AMERICAN BANKER.

Democrats Defect to Yellen's Side on Key Fed Policy

Ian McKendry

May 17, 2016

WASHINGTON — Key Democrats abruptly reversed course Tuesday concerning a monetary policy tool, saying they now support the Federal Reserve's ability to pay interest on banks' excess reserves.

Just three months ago, Fed Chair Janet Yellen took fire from both Democrats and Republicans during a House hearing in which lawmakers characterized the interest payments as another bank bailout.

But after meeting with Yellen in private, top Democrats said they now agree with the Fed that the payments are necessary.

"While I initially raised concerns with this approach, after exploring this matter further and speaking at length with Chair Yellen, it has become abundantly clear that the net benefits to the public that result from this policy are substantial," Rep. Maxine Waters, the top Democrat on the House Financial Services Committee, said in an emailed statement.

The issue, which was the subject of a hearing Tuesday in front of the House monetary policy and trade subcommittee, has gained prominence after Congress targeted the Fed's dividend payments to banks as a source of funding last year. With that funding already seized to pay for a transportation bill, observers warned that the Fed's interest payments would be next on the list.

That appeared to be the case at a hearing in February, in which both Waters and House Financial Services Committee Chairman Jeb Hensarling criticized the payments as a bank subsidy.

While Democrats on Tuesday changed their tune, Republicans did not. Rep. Bill Huizenga, R-Mich., who chairs the subcommittee, said he continued to be concerned about the interest payments.

"There are quite a few questions on both sides of the aisle about [interest on excess reserves] and as we are looking at foreign subsidiaries and large banks being the recipients of the lion's share of this," he said. "That has a number of people very concerned about our small and regional banks."

Huizenga noted that banks had become concerned about the rhetoric around the issue, and indicated they were right to be worried.

"Apparently there are some folks on Wall Street who sent out some alerts … about this hearing that somehow interest on reserves is under attack," he said. "Well, to the fine folks on Wall Street, you are on notice."

At issue is the money that the Fed requires banks to hold as a stipulation of membership. Congress gave the Fed power to pay interest on reserves in 2006, partly as a way to reduce volatility in overnight interest rates. A provision in the 2008 bank bailout bill sped up the effective date on that authority, allowing the Fed to pay at a 0.25% rate. The excess reserves in the Fed system have skyrocketed from roughly $10 billion to more than $2.5 trillion today.

The Fed has consistently argued that this ability is a vital monetary policy tool, and others have noted that it helps preserve the central bank's federal funds rate as the market benchmark.

During the hearing, Republicans pivoted to another line of attack against interest on excess reserves, reframing it as something that deters economic growth.

"The biggest effect comes through the lack of private investment, productive investment, small business investment," George Selgin, a senior fellow at the Cato Institute, said after Rep. Mia Love, R-Utah, asked what the average American at home should know about the Fed's IOER policy. "The Fed grew its encouragement of banks to hold reserves and they cannot both hold reserves and loans … this has a drag on the economy."

But Todd Keister, an economics professor at Rutgers University, defended the policy.

"The ability to pay interest on reserves, including on excess reserves, is critical in encouraging and allowing the Fed to know that when the time came to raise interest rates, it could raise interest rates regardless of the size of its balance sheet," Keister said.

The hearing also touched on other important topics, such as whether the Fed should adopt rule-based monetary policy or how it could eventually unwind its balance sheet.

"This is just the beginning of a long-term debate that we are going to have on the Fed," Waters said. "There is a basic philosophical difference on whether or not the Fed should be independent."