WALL STREET JOURNAL

Some Academics Warn Fed on Risks of Current Rate-Control Tools

Cato Institute scholar George Selgin says today's system is costly to the economy and sets up political risk

Michael S. Derby

December 18, 2018

The Federal Reserve appears to be moving slowly but steadily toward making permanent its current tool kit for short-term interest-rate control, but some academics are asking the central bank to reconsider.

The current system sets a hard and fast range for short-term interest rates and relies on the banking system holding much higher levels of reserves than it did before the financial crisis a decade ago. That interest-rate range now stands at between 2% and 2.25% and most likely will be increased at the conclusion of the Fed's policy meeting this week.

The high end is essentially determined by a rate the Fed pays deposit-taking banks to park reserves on the Fed's books, with the low end marked by a rate the central bank pays money funds and other eligible firms to do likewise. Floating in between is the federal-funds rate.

This system came into play after the financial crisis in part because the central bank gained a long-sought-after ability to pay deposit-taking banks an interest rate on excess reserves parked at the Fed. From that rule change in a crisis environment where short-term rates were set at near zero levels, the current system was forged. It was supposed to be temporary, but over time the Fed began to think differently about the issue, with officials praising the ability to control rates, in turn providing a fine-tuned tool to influence the economy's momentum.

Philadelphia Fed President Patrick Harker said in an interview in November that keeping today's system "would provide continuity from where we are now to the future."

One of the most comprehensive challenges to the Fed's current regime comes in book form, via Cato Institute scholar George Selgin's "Floored." It is a broad rebuke of the current system and a recommendation to return to the precrisis style of setting rates.

Mr. Selgin believes the current system is costly to the economy because it requires banks to maintain large amounts of reserves. Instead of lending them, banks now hoard this money, either for regulatory reasons or to capture the predictable returns that the Fed is offering. What's more, Mr. Selgin explains that the current system divorces the Fed's balance sheet from interest-rate

control. Under the precrisis system, interventions to change rates affected the size of Fed holdings. Before the crisis, those holdings were around $800 billion.

In the current system, the Fed sets rates independently of its holdings. And indeed, its balance sheet topped out at $4.5 trillion from crisis-era stimulus bond buying and is now slowly falling. While the size of the balance sheet might have an influence on what is happening with the economy as a whole, its direct impact is now much reduced.

Mr. Selgin says that sets up a big political risk. He fears that congressional leaders in the future could force the Fed to use its balance sheet for nonmonetary-policy reasons. Congress could, for example, force the Fed to blunt deficits by way of large asset purchases, given that those interventions shouldn't in theory affect inflation or hiring.

"There's a grave risk of the balance sheet becoming a thing of politics," Mr. Selgin said in an interview. He added that he suspects the main reason why Fed officials are even considering holding to the current system is due in part to inertia, and partly because banks themselves, which are able to earn the easy interest income, are lobbying the Fed to keep the current regime.

George Mason University economics professor David Beckworth shares some of the same worries, arguing that the current system distorts credit-making decisions away from the private sector and toward the central bank. In a blog post, he also noted that it leads the Fed to take in safe assets that could otherwise be valuable in the broader financial system.

Mr. Beckworth also agrees with Mr. Selgin that the system splatters unsecured short-term lending between banks. "This market provided useful interbank monitoring and price discovery that no longer exists," he wrote.

Mr. Beckworth sees a middle way, where the Fed still uses its power to pay banks for excess reserves, but instead of using it for the top end of the range, it would employ it to set a firm target for rates that would be below that of market-set rates.