

A New Addition to the Fed's Toolkit

BY DOUG CAMPBELL

On Dec. 12, 2007, the Federal Reserve announced a new tool in the ongoing effort to address financial market disruptions. Under the Term Auction Facility program, the Fed provides credit directly to banks — where the demand for liquidity has been highest.

The announcement was made jointly with four other central banks. The Bank of Canada, the Bank of England, the European Central Bank, and the Swiss National Bank said they would also, in slightly different formats, pump funds into their financial systems backed by a wide set of collateral.

The introduction of the auction program came amid serious strains in the financial markets. In announcing the program, the Fed said it was “designed to address elevated pressures in short-term funding markets.” Those pressures were evident in the widened spread between two closely watched rates — the one-month London Interbank Offered Rate, or LIBOR, which is the rate at which major banks in London are willing to lend Eurodollars to each other; and the overnight indexed swap rate, or OIS, which can be interpreted as the average expected overnight rate over the course of the next month. Because the OIS rate does not tend to reflect credit and liquidity risk pressure as much as LIBOR, the difference between the rates is useful in showing how much such risks are bothering markets. At its heart, the Term Auction Facility program is about getting funds to banks in a time when credit is tight.

Open market operations are the main tool the Fed uses to inject funds into financial markets. Each weekday morning, the trading desk at the New York Fed sends out an electronic message inviting primary dealers — investment banks that regularly trade government securities — to bid on funds. Typically, the Fed buys securities under one-day or two-week repurchase agreements. The awarded funds make their way into the banking system via dealer accounts at clearing banks. In this fashion, the Fed raises or lowers reserve levels at banks. If it wants to lower the target federal funds rate, the Fed auctions more funds, adding to reserves. When there are more reserves, there are more funds for banks to lend out, and so interest rates, specifically, the rates on interbank short-term loans, should go down.

The Fed also supplies liquidity through the so-called discount window. Banks can go to the discount window at their regional Reserve Bank for short-term loans. Historically, the discount rate is set at 1 percentage point more than the target federal funds rate. But in August 2007, as financial market turbulence picked up, the Federal Reserve Board reduced the spread to half a percentage point and in March lowered it further to a quarter point.

The two things that make the Term Auction Facility program different from the discount window are:

- Its anonymity, allowing banks to borrow directly from the Fed without the perceived stigma associated with the primary credit. Though discount window borrowings are also anonymous, bank counterparties and other market participants might be able to discern that a bank has come to the window. Identifying borrowers is much more difficult with the Term Auction Facility program.

- The control that the trading desk wields over the size of the auction, meaning that there is little uncertainty about the effects on bank reserve levels. By contrast, the potential for large, unanticipated discount window borrowings is something that could greatly complicate the New York Fed trading desk's task of offsetting any significant borrowings in open market operations.

(The Term Auction Facility program is separate from several other major credit and auction programs introduced so far this year. The new Primary Dealer Credit Facility, for example, is an overnight loan program in which borrowers can put up a wider set of collateral than in traditional repurchase agreements. Acceptable collateral for the dealer program includes investment-grade corporate securities, municipal securities, and mortgage-backed securities.)

Strictly speaking, the Term Auction Facility program is not a tool to conduct monetary policy. No money is added or withdrawn from circulation, and the Fed's balance sheet remains the same because it liquidates holdings in proportion to dollars lent through the auction. It's much closer in practice to discount window lending. In exchange for the loaned funds, the Fed holds collateral from the banks. The collateral is the same as “the wide variety of collateral that can be used to secure loans at the discount window,” and goes beyond the Treasury and government agency securities required in open market operations.

The first auction was held on Dec. 17. Banks from every Federal Reserve district submitted propositions. A total of 93 depository institutions bid about \$60 billion, out of which an aggregate \$20 billion was awarded in 28-day loans. The “stop-out” rate — the lowest accepted rate — was 4.65 percent, compared with the 4.25 percent target federal funds rate at the time (and the 4.75 primary credit rate).

Though the lending rate is set by the market, the Fed sets a floor. For the Dec. 17 auction, the minimum rate was 4.17. On Feb. 25, when the target federal funds rate was 3 percent, the minimum auction bid rate was 2.81. No maximum rate is necessary — the final auction rate would not likely go much above the discount window rate, since banks could go there

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growers adopted machinery and technology. Arkansas, for example, today has a high technology rice industry. (The United States typically ranks among the top three rice exporters.)

Economic Development Redux

The cycle of boom and bust is older than the rice dream. It goes to show what a tricky proposition economic development can be, Coclanis says. Early settlers made choices about what they could grow that would bring prosperity. “They were right in their assessment, given the limitations of topography, that rice was the best bet,” he says. “But they rolled the dice on rice and put their marbles on rice. And it did not factor into their minds that market conditions could change.” In the end, there was no internal demand to pick up the slack when the export market collapsed.

Variations on this theme continue today. Coclanis consults with Southeast Asian countries about the development

of their economies. He sees parallels between the fallen South Carolina rice complex and the plight of those countries. Problems in Burma, which also became overdependent on exports, serve as an example. “The whole area that became the rice exporting, production area hardly settled till the British came and ... encouraged the Burmese to move from the upper to the low-country area.”

The Rice Niche

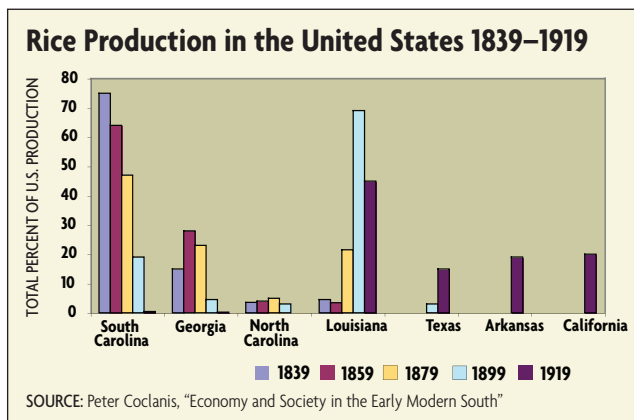
While the old rice empire is gone for good, specialty rice has gained ground. Campbell Coxe notes that in the Western rice-growing states, “they

probably sweep up more than we grow here.”

Still, he aims to make his rice pay. He used to send his crop out to Arkansas for milling, but has since built his own mill, even though “everybody thought we were crazy.” And he’s trying to convince other farmers that there’s a growing gourmet market out there for specialty rice. He gloats a little bit when customers in Korea and Japan order his rice, which, by the way, they can on the Internet at \$8.47 for two pounds. And he feels pretty good about preserving the heirloom Carolina Gold rice for future generations, he and the half dozen or so others in the state who grow it to collect the seed. Some people grow rice to attract waterfowl for hunters; some just like to revisit the history.

“We do think it’s historically beneficial — if nothing else to show people the great history behind the rice,” Coxe says. “This one grain made South Carolina the richest colony in the New World.”

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instead of the more expensive auction for funds. But the discount rate does not place a hard ceiling on the auction rate. In fact, in the first auction in April, the stop-out rate exceeded the discount rate.

Early results suggested the auction program may have been effective. The LIBOR-OIS spread, for example, has narrowed. When the two rates are closer together, credit and liquidity pressures are usually lower. However,

this spread widened again in the first quarter of this year.

The auctions have been conducted on a biweekly basis through February, all were oversubscribed as bidding institutions asked for more funds overall than was offered. Though the identities of both bidding and winning banks are not made public, the total amount of borrowed funds going to each Federal Reserve district is reported. As of Feb. 27, for example,

banks in the Fifth District had \$813 million of the \$60 billion total outstanding in the auction credit program.

The Term Auction Facility program was introduced as a temporary effort. Fed officials have been largely positive, saying it seems to have injected liquidity into the market when it was needed the most. The Fed has said it would seek public comment before deciding whether to make the program permanent.

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