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The Polaris Perspective

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Federal Reserve Purchasing Treasuries

A few weeks ago, a very thoughtful client wrote me asking some very detailed questions. I promised him that I would answer his questions in this forum. Due to the length of the e-mail, I have taken editorial license to cut down his questions to their essence. He asked how it is possible for the Federal Reserve ("the Fed") to purchase Treasuries through the Quantitative Easing (QE) programs, and did this action benefit any of our foreign creditors.

How is the Federal Reserve Purchasing U.S. Treasuries?

The United States Government is borrowing from investors when it auctions Treasury bills, notes, and bonds. Currently, approximately 50% of our government's debt is short-term (two years and under in duration). The government needs to reissue debt by means of auctioning new Treasuries in the open market as these short-term bonds mature.

The Federal Reserve does not purchase Treasuries directly from current holders. Therefore, the Federal Reserve's actions are not positively impacting current holders of our country's debt. When the Federal Reserve purchases Treasuries, it is taking the Treasuries purchased out of the open auction. While no money is printed to purchase these Treasuries, it is treated as a credit on their balance sheet. This is referred to as "monetizing" our debt, or turning debt into money the government can spend. The Fed's purchases decrease the supply of Treasuries, thus making them more valuable. Treasuries that are more valuable don't have to pay as much yield to get buyers. A lower yield drives down interest rates on mortgages and allows corporations to borrow money at better rates. All of this has been done in an attempt to stimulate the economy in a zero interest rate environment.

Who Really Owns Our Debt?

The media has made a lot of noise about China holding significant U.S. debt. According to the statistics released by the U.S. Treasury Department, China is the single largest foreign owner of U.S. Treasuries. As we all know, statistics can be deceiving. As of December 31, 2012, China owned $1.22 trillion, or 7.4% of our $16.4 trillion debt. Japan owns 6.8% of our debt, as a comparison. Over 65% of our debt is owned domestically, with U.S. individuals and institutions owning a little over 30% of our debt. The Federal Reserve, through Quantitative Easing programs, now owns more than 10% of the federal government's debt or approximately $1.65 trillion.

Conclusion

Quantitative Easing of any kind is not a good long-term option for our government. We run the serious risk of devaluating our currency and driving up our national debt. Unfortunately, since Fed Fund rates are already at zero percent, there are not a lot of other options to consider. While the Fed purchasing Treasuries does not have a direct impact on foreign owners of our debt, a strong U.S. economy does. The United States is a net importer of goods. China and Japan want to see the United States' economy grow because that means more of their goods will be purchased by Americans, thus stimulating their own economies. This interdependence virtually guarantees that China and Japan will continue to be

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large purchasers of U.S. Treasuries for years to come.

As always, we welcome your questions and comments.

Sincerely,
Jeff