DO THE BENEFITS OF A BIG BALANCE SHEET FED EXCEED THE COSTS?

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OVERVIEW

- Role of institutions in the making of policy.
- Choice of operating regimes and the role of the Fed's balance sheet - floor system versus corridor system.
- Questions about implementing an operating regime with a big balance sheet (more precisely large volumes of excess reserves.
  - Operational issues
  - Governance issues
  - Economic and political risks

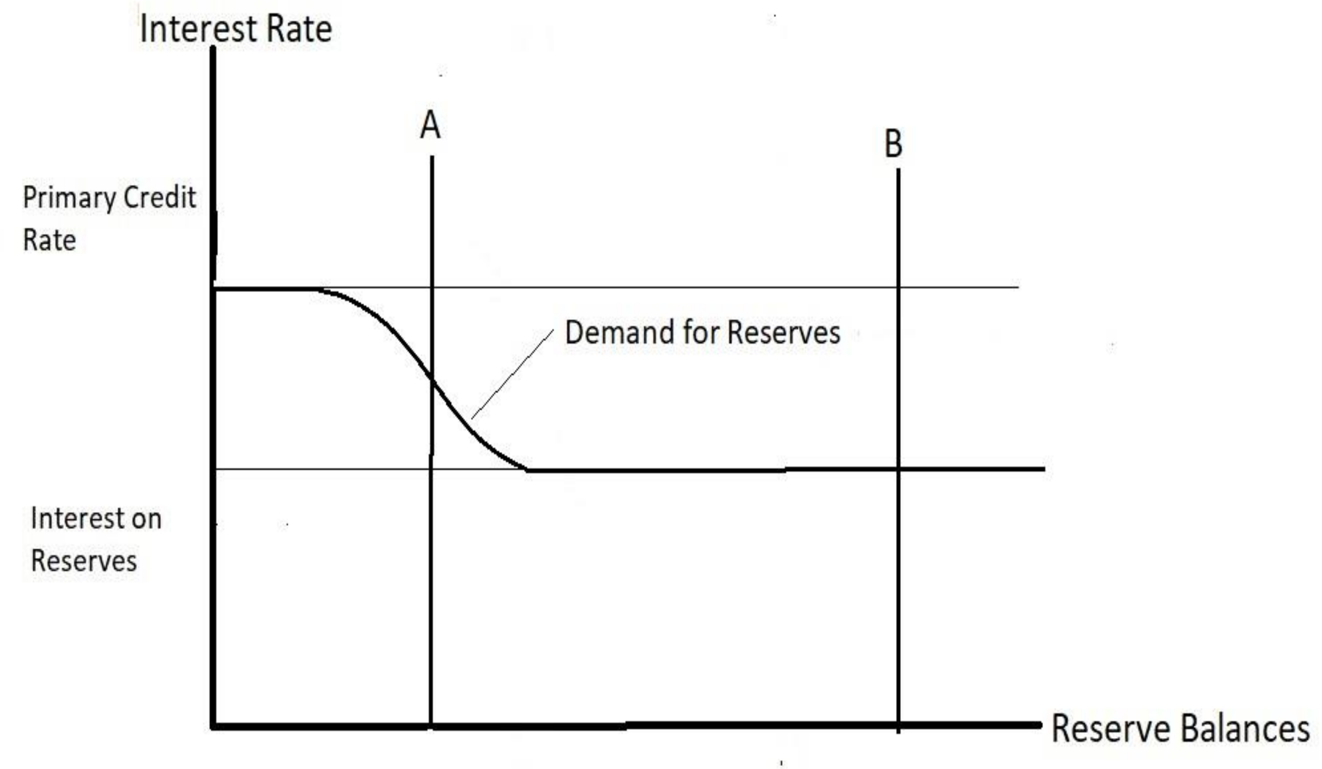
THE ROLE OF INSTITUTIONS

- Policymakers operate in an institutional framework that influences the incentives of actors that, in turn, shape policy choices and outcomes.
- Understanding and recommending good policies often requires understanding and appreciating that institutional environment and its impact on policymaking.
- Political independence is widely viewed as an important pillar of sound monetary policy. Institutional arrangements and operating regimes can support or undermine Fed independence.
- In a democracy, independence must be accompanied by constraints on the breadth and use of authorities in order to ensure accountability.

OPERATING REGIMES AND THE ROLE OF THE BALANCE SHEET

- Central banks around the world operate under different institutional arrangements so there is no one size fits all operating framework. My focus will be on the Fed and thus US institutions.
- Stylized operating regimes with respect to the balance sheet:
  - Corridor system – key take away is that the volume of reserves and thus the balanced sheet plays an important role in the conduct monetary policy.
  - Floor system – key take away is that the volume of reserves, and thus the balance sheet is not integral to the conduct of monetary policy

STYLIZED OPERATING REGIMES



OPERATING REGIMES: CORRIDOR SYSTEM

- The Fed and other countries have extensive experience operating some form of a corridor system with generally favorable results.
- Prior to the crisis the Fed used the fed funds rate, the rate that banks borrow from each other, as the instrument of monetary policy. It made reserves scarce and targeted the fed funds rate by varying the supply of reserves, sometimes through temporary repo agreements. Interest paid on reserves (IOR) was zero.

OPERATING REGIMES: FLOOR SYSTEM

- Under the floor system, the volume of reserves is not crucial to the setting of monetary policy as long demand is satiated at the interest rate paid on reserves.
- The instrument of monetary policy becomes the interest rate paid on reserves (particularly excess reserves, IOER), which is an administered rate set by the Board of Governors (BoG), not a market determined rate such as the fed funds rate that is targeted by the FOMC.

OPERATING REGIMES

- As a consequence of quantitative easing (QE) the Fed expanded its balance sheet almost 5-fold. Reserves increased to about $2.8 trillion in 2014, while required reserves were about $0.09 trillion resulting in about $2.7 trillion in excess reserves. In Jan. 2019 total reserves were about $1.6 trillion and excess reserves accounted for about $1.5 trillion
- One consequence of the large volume of excess reserves is that that the funds market became awash in reserves and it remains so to this day. This has left the funds market largely moribund.
- As a practical matter, the Fed has no choice but to operate a floor-like system for the time being.

QUESTIONS AND CONCERNS

- A question in the mind of economists, the Fed, and investors, is whether the Fed should return to a smaller balance sheet and a corridor-style system or change its operating regime to a floor-style system even for more normal times.
- Recent developments suggest the Fed is inexorably moving toward the adoption of a floor system with something on the order of $1.0 trillion of excess reserves.
- My view is that a lot of questions remain unaddressed. I'll lump them into four categories.
  - Dubious operational benefits
  - Role of the balance sheet in conducting monetary policy
  - Governance issues surrounding the operation of a floor system
  - Political economic issues including Fed independence.

OPERATIONAL ISSUES UNDER A FLOOR SYSTEM

- The Fed's original rationale for expanding the balance sheet was to ensure liquidity at a time of extreme financial stress and market dysfunction (QE 1). The rationale changed with the implementation QE 2 (2010) and QE 3 (2012). In these cases the tremendous growth in excess reserves through the purchase of MBS and longer term Treasuries was claimed to provide monetary accommodation at the zero bound by lowering long-term interest rates and stimulating private sector investment and risk-taking.
- The rationale offered by the Fed for maintaining a large balance sheet even in normal times has mostly focused on
  - simplicity and improved efficiency in the control of short-term rates
  - improvements financial stability and the meeting the increase in the demand for reserves (primarily from LCR)

QUESTIONABLE BENEFITS: SIMPLICITY?

- The Fed argues that the suggested floor system is simple and successful.
- This is not clear. The corridor system involved selecting a target for the ff rate and the use of repos to adjust the volume of reserves to influence the market rate to the target.
- The floor system has a lot of moving parts.
  - As currently implemented it uses a target ff rate expressed as a band of 25 bp determined by the FOMC.
  - It requires the BoG to set the IOR (a separate decision).
  - And it developed the reverse rep program (RRP) to support the lower end of the band by shrinking reserves to ensure the effective ff rate doesn't fall below it.
- The Fed has recently requested comment on a new regulation to prevent a private sector bank from competing with RRP by paying it a lower IOR than it pays other banks.

QUESTIONABLE BENEFITS: LIQUIDITY AND FINANCIAL STABILITY?

- Another argument for the floor regime is that maintaining a "buffer" of highly liquid excess reserves enhances the stability of the banking system. What evidence is there to support such a claim? Is the balance sheet now a tool of financial stability rather than monetary policy? Is this wise? What happens to the transmission of monetary policy and bank credit channels?
- Does this really provide more liquidity or stability to the system?
  - Why does substituting reserves for Treasury securities increase liquidity? Both are highly liquid and meet the qualification for meeting the liquidity coverage ratio (LCR). Is the need for excess reserves driven solely by regulation?
  - What's the evidence that bank reserves enhance overall financial stability more than Treasuries? Only banks can hold reserves but to create them the Fed reduces the amount of Treasuries held by the broader public. Is this an obvious improvement in stability? Alternatively the Fed could purchase risky non-Treasury securities and thus engage in a form of credit policy. Credit policies by the central bank are a form of off-budget fiscal policy.

QUESTIONABLE BENEFITS: INTEREST RATE CONTROL?

- It is argued the a floor system leads to better control and less volatility of short-term interest rates. Yet the volatility of the daily or weekly fed funds in the pre-crisis regime rate never seemed to interfere with the implementation of monetary policy or the transmission of the funds rate target to other short-term rates. Indeed, the market fluctuations in the effective funds rate can and did provide useful information to the Fed.
- Moreover, under the current implementation of the floor system the Fed has had to vastly increase the range of market participants with which it is a direct counterparty. Is this the role we want the Fed to play? Where does the logic of this increase in span of control end?

WHAT HAPPENS TO THE CONDUCT OF MONETARY POLICY?

- The Fed argued that expanding balance sheet was essential to providing monetary accommodation. However, in building its case for continuing with an operating regime with a large balance sheet, the Fed has said little about the consequences of the large balance sheet for the stance of monetary policy.
- It is incumbent on the Fed to be clear about the relationship, or lack thereof, between monetary policy and the large balance sheet and volume of excess reserves. If quantitative easing (QE) was so important and effective, how can it be ignored in the conduct of monetary policy under the floor regime they seem to want to continue even in normal times? How will the size of the balance sheet impact the setting of IOR?

GOVERNANCE ISSUES

- According to the Federal Reserve Act, it is the Board of Governors, not the FOMC, that sets IOR. Thus, legally, the FOMC does not have the sole authority to conduct monetary policy.
- This also raises the operational question as to what body will decide the appropriate size of the balance or, more specifically, the volume of excess reserves.
- Moreover, how will the Fed decide appropriate volume of excess reserves? Fed officials suggest they will learn from experience. But what will be the criteria for deciding? If its regulation such LCR when that could be yet another source of uncertainty and variability.
- Answers are vague and accountability unclear.

POLITICAL ECONOMY AND THE RISK TO FED INDEPENDENCE

- I mentioned at the outset that when considering policies, one must consider and understand the institutions.
- In adopting a framework where a large volume of excess reserves becomes a standing feature of the operating regime risks political interference. Under such an operating system, the volume of excess reserves is no longer directly tied to the stance of monetary policy. The balance sheet becomes a free parameter.

POLITICAL ECONOMY AND THE RISK TO FED INDEPENDENCE

- A large balance sheet unconstrained by monetary policy is ripe for abuse. Congress and an Administration would be tempted to look to the balance sheet for other purposes.
  - Credit policy
  - Off-budget fiscal policy
- The asset side of the Fed's balance could become a political issue.
  - Diversification
  - Investment: Infrastructure, New Green Deal, etc
  - CFPB (Dodd-Frank 2012); Transportation Bill (2015)
  - Bailouts or rescues of state and local governments
  - Political fallout from large interest payments (perceived as subsidies) to big banks and foreign banks

SUMMARY

- The case for maintaining a large balance with significant excess reserves is far from compelling. Operationally it has many moving parts and the financial stability benefits are dubious.
- The conduct of monetary policy has not been fully addressed nor have the governance or accountability issues.
- The temptation for politicians to exploit the balance for their own purposes risks politicizing the Fed and undermining its independence.