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Derby's Take: A Fed Critic Takes Aim at Central Bank's Rate-Control Tools

Michael Derby

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One of the virtues of the Federal Reserve's postcrisis rate-control tool kit was supposed to be its simplicity of operation. But things haven't quite worked out that way, leading some critics to wonder if it's time for central bankers to consider new options.

One such critic, Cato Institute scholar George Selgin, argues that the system's problems are nothing new and that it never worked as planned.

Before the financial crisis, the Fed controlled rates and in turn the broader cost of credit by regularly intervening in markets to set the level of the federal-funds rate, which governs the cost of banks lending reserves to each other.

The Fed's response to the crisis, however, featured massive rounds of Treasury and mortgage bond buying that left the financial system flush with money. At the same time, regulatory changes aimed at ensuring banks have enough liquidity on hand to deal with unexpected stress induced firms to hold on to money rather than lend it.

Those forces drained the life out of the federal-funds rate market and drove the Fed to find a new way to set rates. It settled on what's called a "floor" system. It still cared about the fed-funds rate, but instead of targeting a specific point it now used a range. Initially, that was determined at the high end by what the Fed paid banks to park reserves at the central bank, with another rate available for money funds setting the low end.

In an opinion piece for Bloomberg, former New York Fed leader William Dudley wrote this system "is much simpler to carry out. As long as there are sufficient reserves in the banking system, the Fed does not have to intervene frequently to adjust the supply of reserves to hit its interest rate objective."

And there's the rub. The Fed had been allowing its balance sheet, which peaked at $4.5 trillion, to shrink, and that drawdown hit a wall last September. The Fed's withdrawal of liquidity led to banking system reserves hitting what appeared to be an insufficient level sooner than expected, causing short-term rates to spike. To tame markets, the Fed started to expand its balance sheet by buying Treasury bills last October, and it has been intervening with old-school repurchase agreement operations, or repos, since September.

The Fed is unsure when it can end the repos, and it isn't entirely clear when it will be able to stop buying Treasury bills, nor are private-sector analysts. If it has to keep buying Treasurys and tweak reserves with repos, then it effectively has a fusion of the pre- and post-crisis systems, and it's hard to argue that's a simple system.

The Fed also has been forced to tweak the interest on excess reserves rate, or IOER, and its reverse-repo rate, so now neither align with the fed-funds target rate range, as they did before. IOER may be in for an additional tweak, perhaps soon.

The Cato Institute's Mr. Selgin argues in a new article that the Fed's floor system has struggled to meet its billing pretty much all the way along. "There appears to be a lot more to the U.S. money market than Mr. Dudley and other proponents of the floor system dream of in their philosophy."

While there is no sense Fed officials are anywhere close to giving up on the current regime, they are contemplating adding a standing repo facility that would allow eligible banks fast access to liquidity and tame short-term rate surges. But that would still leave a hodgepodge of interest rates and still may not close off the need for repo operations.

Mr. Selgin writes of another version of a "simple" system the Fed could use. It could ditch the current regime, allow its interest on excess reserves rate to set the low end of the rate range, and use a standing repo facility to bound the top end of the range.

"This is a tried-and-true system employed by many of the world's central banks. Yet the Fed itself has yet to try it," Mr. Selgin writes.