Comment

The threat posed by ballooning Federal reserves

John Taylor

An explosion of money is the main reason, but not the only one, to be concerned about last week's surprise decision by the Federal Reserve to increase sharply its holdings of mortgage backed securities and to start purchasing longer term Treasury securities.

First consider the monetary effects. When the Fed purchases public or private securities or makes loans to banks or to other private firms, it must finance them. The Fed can borrow the funds, or it can ask the Treasury to borrow the funds, or it can do it the old-fashioned way: create money. The Fed creates money in part by printing it but mostly by crediting banks with deposits at the Fed. Those deposits are called reserve balances and are the key component – along with currency – of base money or central bank money which ultimately brings about changes in broader money supply measures.

These deposits or reserves have been exploding as the Fed has made loans and purchased securities. Six months ago reserves were $8bn, in a range appropriate for its interest rate target at the time. As of last week, reserves were nearly 100 times larger at $778bn, the result of creating money to finance loans to banks, investment banks, AIG, central banks and purchases of private securities. Before last week's federal open market committee meeting, I projected these would increase to $2,215bn by the end of this year if the new Consumer and Business Loan Initiative of the Treasury were to be financed by money creation. With last week's dramatic announcement, the Fed will have to increase reserves by another $1,150bn to $3,365bn by the end of the year if the securities purchases are financed by money creation. Quantitative easing or credit easing means that the growth rate of the quantity of money increases, but there is no monetary principle or empirical evidence supporting such an explosion.

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There is no question that this enormous increase from $8bn to $3,365bn will lead to higher inflation unless it is reversed. With the economy in a very weak state and commodity prices falling, inflation does not appear to be a problem now. The growth of reserves has led to an increase in the growth rate of the broader money aggregates, but less than proportionately because banks are still holding excess reserves. The Fed has expressed its concern about inflation with its new target-like longer term forecasts for inflation and by saying it will remove the reserves in due time. However, increases in money growth affect inflation with a long and variable lag. Will the Fed be able to change course in time? To do so, it will have to undertake the politically difficult task of getting more than $3,000bn of government securities, private securities and loans off its balance sheet. Making it more difficult are the extraordinary borrowing demands by the Treasury and the announcement of Treasury purchases by the Fed.

Some argue that the unprecedented actions by the Fed are filling in for a lacklustre performance by the Congress and the administration, especially in light of the uproar over the AIG bonuses. But even if there are short-term benefits, they will be offset by the cost of lost independence of the Fed. What justification is there for an independent government agency to engage in such selective lending activities? The announcement by the Fed that it will purchase long-term Treasuries is reminiscent of the period just before the Accord of 1951 when the Fed had little independence.

The reason for these interventions is that the Fed wants to improve the flow of credit and lower interest rates for a wide range of borrowers. However, it is by no means clear that the interventions will be effective beyond a very short period, and they may be counterproductive. I found, for example, that the Term Auction Facility, set up to improve the functioning of the money market and drive down spreads on term interbank lending relative to overnight loans, had no noticeable impact on interest rate spreads. Such actions may have prolonged the crisis by not addressing the fundamental problems in the banks.

These extraordinary measures have the potential to change permanently the role of the Fed in harmful ways. The success of monetary policy during the great moderation period of long expansions and mild recessions was not due to large discretionary interventions, but to following predictable policies and guidelines that worked.

The writer, a professor of economics at Stanford and a senior fellow at the Hoover Institution, is the author of Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis