The Washington Post

The Federal Reserve could once push back against big spending projects like the Green New Deal. Not anymore.

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February 20, 2019

Of many bold ideas pitched in Rep. Alexandria Ocasio-Cortez's proposed "Green New Deal," the boldest may be her plan for paying its multitrillion-dollar price tag.

We can do it, she said in a blog post that has since been removed from her website, "in the same ways that we paid for the 2008 bank bailout and the extended quantitative easing programs, the same ways we paid for World War II and many other wars." In other words, we can have the Federal Reserve pay for it.

Wouldn't having the Fed pick up the tabs for multitrillion-dollar projects cause inflation? Not long ago, it would have. But during the subprime crisis, the Fed took steps that severed the once relatively tight link between the amount of government debt it took on and the tendency of prices to increase. As a result, it's now more tempting than ever for politicians to expect the Fed to serve not just as the banking system's lender of last resort, but as the government's financier of first resort.

The Fed used to have a good excuse for not financing big projects

Before the crisis, the Fed kept a lid on inflation by limiting the supply of bank reserves, meaning the actual cash banks keep in their tills, vaults and cash machines, together with deposit credits they can draw on at their district Federal Reserve Banks.

Banks need reserves to meet minimum legal requirements and to settle accounts with one another at the end of each business day. Generally, the more deposits and loans banks have to manage, the more reserves they need. So long as they also keep no more reserves on hand than they need, as is the case when reserves don't pay interest, the Fed can control inflation by making reserves more or less plentiful. To combat deflation before the crisis, the Fed created fresh reserves by buying government securities in the open market. The sellers of those securities then deposited the proceeds with their banks, adding to their reserves. To combat inflation, it unloaded securities from its portfolio, taking back an equal sum of reserves.

Under this traditional setup, if the Fed bought too many securities, inflation would break loose. Consequently, whenever Congress, or some president, pressured Fed officials for funding, they had a ready answer: They could only do so much without violating the Fed's mandate.

Sometimes the excuse didn’t work

During both world wars, and again during the spending surge accompanying the Vietnam War and the Great Society, the Fed yielded to government pressure. But the consequences were as predicted: rising prices or (in the case of World War II) strict wage and price controls, with their attendant shortages. Still, fear of these consequences made it relatively easy for the Fed to resist peacetime demands that it buy up government debt.

Now the game has changed

A dramatic change came with the September 2008 collapse of Lehman Bros. Fearing that its post-Lehman emergency lending would cause it to blow past its inflation goal, the Fed deliberately severed the link connecting reserve creation to inflation by starting to pay interest on bank reserves. The idea was to get banks to sit on extra reserves that came their way, instead of using them to grow their own balance sheets. The change meant that the stance of monetary policy no longer depended on how many reserves the Fed created, or how many securities it purchased. Instead, it depended on how high or low the Fed set the interest rate it paid on bank reserves.

Although the Fed soon switched from fearing inflation to fighting recession, it kept on paying banks to hoard reserves, and did so even as other central banks turned to negative interest rates. Instead of going negative itself, the Fed resorted to unprecedented purchases of long-term government securities, in a policy that became known as “quantitative easing,” in the hope that such purchases would boost the economy despite banks’ tendency to stockpile cash.

A temporary fix has become permanent

Although the Fed’s unconventional post-crisis system was originally supposed to be temporary, it officially became permanent when Chairman Jerome H. Powell announced, at his Jan. 30 news conference, the Fed’s “decision … to continue indefinitely using our current operating procedure for implementing monetary policy … so that active management of reserves is not required.”

That “active management of reserves is not required” means, among other things, that the Fed can create *any*quantity of reserves, and, hence, purchase any amount of government debt, without losing control of inflation. Were inflation to break out, it could check it by further raising the interest rate it pays banks to hold reserves. That’s assuming, of course, that the government itself doesn’t check inflation by raising taxes or spending less.

Because inflation still has to be guarded against somehow, the Fed’s newfound ability to stock up on government debt doesn’t add up to a free lunch. It does give politicians whose pet projects come with big price tags more reason than ever to suggest that the Fed can pay for them.

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