A Short Law to Enhance the Efficiency and Stability of the US Financial System

An unintended consequence of the Fed's large-scale asset purchases[1] has been a stunning increase in US bank reserves and an equivalent reduction in high quality liquid assets (HQLA) available to global financial markets. Other significant central banks, by also financing their balance sheet expansion with reserves, have contributed to global "collateral damage"[2]. Here I propose a short law that would enable the Federal Reserve and US Treasury to remedy problems emanating from the fact that bank reserves are an inferior financing instrument available only to US banks compared to Treasury bills—available to all global financial market participants. The proposal is similar to arrangements currently in place in other countries, e.g. Mexico and Israel, and may most simply be understood as formalizing the US Supplementary Financing Program, successfully employed to assist the Federal Reserve to manage the consequences of the financial interventions associated with the Lehman Brothers insolvency[3].

A second important advantage of Treasury bills over reserves is that the yield on the former is set through well-tested auction processes in an open market while interest on reserves (IOR) is set by administrative fiat. In former times, when central banks had inconsequential financial footprints, this point was trivial. Now that central banks are *borrowing* trillions of dollars, euros, etc, from banks, raising the policy rate (now the IOR) may be attended not only with the usual adverse political pressures but also with criticisms that this directly feeds banks' bottom lines at the expense of central bank profits and dividend transfers to government.

The primary objectives of the law are to:

- Allow US banks to shrink their balance sheets (reserves and deposits) and exit the zero-margin intermediation of nonbank credit to the Treasury via Federal Reserve Banks (≈ $ 3.8 trillion) while increasing HQLA availability in global capital markets.
- Reduce the footprint of administered Federal Reserve interest rates (IOR) in financial markets.
- Improve the capital efficiency of US regulatory requirements (SLR).
- Return management of all US Federal financing to the US Treasury under auction procedures.

A Law to Enhance the Functioning and Stability of the US Financial System

1. Be it defined that "US Treasury Bills issued for monetary regulation purposes" (hereafter MTB) are those bills issued and redeemed solely for the purpose of enabling the Federal Reserve to regulate the quantity of reserves financial institutions hold with Federal Reserve Banks.
2. MTB shall be exempt from the Public Debt Limit established in 31 U.S. Code § 3101.
3. Federal Reserve Banks shall not issue own debt instruments so long as they are enabled, as agents of the US Treasury, to issue MTB for the purposes outlined in this Law.
4. Proceeds from the sale of MTB are to be deposited in a segregated account at the Federal Reserve Bank of New York denoted the "Monetary Regulation Account" (hereafter MRA).
5. US Treasury funds held in the MRA may be used only to redeem MTB.
6. The FRBNY shall accrue and pay interest on balances in the MRA at a rate equal to the equivalent interest rate implied by the discount at which MTB are sold.
7. In close coordination with the FRBNY, the US Treasury shall include projections for the issuance and redemption of MTB in the Quarterly Refunding Statement and will separately identify, within each subsequent auction announcement, the amount of MTB being offered.
8. Apart from the requirement established in paragraph 7, MTB shall be identical to treasury bills not so identified.
9. Nothing in this Law shall be construed as limiting the ability of the United States Treasury and the Federal Reserve Banks to reach an agreement whereby the Treasury would engage in an early redemption of US Treasury securities currently held in the System Open Market Account to reduce the size of the balance sheet of the Consolidated Federal Reserve System.
10. The US Treasury and Federal Reserve shall closely coordinate the issuance and redemption of MTBs.

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[1] See Kohn (2010) and Martin, McAndrews and Skeie (2011).
[2] See McCauley (2021), McCauley and McGuire (2014), Stella (2020), and Stella (2005).
[3] See FRBNY (2008).

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