How our 'big, fat Fed' put on trillions and why it needs to lose them now

George Selgin

April 3, 2017

Since late 2008, when it began the first of several rounds of large-scale asset purchases, aka "Quantitative Easing," the Fed's balance sheet has grown from just $900 billion in assets to more than $4.4 *trillion*. And although Fed officials promised it would slim down once the economy recovered, our big, fat Fed is as hefty as ever.

Lately, some Fed bank presidents have been calling for it to start keeping its promise. The Fed needs to listen; and so does Congress. There's nothing "normal" about the Fed's $4.4 trillion dollar balance sheet, or its correspondingly swollen footprint on America's credit system. That swollen footprint is bad news for the U.S. economy, because it means that a large chunk of the public's savings that might help revive the nation's flagging productivity is instead diverted to the government and its agencies.

Before the subprime crisis, banks kept very modest reserve balances at the Fed. To meet occasional shortfalls, they borrowed reserves, or "federal funds," overnight from other banks, at the so-called federal (or "fed") funds rate. Monetary policy boiled down to deciding where the fed funds rate had to be if the Fed was to achieve desired levels of inflation and unemployment, and adjusting the supply of bank reserves to make the actual funds rate hit the chosen target.

Because banks, in that pre-crisis set-up, managed with only modest reserves, almost every dollar in bank deposits went to finance bank loans to businesses or consumers, and the Fed's credit footprint was correspondingly small. Total Fed assets were just *one-eighth* those of all U.S. commercial banks. In other words, the Fed was able to control total credit creation, while letting commercial bankers determine where the credit should go.

During the financial crisis, everything changed, as the Fed stumbled its way into the radically different set-up now in place. Worried, in October 2008, that its emergency lending would push the fed funds rate below target, the Fed started paying banks interest on their excess reserves (IOER) so that the banks would hoard reserves instead of lending them to other banks. Thanks to Quantitative Easing, the banks ended up accumulating $2.7 *trillion* in excess reserves.

"There's nothing "normal" about the Fed's $4.4 trillion dollar balance sheet, or its correspondingly swollen footprint on America's credit system."

Although it succeeded all-too-well in getting banks to hoard reserves, IOER failed to keep the fed funds rate from plunging toward zero. To prop it up, the Fed introduced a second tool, "Overnight Reverse Repurchase Agreements" (ON-RRPs) designed to pay interest to non-bank financial firms to park cash with it. The ON-RRP rate set a lower limit to what was now a fed funds target "range." It also meant that the Fed was commandeering credit, not just from banks, but from other financial institutions.

The upshot of all these crisis-inspired innovations is a Federal Reserve whose command over the nation's credit has vastly increased. Relative to the U.S. commercial banking system, the Fed is now *four times* its size before the crisis. Bank reserves, once a modest fraction of a percent of total bank deposits, are now equal to a fifth of those deposits. And bank lending to businesses and consumers, formerly matched almost dollar-to-dollar to bank deposits, now accounts for only 80 cents of every dollar. The rest goes to the Fed and, from there, to the government and other agencies whose securities the Fed purchases.

For central banks to get commercial banks to steer substantial amounts of scarce savings their way is nothing new. The central banks of less-developed nations do it often. When they do, economists call it "financial repression." It is, those same economists say, an important reason why many poor countries stay poor. Now the Fed itself is practicing financial repression, disguised as high-tech monetary policy. And the U.S. economy is suffering accordingly.

That's why those Fed officials who want the Fed to shrink sooner than later have got a point. If the Fed's own officers can't convince it to start shrinking, Congress should consider compelling it to do so. It might add a provision to the new Financial CHOICE Act ("Financial CHOICE ACT 2.0") setting a deadline for Fed balance-sheet reduction. Better still, Congress might include one calling for the phasing-out both of interest payments on excess reserves and of the Fed's overnight reverse repurchase agreement program.

Although some Fed officials will no doubt protest that such measures interfere with the Fed's independence, Congress should resist such complaints. The Fed's mandate calls upon it to manage the nation's credit supply in pursuit of stable prices and full employment. It doesn't authorize it to compete with private-sector lenders for a large chunk of the nation's savings. If the Fed itself won't resist mission-creep, Congress has not only the right, but the duty, to put a stop to it.

George Selgin is a senior fellow and director of the Center for Monetary and Financial Alternatives at the Cato Institute and Professor Emeritus of Economics at the University of Georgia. His research covers a broad range of topics within the field of monetary economics, including monetary history, macroeconomic theory, and the history of monetary thought.