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Lacker Says Fed Should Have Bought U.S. Treasuries

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The extraordinary actions taken by the Fed during the financial crisis were a "problematic exercise in credit allocation," according to Federal Reserve Bank of Richmond president Jeffrey M. Lacker, who added purchases of U.S. Treasury securities could have created the same "expansion of reserve supply."

"In modern financial panics, banks often seek to hoard reserve balances, which again would be contractionary absent an accommodating increase in the central bank reserve supply," he told the CATO Institute's Annual Monetary Conference, according to text of the speech released by the Fed. "In both cases, the need is for an increase in outstanding central bank monetary liabilities."

The Fed responded to the crisis by "lending through the Term Auction Facility and in support of the merger of Bear Stearns and JPMorgan Chase," which "was offset by sales of U.S. Treasury securities from the Fed's portfolio." In September 2008 the "supply of excess reserves began to increase significantly. This expansion was accomplished through the acquisition of an expanding set of private assets-loans to banks and other financial institutions and later mortgage-backed securities and debt issued by the GSEs.

Although some people called "a standard, monetary expansion in the face of a deflationary threat, the Fed's own characterization often emphasized instead the intent to provide direct assistance to dysfunctional segments of the credit markets," he said. "Clearly, an equivalent expansion of reserve supply could have been achieved via purchases of U.S. Treasury securities-that is, without credit allocation."

While limiting the Fed's bank lending powers would contrast with its perceived duties as a "lender of last resort," a belief, Lacker said, "derives from an era of commodity money standard, when central bank lending in a crisis was the way to expand currency supply to meet a sudden increase in demand." He noted, the preamble to the Federal Reserve Act says the bank's purpose is "to furnish an elastic currency," not to furnish elastic credit.

He said the bank "could easily manage the supply of monetary assets" using only U.S. Treasury securities. "While it might sound extreme, I believe that a regime in which the Federal Reserve is restricted to hold only U.S. Treasury securities purchased on the open market is worthy of consideration."