MAR 18, 2009 @ 06:50 PM 528

2 Free Issues of Forbes

The Buyer Of Last Resort

By Joshua Zumbrun

WASHINGTON, D.C.--For anyone asking how the government is going to pay for the $787 billion stimulus and the $700 billion bank rescue, ask no more. The Federal Reserve will simply print new dollars.

That was the word from the Federal Reserve today. The Fed's open market committee agreed to purchase $300 billion in longer-term Treasury securities over the next six months.

Many interest rates are benchmarked to Treasuries. The massive purchase, by the Federal Reserve, should drive these rates down and make borrowing cheaper. This is the Fed's stated goal, "to help improve conditions in private credit markets." The Fed also announced it would increase its purchases of mortgage-backed securities to $1.25 trillion from $500 billion. The Fed is continuing to push its traditional target rate toward zero. Combined, these new moves should drive down rates on Treasuries, mortgages and many other interest rates across the economy.

But the Fed is also making it cheaper for the government to borrow money. The $300 billion of longer-term debt the Fed plans to buy is "a substantial part of long-dated Treasury issue expected over the next six months," says Desmond Lachman, a resident fellow at the American Enterprise Institute. No more fretting if enough buyers will materialize.

Printing new money for this purpose is known as monetizing the debt--"A strategy that appears in the encyclopedia under the heading, 'how to trigger inflation,'" says a note from Guy LeBas, a fixed-income strategist at Janney Montgomery Scott, "In any other environment, this monetization would be deeply troubling."

The Fed clearly believes this is not a standard environment. "In light of increasing economic slack here and abroad, the committee expects that inflation will remain subdued," says the Fed statement.

For now, markets seem to agree that inflation is unlikely. If runaway inflation were obviously around the corner, investors would presumably be flocking to inflation-indexed Treasury securities, known as TIPS. But as AEI's Lachman notes, the rates on TIPS suggest that markets see a relatively low rate of inflation over the next 10 years.

With demand slackening around the world, a stagflation scenario appears unlikely. Runaway inflation would require people to spend that money, which they still appear unlikely to do. And since the recession is global, the dollar should remain relatively strong. A flight to the currencies of other nations in deep recessions with badly-damaged financial sectors and debt-laden governments is unlikely to provide a better return. "I don't think you can have a dollar crisis if Japan and Europe are in worse shape than the United States," says Lachman.

The Fed was known to be considering the idea of purchasing Treasuries--it was one of the few untapped options in the Fed toolkit if the economy continued to worsen. "While most people expected this step to be taken at some time, this rhetoric pointed toward Treasury purchases occurring at a later meeting," says a note from Michael Feroli, U.S. economist for JPMorgan, "The simplest explanation for the change in thinking is that the committee was increasingly losing hope in the prospect of a medium-term recovery in the economy."

Today's move from the Federal Reserve caused the rate on 10-year Treasuries to dive to 2.5% from 3%. From the perspective of the U.S. Treasury, that half-percent rate reduction saves billions in future debt payments.

The Fed's move keeps the debt affordable and might not spark inflation. Yet it still may not be enough to revive the economy. "Purchasing long-dated Treasuries is going to put money into the system, but that money is not going to go anywhere," says Joseph Mason, a professor at Louisiana State University and senior fellow at the Wharton School, "monetary theory is in over its head." And Mason says he believes the Fed is losing hope that Congress, fatigued by bailouts and incensed by AIG bonuses, has the political will to accomplish much.

Thus the biggest concern is not that printing money to buy debt will start inflation, but that it will do nothing at all.