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FED SHADOW

Regime Change at the Fed

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Interest on reserves could either accelerate or prevent inflation -- it depends on how the Fed handles this powerful new tool.

Update to strategic view
US MACRO: Paying interest on reserves could be a pernicious gimmick allowing the Fed to maintain a given funds rate target while nevertheless flooding the system with excess liquidity. Or it could be an elegant solution to the problem of continuing to sterilize massive liquidity injections intended to calm the credit crisis. It's hard to see how the present scope of liquidity provision could not lead to higher inflation, even if the Fed uses this powerful new tool wisely.
[see Investment Strategy Dashboard]

As the Fed expands its responsibilities and operations on a vast scale in attempting to finally quell the credit market panic, officials have taken to referring to this period as one of "regime change" -- obviously meant in a different sense than the once-familiar usage of that phrase by President Bush. But if the Fed's crisis management efforts are ultimately to be more successful than the foreign policies of the Bush administration, it must straddle a fine line requiring a degree of dexterity for which it has not often been noted -- providing enough cash to relieve distressed markets, without flooding the markets with a liquidity excess that would further significantly weaken dollar purchasing power and pave the way for a period of inflation significantly elevated from its already high levels. In the final analysis, it would be a bitter pill to swallow if endeavoring to restore market stability comes at the price of a sharp escalation of inflation.

Critical to determining the outcome on that score will be the Fed's handling of its new authority to pay interest on reserves under the Emergency Economic Stabilization Act. While the Fed has long sought such authority, and was scheduled to begin paying interest on reserve holdings in 2011 under legislation enacted earlier, it urged its inclusion in the rescue bill to help it deal with the current crisis. It solves two separate but related problems for the Fed. First, the volume of liquidity injections devoted to its various credit programs and special liquidity facilities has compromised the Fed's ability to maintain its federal funds rate target. Interest on excess reserves effectively puts a floor under the funds rate, because banks would have no incentive to lend reserves in the funds market -- an unsecured overnight loan -- at a rate lower than the Fed would pay them for a riskless deposit. Second, until fairly recently, the open market desk was able to sterilize the Fed's large liquidity injections by selling assets from its balance sheet. At the outset of the crisis a little more than a year ago, the Fed held outright about $800 billion in Treasury securities. Those holdings, however, have fallen sharply, as the desk sterilized its liquidity injections and assets were pledged under the Term Securities Lending Facility. The Fed

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now has unencumbered access to less than $250 billion in assets on its balance sheet. Paying interest on reserves attracts deposits that the Fed can lend, without having to make further asset sales.

These two concerns have converged in the last several weeks. With the open market desk no longer able to sterilize ever-larger liquidity injections, the funds rate was trading well below the 2% target that prevailed prior to last week's 50 basis point cut. In the first week of October, it closed at an effective rate of 0.67% one day, and closed below 1.5% on nine of the past 15 trading days. But these two concerns are ultimately separable, and the key question now is how and if the Fed will choose to separate them. If the sole objective is simply to put a floor under the funds rate, that would potentially mean that the Fed would effectively have no constraint on its liquidity-adding capacity. The funds rate would remain anchored no matter how much liquidity is added -- "non-zero quantitative easing," as some commentators have called it. In the material it released and in various public statements, the Fed did not seem to shy away from conveying the impression that this was the objective. Fed chairman Ben Bernanke himself last week offered that the payment of interest on reserves "will allow us to expand our lending as needed to support the system while better managing the federal funds rate."

On the other hand, since the introduction of the various new liquidity facilities earlier this year, that Fed's revealed preference has been to sterilize its lending, as evidenced by the depletion of its securities portfolio. One response has been the Supplementary Financing Program with the Treasury Department. Here, the Treasury sells bills in the open market and transfers the funds to the Fed, effecting a liquidity draining operation. To date, this has withdrawn some $405 billion from the system. In the last four weeks, however, the Fed's liquidity operations have injected more than $600 billion, expanding the Fed's balance sheet by an extraordinary 68%. This is where paying interest to attract excess reserves comes in. The excess reserves that will be put on deposit at the Fed will be self-sterilizing. These will be pre-existing balances pulled from the available liquidity supply. The Fed has not yet provided details on how it intends to operate the system, but it would stand to reason that the Fed's first option would be to use these reserves to fund its liquidity programs, rather than injecting additional liquidity through open market operations. Presumably, the availability of interest will bring a considerable boost to excess reserve balances, and may prove sufficient to meet the Fed's liquidity needs. As an illustrative example, in the most recent statement week the Fed's liquidity operations netted out to about $103 billion, while excess reserves totaled $136 billion.

So there are two very different ways the Fed might go here. One -- a terribly inflationary possibility -- is to use interest on reserves to stabilize the funds rate while still injecting massive quantities of monetary liquidity. And two -- a counterinflationary possibility -- is to use interest on reserves to attract deposits of existing liquidity that can be lent where they are needed, without inflationary open market operations. There's obviously great uncertainty at this point regarding the course of coming events and the Fed's perception of how it should best respond with its new power to pay interest on reserves. Conceivably, the Fed's liquidity needs could well end up outpacing the deposits that will be available through the excess reserve channel. In that case, the inflation implications would be ominous.

BOTTOM LINE: The Fed's new authority to pay interest on reserves presents both troubling and comforting possibilities. The system could potentially lead to essentially unlimited and highly inflationary additions to liquidity. On the other hand, it could be used to sterilize the massive liquidity injections required to meet the exigencies of the credit crisis. Either way, given the Fed's open-ended liquidity stance in the present crisis, it is difficult to avoid drawing the conclusion that it is prepared to accept an increase in inflation as the price to be paid for restoring market stability.