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BankThink Fed must stop rewarding banks for not lending

George Selgin and Norbert Michel

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Federal Reserve officials are beginning to call for shrinking the central bank's bloated balance sheet. That's good news. Doing so reduces taxpayer risk, and undoes the Fed's massive allocation of credit to its preferred sectors, government and housing. This will close a chapter on one of the most controversial periods in the Fed's history. The bad news: If the Fed doesn't simultaneously stop paying banks to hoard money, the Fed will create the next recession.

During the financial crisis, the Fed put its traditional tools of monetary control on ice, and switched to experimental ones. One of those new tools, paying interest on excess reserves, started in October 2008. It encouraged banks to park money at the Fed instead of lending to businesses and households.

What drove Fed officials to discourage lending in the throes of a financial meltdown? It was an especially odd move given that the Fed was concurrently making so-called emergency loans to keep financial institutions afloat. But Fed officials feared that unless they got banks to hoard the fresh reserves created by their emergency lending, the flood of extra dollars would send the federal funds rate to zero — well below their 1.5% target. Influencing the federal funds rate was traditionally one of the Fed's key methods for controlling the growth of credit and meeting its employment and inflation goals.

The experiment failed dramatically. The federal funds rate dropped toward zero anyway.

The Fed did succeed, however, in getting banks to sit on those fresh reserves, curbing new loans banks would typically make when fresh deposits show up. It was thanks to interest on excess reserves that the Fed ended up stimulating so little in the economy, despite its efforts to ease so much.

The new policy appeared intended to enhance the Fed's traditional methods of monetary control. But in fact, it rendered those methods almost entirely impotent.

Returning to "normal" monetary policy means undoing *all* of those changes that made old-fashioned monetary policy ineffective in the first place. Shrinking the Fed's balance sheet isn't enough. In fact, on its own it's dangerous. If the Fed keeps paying banks not to lend at the same time it starts slimming its balance sheet, we could be in for very tight money.

In 1936, the Fed faced a similar situation. Fearing an outbreak of inflation, the Fed responded by raising banks' legal reserve requirements. But, like today, banks wanted those big reserve

cushions. To keep them, they clamped down on credit. The outcome was the notorious "Roosevelt Recession."

Another recession is the last thing this economy needs. But if the Fed sticks to its present normalization plan, that is exactly where we are headed.

To normalize without inviting a new recession, the Fed needs to combine its plan for shrinking the balance sheet with one for phasing-out interest on excess reserves.

Shedding assets tightens credit, but discouraging banks from holding reserves loosens it. By doing both at once — reducing assets and lowering interest on excess reserves — the Fed can keep money from becoming either too loose or too tight.

The balancing act won't be easy, but it's both possible, and worth it.

Oddly, the Fed has been moving in the opposite direction, raising the interest rates it pays banks and other financial institutions to keep excess reserves. And the public, having had its fill of "low interest rates," has been buying it as a step in the Fed's "normalization" plan. But so long as the Fed encourages banks to hoard money, it is not returning to the pre-crisis approach of monetary policy.

During the financial crisis the Fed ran many risky monetary policy experiments. One set of experiments added trillions of dollars of fresh reserves to the banking system and distorted credit markets. Another encouraged banks and other financial institutions to hoard those reserves, instead of lending or investing them.

Just how helpful these experiments were in ending the crisis, or promoting recovery, remains unclear. Only one thing is certain: If we want "normal" monetary policy without creating a recession, the Fed must shrink its balance sheet and stop paying banks not to lend.

George Selgin is director of the Center for Monetary and Financial Alternatives at the Cato Institute.

Norbert Michel is a senior research fellow in financial regulations and monetary policy at the Heritage Foundation.