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Is the Fed Monetizing Government Debt?

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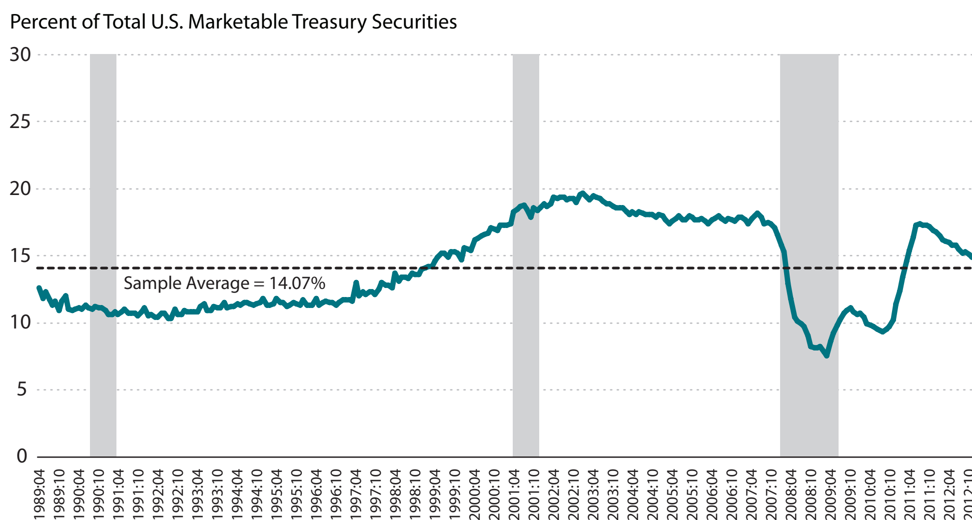
The Federal Reserve System of the United States creates the country's monetary base. The monetary base consists of currency (Federal Reserve notes and coins) in circulation and deposits (Federal Reserve credits) held by depository institutions at regional Federal Reserve Banks. Since August 2008, the Fed has tripled the monetary base from about $0.8 trillion to $2.7 trillion. More than half of this new money was used to purchase U.S. government bonds (Treasury debt),[1] which has led some commentators to complain that the Fed is "monetizing government debt." The concern is that the Fed's actions are somehow enabling excessive government borrowing and possibly risking future inflation.

Before proceeding, we have to be clear what we mean by "monetizing the debt." To this end, we review some basic principles. The Fed is required by mandate to keep inflation low and stable and to stabilize the business cycle to the best of its ability. The Fed fulfills its dual mandate primarily by open market sales and purchases of (mainly government) securities. If the Fed wants to lower interest rates, it creates money and uses it to purchase Treasury debt. If the Fed wants to raise interest rates, it destroys the money collected through sales of Treasury debt. Consequently, there is a sense in which the Fed is "monetizing" and "demonetizing" government debt over the course of the typical business cycle.

What is usually meant by "monetizing the debt," however, is the use of money creation as a *permanent* source of financing for government spending. Thus, to ascertain whether the Fed has in fact monetized its purchases of $1.2 trillion in government bonds since 2008, we have to know what the Fed intends to do with its portfolio of assets over time.[2]

If the recent rapid accumulation of Treasury debt on the Fed's balance sheet constitutes a permanent acquisition, then the corresponding supply of new money would be expected to remain in the economy (as either cash in circulation or bank reserves) permanently as well. As the interest earned on securities held by the Fed is remitted to the Treasury, the government essentially can borrow and spend this money for free. If, on the other hand, the recent increase in Fed Treasury debt holdings is only temporary (an unusually large acquisition in response to an unusually large recession), then the public must expect that the monetary base at some point will return to a more normal level (through sales of securities or by letting the securities mature without replacing them). Under this latter scenario, the Fed is not monetizing government debt—it is simply

Federal Reserve Holdings of U.S. Marketable Securities



NOTE: The gray bars denote recessions as determined by the National Bureau of Economic Research.
SOURCE: Federal Reserve Board.

managing the supply of the monetary base in accordance with the goals set by its dual mandate. Some means other than money creation will be needed to finance the Treasury debt returned to the public through open market sales.

For the record, Fed Chairman Ben Bernanke has repeatedly propounded this latter view (see, for example, Bernanke, 2012). The credibility of Fed policy is arguably reflected in the time path of inflation and inflation expectations. Since 2008, inflation has averaged less than the Fed's official long-run inflation target of 2 percent per year. Moreover, market-based measures of inflation expectations remain well anchored (see Pasaogullari and Waiwood, 2012). So it seems that to this point, at least, the Fed's credibility is passing the market test.

Under this latter scenario, the Fed is not monetizing government debt—it is simply managing the supply of the monetary base in accordance with the goals set by its dual mandate.

Of course, the claim that Fed policy is exerting downward pressure on interest rates, especially at the short end of the yield curve, has some merit. The quantitative impact of Fed policy on longer rates, however, is debatable. The reason for this is because an elevated worldwide demand for U.S. Treasury securities is keeping yields low independently of Fed policy. The possibility that forces outside the Fed have a large impact on yields is suggested by the data in the chart. As the chart shows, the vast majority (85%) of marketable U.S. Treasury debt is held outside the Fed and is close to the average ratio held over the past 20 years. ■

Notes

[1] Most of the remaining new money has been used to purchase mortgage-backed securities.

[2] Thornton (2010) offers a somewhat different definition; he argues that debt monetization should be defined in terms of whether the Fed is intentionally helping the government finance expenditures.

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Views expressed do not necessarily reflect official positions of the Federal Reserve System.