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Fed Traders Buy Billions in U.S. Debt

Nation at risk of credit downgrading of triple-A rating

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The Federal Reserve's Quantitative Easing 2 traders are fast at work, ensconced in the operations room of the New York Fed's fortress-like headquarters on Wall Street, buying billions of dollars of U.S. bonds, the New York Times reported.

The goal is to fully implement by June the Fed's purchase of $600 billion in Treasury debt to complete the Fed's policy of intervening into the economy in a policy known as Quantitative Easing 2.

At the same time, Moody's and Standard & Poor's warned the triple-A sovereign debt rating of the United States is in jeopardy of being downgraded if there continues to be a deterioration in the negative fundamentals of the United States, including the trillion-dollar federal-budget deficits President Obama has run in the last two years.

Unfortunately, this is not the first time since the current economic downturn began that the Fed has bought U.S. debt, and it may not be the last time.

Fed bought $1.7 trillion in U.S. mortgage, Treasury debt in 2009-2010

In March 2009, the Federal Reserve had announced terminating an earlier plan under which the Fed had purchased $1.25 trillion in federal government mortgage-backed securities issued by Freddie Mae and Fannie Mac.

Then, in October 2009, the Fed terminated an earlier program that had purchased an additional $300 billion in U.S. Treasury debt, making the total Fed purchase of U.S. debt in 2009 total an excess of $1.5 trillion.

All total, the Wall Street Journal estimated the Fed ended up buying $1.7 trillion in mortgage and Treasury debt in 2009 before the program was discontinued.

That was considering the first round of Quantitative Easing Round, now commonly known as QE1.

The strategy of the federal government buying its own debt involves an effort to keep interest rates low to keep the costs low in borrowing to pay interest on the debt and borrowing even more to pay for each year's trillion-dollar federal-budget deficit under Obama.

In the process of buying federal debt, the balance sheet of the Federal Reserve has gone from under $1trillion in 2008 to approximately $2.3 trillion today, according to the Wall Street Journal.

Having the Fed buy federal debt involves a process economists typically call “monetizing the debt,” in that the Federal Reserve essentially is printing money to purchase U.S. debt in a process most Americans would understand as using the MasterCard to pay the Visa bill.

“Out of nearly $2.1 trillion of net issuance across the Treasury, Agencies and MBS [Mortgage-Backed Securities] markets from June 2008-9, the Federal Reserve has accounted for nearly 40 percent of the total demand, buying more than every foreign government combined,” Jon Harooni, a senior analyst at Glenhill Capital, a hedge fund in New York City, and Ravi Tanuku, a research analyst at Fred Alger Management, an investment firm in New York City, wrote in October 2009, criticizing the policy being implemented by Fed Chairman Ben Bernanke and Treasury Secretary Tim Geithner.

“It is not much of a stretch to say the Fed has become the entire mortgage market; it has purchased nearly $500 billion of MBS securities during a period where there was only $350 billion issued,” they continued.

“Looking at the first seven calendar months of 2009 yields similarly startling results: Of the total $1.1 trillion of net issuance across these markets, the Fed has purchased $861 billion or almost 80 percent.”

China irate

International Business Editor Ambrose Evans-Pritchard, writing in the Telegraph in London, reported that China was irate because the Fed’s QE2 policy “risks accelerating the demise of the dollar-based currency system, perhaps leading to an unstable tripod with the euro and yuan, or a hybrid gold standard, or a multi-metal ‘bancor’ along the lines proposed by John Maynard Keynes in the 1940s.”

“The continued and drastic U.S. dollar depreciation recently has led countries including Japan, South Korea and Thailand to intervene in the currency market, intensifying a ‘currency war,'” China’s commerce ministry said Monday. “In the mid-term, the U.S. dollar will continue to weaken and gaming between major currencies will escalate.”

The G20 summit meeting in London in April 2009 took an important step to create a new one-world currency through the International Monetary Fund that is designed to replace the dollar as the world’s foreign-exchange reserve currency of choice.

Point 19 of the final communique from the G20 summit in London on April 2, 2009, specified that, “We have agreed to support a general SDR which will inject $250 billion into the world economy and increase global liquidity,” taking the first steps forward to implement China’s proposal that Special Drawing Rights at the International Monetary Fund should be created as a foreign-exchange currency to replace the dollar.

SDRs are international reserve assets that are calculated by the IMF in a basket of major currencies that are allocated to the IMF 185 member nation-states in relation to the capital, largely in gold or widely accepted foreign currencies that the IMF member nation-states have on deposit with the IMF.

In the short-run, the Fed’s QE2 policy has boosted the Dow to a two-year high, trading last week over 11,500.

Unfortunately, any stimulus to the stock market will be temporary as QE2 merely creates a new bubble, much as the Fed helped create the mortgage bubble by keeping interest rates at 1 percent during 2003-2004.

Inevitably, the Fed will follow QE2 with QE3. Still, at some point the ability of the Fed to purchase U.S. debt will have to come to an end. So far, neither QE2 nor QE3 has done much to improve either employment prospects or the housing market.

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