THE HILL

The big, fat Fed has diet problems

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President Trump's strident public criticism of the Fed's interest rate hikes has made its future monetary policy plans an even greater focus of public concern and commentary than usual. Will the Fed raise rates again? Should it? And, whatever it decides to do, will Trump's browbeating have played a part?

But important as the Fed's upcoming rate decisions are, it's poised to make another decision that could prove still more important: whether to keep shrinking its balance sheet, as it has long promised to do, or to quit doing so —as some experts, both in and outside of the Fed, have been urging.

While the wrong choice may make life easier for Fed bureaucrats, it could also do considerably more harm to the U.S. economy than any quarter-point rate-setting blunder.

Until recently, just about everyone agreed that the Fed badly needed to slim down. Before the 2008 financial crisis, it held fewer than $900 billion in assets.

But after several rounds of quantitative easing — the large-scale purchasing of government securities in order to drive down interest rates and increase lending — those assets ballooned to $4.5 trillion!

Today, thanks to a diet the Fed went on last October, they're down to under $4.2 trillion. Were it to stick to that diet, in three years or so, the Fed would ultimately shed another $1 trillion.

A regimen that would leave the Fed three times its pre-crisis size after several years hardly qualifies as a crash diet. Yet, some officials are now saying that the regimen is more than the U.S. economy can handle.

The Fed's diet, a sort of "quantitative tightening," drains reserves, cash and cash equivalents, from the banking system. But, these officials say, thanks to a liquidity coverage ratio (LCR) requirement in place since 2015, banks can no longer afford to part with any reserves.

By making them do so, the Fed's diet has been putting unwanted upward pressure on short-term interest rates —interfering with the Fed's plan to raise those rates according to its own timetable. To stick to that schedule, and otherwise keep a handle on interest rates, the Fed needs to stay fat after all.

What’s so bad about a big, fat Fed? Plenty, actually.

Unlike ordinary banks, the Fed doesn’t make loans to consumers or to businesses, apart from struggling banks. Instead, it invests most of the savings that come its way, including reserves banks keep with it, in government securities, including the agency mortgage-backed securities it bought during the crisis.

That’s good news for the government, but bad news for ordinary borrowers. It also means less funding of productive investment. Consequently, the bigger the Fed’s “credit footprint” — its size compared to the entire U.S. banking system — the more of a drag it is on economic productivity.

Thanks to quantitative easing, the Fed’s credit footprint is now almost four times its size before the crisis. That’s four times as much saving as before, relative to the total flowing into commercial banks, that’s being sequestered by the Fed instead of financing ordinary bank loans. Small wonder, then, that Fed officials felt obliged to put the Fed on a diet.

But has the Fed no choice now but to backslide? Don’t believe it.

Despite what some experts claim, banks don’t need trillions in reserves to meet the new LCR requirements. While reserves qualify as “high-quality liquid assets” that meet those requirements, so do the Treasury securities that roll-off the Fed’s balance sheet as it slims down. In other words, the Fed’s diet doesn’t reduce the available supply of high-quality liquid assets — not even by a penny.

Why, then, has that diet been pushing rates up? The cause isn’t the Fed’s diet, but its policy of paying interest on bank reserves. Since October 2008, the Fed has paid banks more to hold reserves than they might earn by holding short-term Treasury securities.

So even though banks might meet their LCR requirements using Treasuries instead of cash, they’d rather scramble after an ever-shrinking pool of more profitable reserves. The solution is as obvious as the cause: Instead of quitting its diet, the Fed needs to make reserve-hoarding less lucrative.

At the risk of appearing to appease President Trump, the Fed could do this by foregoing its planned rate increases, which include increases in the rate it pays on bank reserves.

As market rates rise, that step alone will encourage banks to part with more reserves, allowing the Fed to stick to its diet and eventually reduce its balance sheet more aggressively, as economic conditions dictate.

To gauge its policy stance as it lets the interest rate on reserves slip behind short-term market rates, it can switch to using one of those rates as a policy reference rate — something Fed officials have already thought of doing.

So long as the Fed’s diet, and consequent mopping-up of bank reserves, keep pace with banks’ own shrinking demand for cash, monetary policy need never go off course.

In short, the U.S. economy isn’t caught between the Scylla of an obese Fed on the one hand and the Charybdis of a wayward monetary system on the other. The Fed can steer it clear of both hazards. Let it stop encouraging banks to hoard reserves, and it can safely become as svelte as it was before the crisis.

Let it, in other words, seek a genuine normalization of monetary policy, instead of the half-hearted and ultimately self-defeating version it's been trying to fob off on the American public.

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