign banks?

The Fed could choose heavy bank regulation to hold down its bank payments, much as China imposes a 20% reserve requirement on banks. But the Fed's interest payments to banks add to bank profits, increasing bank equity capital, one of the Fed's other regulatory goals. These conflicts will get worse if the Fed decides it needs to raise interest rates.

As an alternative to bank funding, the Treasury said in August that it was considering an increase in its deposits at the Fed, currently averaging $60 billion. A bigger Treasury deposit would help the Fed diversify its liabilities away from bank loans and free up bank assets that might be loaned to the private sector. Treasury would in effect be helping the Fed reduce its higher-cost bank debt and replacing it with extra Treasury debt.

Since Treasury's marginal funding cost (the Treasury bill rate) is below the Fed's 0.25% payments for bank reserves, an increase to $500 billion in Treasury's deposit at the Fed could knock as much as $600 million annually off the fiscal deficit. Treasury argues that a bigger deposit would provide a cushion in the event of a disruption of a Treasury auction.

The drawback, a major one, is that an expandable Treasury deposit would bring the Fed even closer to a sovereign-wealth fund by establishing quasi-permanent Treasury funding for the Fed's portfolio. And it would further intertwine fiscal policy with monetary policy. The Fed is already increasing the deficit by paying an above-market interest rate to banks and reducing it by buying back longer-term bonds, though the reduction may get reversed if interest rates rise.

Instead of tackling a complex new investment mission, the Fed should establish a clear portfolio wind-down process that would let it concentrate on monetary and regulatory policy rather than investment management. It needs to acknowledge and communicate the substantial benefits from reducing its stockpile of bonds and moving interest rates above zero. These policy improvements would create a cushion for rate cuts in an emergency, improve the allocation of credit, encourage savers and unfreeze short-term credit markets, helping to boost the U.S. economy and raise Americans' incomes.

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