Meeting the Y2K Demand for Base Money

Fireworks and celebration traditionally greet the New Year. This year, some households and businesses are greeting it with concern that electronic banking, payments, and retail sales systems may temporarily fail. Of course, no one can be certain that problems will not occur—ATMs run out of currency even on ordinary weekends. But during the past year, financial system regulators have taken extraordinary steps to be prepared. Beyond immunizing its own computer systems against the infamous Y2K “bug” and assisting the banking system in its preparations, the Federal Reserve has temporarily liberalized the way it provides base money—currency and deposits at Federal Reserve Banks—to banks and the public.

To assure the liquidity of the money market, the Fed’s Open Market Desk in New York City has temporarily changed the way it interacts with government security dealers. The Desk has broadened the types of collateral that it will accept in repurchase agreements with dealers, increased the maximum length of such agreements to 90 days, and opened a facility to auction options over year-end on repurchase agreements. To assure individual depository institutions that the Fed will be there to provide base money over year-end if needed, the Fed is operating a Special Liquidity Facility between Oct. 1, 1999, and April 7, 2000. Similar to the discount window, the facility will provide banks with advances (loans) of deposits at Federal Reserve Banks. The advances must be secured by acceptable collateral, including Treasury and agency securities, certain mortgage and commercial loans, and bankers acceptances. In other respects, special facility advances differ from those at the discount window. Facility loans are priced at 150 basis points above the Federal Open Market Committee’s desired target for the federal funds rate (rather than at the discount rate). Depository institutions, however, face no restriction on the use of funds nor the duration of the advances (until April 7, 2000), and they are not required to seek funds elsewhere first.

Although some increase in the amount of deposits held by banks at the Fed is to be expected over year-end, most analysts anticipate that the larger increase will be in the public’s demand for currency. When a depository institution orders currency from the Fed, it “pays” for the currency with a debit to its account at the Fed. If necessary, the institution may borrow from other depositories or obtain an advance from the Fed. But, before shipping the currency, the Fed must secure the currency with its own acceptable collateral. Such collateral includes Federal Reserve Bank assets such as: gold certificates issued by the Treasury; special drawing rights certificates owned by the Treasury; Treasury and agency securities; and advances to depository institutions that have been secured by certain short-term commercial and agricultural loans or by Treasury and agency securities.

Major surges in currency demand are unusual events in the United States. Hence, most of the time, the statutory collateral requirements for the issue of Federal Reserve notes are little-noticed. It seems unlikely that the collateral requirements on the issue of Federal Reserve notes will become a binding constraint over year-end. Although the spread of retail sweep programs during the past five years has reduced both banks’ deposits at the Fed and the amount of Treasury securities held by the Fed, depository institutions currently store some $500 billion of acceptable household and business loans in the Federal Reserve’s Definitive Safekeeping System. And, as of August 1999, commercial banks owned more than $800 billion in acceptable Treasury and agency securities.

—Richard G. Anderson