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# The Fed's dangerous 'new normal'

***Is the Fed becoming the president's piggy bank of choice?***

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The American public doesn't have much appetite for monetary matters, and most of that limited attention has been riveted on the political fights over President Donald Trump's controversial nominees to the Federal Reserve Board. But there's a far more serious piece of news on the Fed front.

The Fed's once-revered independence and traditional controls on government spending have been dangerously eroded, with almost no public notice or debate. And unless the Fed itself or Congress does something about it, our financial system is at risk.

When did this happen? In a news conference in March, Fed Chairman Jerome Powell announced that the central bank would stop unwinding its balance sheet this September. That decision, phrased in the typically dry language of central bank news releases, didn't make headlines. Yet it was a watershed: It was the most obvious sign yet that the Fed's program to "normalize" monetary policy, as it had promised to do since 2009, was coming to an end. In essence, the Fed has decided to keep its emergency monetary powers and stick to its new methods of managing the supply of money in the economy indefinitely.

That "new normal," which the Fed adopted during the financial crisis, includes novel methods for controlling interest rates. During the crisis, those methods allowed the Fed to engage in "quantitative easing," meaning large-scale purchases of government bonds and other securities. But while they helped it fight the Great Recession, the Fed's quantitative easing powers also fudged the traditional boundary line between fiscal policy, which Congress controls and which includes decisions about government funding, and monetary policy, which the Fed controls and which is supposed to be dedicated solely to fighting recessions and limiting inflation.

**BY BLURRING THAT** boundary line, the Fed's new methods threaten to undermine its critically important independence. An independent central bank ensures that neither the president nor Congress can decide to fund special projects or tweak economic growth by compelling the Fed to print more money. But the longer the Fed retains its "new normal," the more that independence is at risk.

To understand why this new normal is so risky, you first need to understand how we got here.

Before the 2008 financial crisis, the Fed controlled inflation by creating or destroying bank reserves. When the Fed created reserves, interest rates declined, banks increased their lending and the supply of money in the economy expanded. When it supplied fewer reserves, it checked inflation.

But after the failure of Lehman Brothers in September 2008, the Fed started paying interest on banks' reserves — the cash that banks must hold to meet reserve requirements and settle accounts with one another. Its goal was to get banks to stockpile reserves its emergency lending was creating instead of lending them, to avoid excessive money growth in the economy and prevent inflation. The decision to pay interest on reserves effectively allowed the Fed to control inflation no matter how many reserves it created — something it never could do before.

Second, in its first round of what later became known as quantitative easing, the Fed took the extraordinary move of buying large quantities of mortgage-backed securities from banks to keep their value from plummeting as the asset markets froze. In later rounds of quantitative easing, it also bought large amounts of long-term Treasury securities.

These two new policies left banks holding more than $2.5 trillion in reserves and quadrupling the overall size of the Fed's assets. In the past, such a large increase in bank reserves would have led to high inflation. But the Fed could now avoid that result simply by making sure the rate it paid banks stayed high enough to get them to hoard any reserves the Fed created. That's why quantitative easing hasn't made prices skyrocket, as many Republicans feared it would when they were still a party of monetary hawks.

When quantitative easing began, then-Chairman Ben Bernanke promised that after the recession ended the Fed would revert to its "normal" self — meaning that the central bank would go back to a modest-size balance sheet and stop encouraging banks to hoard reserves. Later, the Fed released a normalization planexplaining how it would "unwind" its swollen balance sheet — letting it shrink as its bond holdings matured — and otherwise get back to business as usual.

Now that Powell has announced an end to that unwinding, is the Fed almost back to normal? Hardly. Far from resembling its precrisis self, it looks and operates much as it did in the worst days of the recession, bloated balance sheet and all. When Lehman Brothers failed, the Fed held $900 billion in assets, consisting mainly of short-term Treasury bills. Quantitative easing added another $3.6 *trillion*, all in long-term Treasury and mortgage-backed securities. When its unwinding ends in September, the Fed's assets will still top $3.8 trillion.

**FED OFFICIALS WERE** once proud of the Fed's lean, clean portfolio: "lean" because it was small relative to the size of the U.S. economy; "clean" because it was free of risky, including long-term, assets. Having it so, a 2002 Fed study said, kept the central bank from interfering with "relative asset values and credit allocation within the private sector." That decision kept the Fed clear of fiscal policy, leaving support for particular markets, such as housing, and responsibility for funding the government entirely to the Treasury and Congress.

But today, the Fed's willingness to hold on to the massive reserves, coupled with its ability to gobble up debt — including government debt — without fueling inflation, make it harder for Fed officials to resist a Republican administration's own call for renewed quantitative easing. Instead of more "quantitative tightening," Trump said in April, the Fed "should actually now be quantitative easing. … You would see a rocket ship." Fed officials might scoff at Trump's rocket ship analogy, but they can no longer claim that caving in to his demands would mean losing their ability to control inflation.

Trump is not the only politician Fed officials have to worry about: Politicians of either party are equally likely to lean on it. While Republicans are learning to lovethe Fed's printing press — not one Republican senator scolded Powell for the Fed's decision to stop raising interest rates and prematurely end its unwind — Democrats see more quantitative easing as a painless way to finance their own favorite projects. Instead of being a fluke, in other words, Trump's call for more quantitative easing may turn out to be a taste of things to come.

Whether the aim is suppressing illegal immigration or reducing carbon emissions, politicians' growing tendency to see quantitative easing as a pain-free alternative to taxation or unassisted government borrowing threatens to short-circuit the traditional democratic appropriations process, and especially so if the desired end can be deemed a national emergency. What's more, by exposing themselves to pressure "to manage [the Fed's] portfolio for political ends," former Fed Board member Charles Plosser notes, Fed officials could end up further compromising the Fed's already limited independence.

In other words: In the past, the biggest restraint on the Fed's ability to fund public spending was the prospect that it would lose control of interest rates and inflation if it bought too many government bonds. Now, with the central bank able to buy oodles of Treasury bills while still controlling inflation — and facing pressure by both Trump and the Democrats to do so — that restraint may give way.

In short, the Fed's willingness to stay stuffed to the gills with government debt and its new inflation control procedures risk converting it from the banking system's lender of last resort to the government's piggy bank of first resort.

The good news is that a safer outcome, meaning one that can limit politicians' ability to abuse the Fed's powers, is still possible. Instead of settling for a new normal, Fed officials need to return to the old one, or something more like it, with a lean balance sheet, one that can't swallow up debt without triggering inflation. They need to do that for their own sake, to protect the Fed's independence. But mostly they need to do it for ours.

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