Exposing The Charade That Is Fed Policy 'Normalization'

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Now that Janet Yellen has had a chance to defend the Fed's recent policy moves before Congress, the public must decide whether or not she has succeeded. Doing that means coming to grips with the difference between what the Fed's moves are *supposed* to have accomplished, and what those moves *really* accomplished.

According to Chairwoman Yellen, when the Federal Open Market Committee raised its federal funds rate target last December, it took its first step toward monetary policy "normalization," meaning a return toward normal Fed operating procedures, as relied upon before the crisis.

So far, the public seems to be buying it. But the public is being hoodwinked: Instead of returning to normal, Fed policy is now weirder than ever. And that's bad news for all sorts of reasons, starting with the fact that the Fed is sailing in uncharted seas, where it risks running aground.

To see through the Fed's charade, one must recall what "normal" monetary policy once meant.

Before the crisis, banks kept only minimal reserves at the Fed, expanding their loans and investments, and total bank deposits, until available reserves just sufficed to meet minimum legal requirements. To keep reserve needs to a bare minimum, banks with extra reserves or "Federal funds" lent them, at the so-called "Federal funds rate," to others that ran short.

"Normal" policy consisted of having the FOMC specify a target funds rate, according to whether tightening or loosening (or no change) seemed desirable. The Fed then made reserves more or less scarce, by selling or buying securities on the open market, to keep the funds rate on target.

Monetary policy turned abnormal with the collapse of Lehman Brothers. First, the Fed's emergency lending created large quantities of reserves. Then, to keep bank lending from

undermining its policy target, the Fed started paying interest on bank reserves. Finally, as recovery faltered, it created still more reserves for banks to hoard.

Because only banks could earn interest on reserves, other institutions with Fed accounts were still willing to lend them at below the Fed's target rate. To save face, the Fed switched to a target "range" running from zero to the rate it paid on reserves, then fixed at just 25 basis points.

It was as if a marksman, finding his arrows falling short, moved the target to where they'd fallen.

The Fed's original target range lasted from December 2008 until last month. In the meantime, its various rounds of Quantitative Easing caused the quantity of excess reserves, which seldom approached $2 billion before the crisis, to climb to just shy of $2.9 trillion by April 2014.

Seen against this backdrop, policy "normalization" ought to mean a return, however gradual, to a (relatively) modest-sized Fed, along with a reduction of interest on reserves – to zero or still lower, if necessary.

Is that what the Fed's been up to? Hardly. The Fed balance sheet is as large and as loaded-down with long-term securities as ever. Instead of raising rates by selling off assets, the Fed has lifted them using "overnight reverse repos" — borrowing cash from financial institutions, using its long-term Treasury securities as collateral.

Because the securities stay on the Fed's balance sheet, the balance sheet doesn't shrink. Instead, the mix of Fed liabilities changes: Repos go up, while banks' excess reserves go down. It all boils down to a scheme by which the Fed pays nonbank counterparties, and not just banks, to hoard cash instead of lending it.

The problem isn't just one of smoke and mirrors masking reality. Relying on repos is risky, because determining the volume needed to achieve any particular degree of credit-tightening is largely a guessing game.

And because repos, unlike open-market sales, leave securities on the Fed's books, instead of returning them to the marketplace, they do nothing to relieve the collateral shortage that's been hindering private lending.

To implement the upper bound of its new funds-rate target, the Fed doubled down on interest on reserves, further increasing its credit-market footprint. The move also got the Fed further out of sync, both with its own experts' estimates of the "natural" (neither inflationary nor deflationary) fed funds rate, and with other central banks that have instead been turning to negative interest rates.

Appearances can deceive. The public, accustomed as it has been to thinking of monetary policy as a matter of the Fed "setting" interest rates, came to identify "abnormal" policy with low

interest rates. It then found it easy to believe that any increase in interest rates, however achieved, must be "normalizing."

Perhaps the FOMC itself believes it. But if that's so, besides fooling the public, its members have been fooling themselves.

Genuine monetary policy normalization, consisting not of an arbitrary "liftoff" of policy rates, but of their return to "natural" levels, and an eventual reduction in the Fed's credit footprint, may not be easy, and it may take a long time. But the only way to get there is for the Fed to quit passing off counterfeit "normalization" in place of the real thing.

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