Fed Explored Starting Sales of Bonds as Balance Sheet Grows
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Dec. 10 (Bloomberg) -- The Federal Reserve explored the idea of issuing its own debt in discussions with Congress as the central bank sought ways of coping with a balance sheet that has more than doubled in the past year.

The Fed began examining the issue after Treasury officials scaled back their funding assistance for the central bank in the last two months, a person briefed by a government official said on condition of anonymity. Another person informed of the matter said at least one discussion was held with Congress, which would need to pass a law to provide the authority to sell bonds.

The Treasury, which has a legal limit on the amount of debt in can sell, abandoned new issues of bills to finance the Fed in mid-November. Since then, incoming President Barack Obama has picked New York Fed President Timothy Geithner for Treasury secretary, making coordination between the agencies more likely, analysts said.

Debt issuance would offer the Fed a funding source other than creating money. The central bank's emergency lending programs in the past year have swelled its balance sheet, forcing it to create a surplus of reserves at commercial banks.

"The creation of excess reserves is the least desirable form of central bank balance-sheet expansion during periods when bank balance sheets are a critical to bottleneck to financial flows," said Lou Crandall, chief economist at Wrightson ICAP LLC. "You have your choice then: Either the Fed can issue liabilities to the general public, or you can issue Treasury liabilities. The preferred option is Treasuries."

Assets Climb

Assets on the Fed's balance sheet have more than doubled over the past year, reaching $2.14 trillion on Dec. 3, and may increase more as the Fed buys up to $600 billion of housing- finance debt and securities.

The Wall Street Journal reported the Fed's discussions with Congress earlier.

The interest-rate setting Federal Open Market Committee meets Dec. 15-16, when officials are set to discuss how to boost the economy beyond lowering rates. The FOMC has already cut the benchmark rate to 1 percent, limiting the scope for further cuts.

Policy makers' plans would involve financing even more cash injections into the economy either through pumping up bank reserves or possibly through some form of debt issuance. The debt idea is still at a preliminary stage, one of the people said.

Until November, Fed officials were able to access financial markets through U.S. Treasury issues of special-purpose bills. The Treasury placed the cash on deposit on the Fed. The Treasury announced Nov. 17 that the “balance in the Treasury Supplemental Financing Account will decrease in coming weeks” to “preserve flexibility in the conduct of debt management.”

Surplus Reserves

The Treasury’s move prompted Fed officials to begin discussions on alternatives. Meanwhile, the central bank relied on the banking system, creating excess reserves, which affect the balance-sheet capacity of private lenders. Excess reserves in banks jumped to $559 billion at the end of November from $1.7 billion a year earlier.

The flood of cash has interfered with the Fed’s ability to keep the overnight lending rate between banks close to the target set by the FOMC. The average daily federal funds rate yesterday was 0.13 percent.