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Fed Weighs 'Sterilized' Bond Buying if It Acts

By JON HILSENRATH

Federal Reserve officials are considering a new type of bond-buying program designed to subdue worries about future inflation if they decide to take new steps to boost the economy in the months ahead.

Under the new approach, the Fed would print new money to buy long-term mortgage or Treasury bonds but effectively tie up that money by borrowing it back for short periods at low rates. The aim of such an approach would be to relieve anxieties that money printing could fuel inflation later, a fear widely expressed by critics of the Fed's previous efforts to aid the recovery.

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Federal Reserve Board Chairman Ben Bernanke

Fed officials are set to meet next week and have signaled that they are unlikely to launch new programs at that meeting. Moreover, it is far from certain the Fed will launch another program later on. If growth or inflation pick up much, officials seem unlikely to launch a bond-buying program because the economy might not need the extra help or because doing more could spur higher inflation. But if growth disappoints or inflation slows substantially, Fed officials might decide to act again.

The Fed's approach to a bond buying program matters a lot to many investors. More money printing could push commodities and stock prices higher, or send the dollar lower, if it sparks a perception among investors that inflation is moving higher, said Michael Feroli, an economist with J.P Morgan Chase. However, if the Fed chooses a course aimed at restraining inflation expectations, the impact on those markets might be more muted.

Fed officials have used different types of bond-buying programs since 2008. In each case the aim has been to drive down long-term interest rates to spur investment and spending by businesses and households. In case they decide to act again, they're exploring three different approaches, according to people familiar with the matter. Those approaches are:

• First, they could use the method they used aggressively from 2008 into 2011, in which the Fed effectively printed money and used it to purchase Treasury securities and mortgage debt. The Fed has already acquired more than $2.3 trillion of securities in several rounds of purchases using this approach, widely known as "quantitative easing," or QE.

• Second, the Fed could reprise a program launched last year in which it is selling short-term Treasury securities and using the proceeds to buy long-term bonds. This $400 billion program, known as "Operation Twist," allows the Fed to buy bonds without creating new money.

• Third, in the new novel approach, the Fed could print money to buy long-term bonds, but restrict how investors and banks use that money by employing new market tools they have designed to better manage cash sloshing around in the financial system. This is known as "sterilized" QE.

The Fed's objective under any of these programs would be to reduce the holdings of long-term securities in the hands of investors and banks. The Fed believes that reducing the amount of long-term bonds in the hands of investors drives down long-term interest rates, encourages more risk-taking, and thus spurs spending and investment by households and businesses.

The differences between the three approaches involve where the money comes from and where it ends up. The Fed hasn't literally print more money, but it has electronically credited the accounts of banks and investors with new money when it purchased their bonds under quantitative easing. The Fed has pumped more than $1.6 trillion in new money into the financial system this way, and has also rejiggered it existing holdings, as part of its bond-buying efforts.

Many Fed officials believe strongly the bank reserves it has created as part of this money creation aren't an inflation threat. But they are acutely aware of a popular perception, also held by a few inside the Fed itself, that the money the Fed has created could cause an inflation problem down the road. An approach that limits the amount of new money flowing into the system—through another Operation Twist or a sterilized operation—could help them manage that perception.

Under the third approach, the Fed would create new money as it buys long-term bonds. But then it would effectively lock up the money rather than letting it loose in the broader economy. The Fed would do this by borrowing the money back from investors for short periods—say, 28 days—in exchange for some low interest rate it would pay investors.

Transactions like those under the third scenario are called "reverse repos." A related program called "term deposits" also ties up short-term money held by banks. The effect of this approach is the same as Operation Twist: The Fed would hold more long-term bonds and investors and banks would get more short-term holdings in exchange.

Officials at the Federal Reserve Bank of New York have designed the reverse-repo program for use when the economy is much stronger and they want to tighten credit. But the same tools could, in theory, be used now to fine-tune a program meant to ease credit conditions.

Fed officials in New York and at the board in Washington are considering the costs and benefits of the different approaches. They have been pleased with the results of Operation Twist. But they would face some practical limits if they wanted to repeat it.

Louis Crandall, a money-market analyst with Wrightson ICAP LLC, estimates the Fed would have only about $200 billion of short-term securities left to work with in the second half of the year if it decides to repeat the Operation Twist program as currently designed. The current program ends June 30.

The third approach has some benefits the other options don't have. Unlike Operation Twist, the size of the program wouldn't be constrained by the Fed's own holdings of short-term Treasurys. This approach would also give officials an opportunity to try out some of their new tools to see how they work on a large scale.

Moreover, the program could be conducted with financial institutions other than banks, like money-market funds, increasing the Fed's flexibility in managing reserves. The reverse-repo program was designed to include money-market funds and these institutions don't participate directly with the Fed in other operations.

Still there are potential drawbacks. Reverse repos could push short-term interest rates—now near zero—higher than the Fed wants them to go. Moreover, the Fed has described the reverse-repo program as a tool to use when it wants to tighten credit. Using it in combination with a bond-buying program meant to ease credit could "send a lot of conflicting signals" to the markets, Mr. Feroli said.

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