

EXITING CREDIT POLICY TO PRESERVE SOUND MONETARY POLICY

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INTRODUCTION

The credit market turmoil challenged the Federal Reserve as never before. The Fed pushed short term interest rates to near zero last year and expanded its balance sheet by a trillion dollars. The Fed created over 800 billion dollars of bank reserves which it lent together with funds supplied by supplementary Treasury deposits to financial institutions through various liquidity facilities and by purchasing a variety of private securities.

Partly as a result of stimulus provided by the Fed, economic activity in the United States appears likely to expand again in the second half of 2009. The Great Recession that began in December 2007 looks to be ending, although the unemployment rate will likely remain high until GDP begins to grow in excess of productivity growth plus labor force growth somewhere above 2 to 3 percent per year.

In view of the enormous stimulus that the Fed put in place, with the end of the recession in sight the Fed began to discuss withdrawing its policy stimulus last summer, internally at first, then publicly in its July 2009 *Monetary Policy Report to the Congress*. Chairman Bernanke featured the Fed's thinking about its "exit strategy" prominently in his prepared testimony before Congress on July 21st, and on the same day in an op-ed in the *Wall Street Journal* entitled "The Fed's Exit Strategy."

We commend Chairman Bernanke for his high-profile public discussion of the Fed's exit strategy. The decisions that govern economic activity—spending, investing, job seeking, hiring, wage and price setting—are forward looking. The public must be confident of the future to take decisions necessary to create a robust recovery. And the Fed needs to make the public confident of its exit strategy in order to facilitate that recovery.

The key is to anchor inflation expectations to keep actual wage and price inflation stable, so that the public can count on non-inflationary prices and wages in its business and financial plans. The Fed must make price stability the cornerstone of its exit strategy; otherwise it runs the risk of losing control of beliefs about inflation given the trillion-dollar increase in its balance sheet and the huge government budget deficit. Sharply higher inflation premia in bond rates or a sharply lower foreign exchange rate due to inflation concerns could force the Fed to tighten policy more aggressively than otherwise and jeopardize the economic recovery.

To improve the effectiveness of the Fed's exit strategy, and in keeping with the Fed's longstanding intention to make its operations, its balance sheet, and the nature of its policy actions more transparent, we think it is essential that the Fed describe the package of policies pursued during the credit turmoil as a combination of three fundamental and distinct policies: monetary policy, credit policy, and interest on reserves policy.

Below, we draw the essential distinctions among monetary, credit, and interest on reserves policy as we define them, and we describe how the Fed utilized the three in combination to support economic activity in the credit turmoil.

To build credibility for its exit strategy, the Fed must assure the public that it has the *operational means* to withdraw stimulus flexibly, that it has the political *independence* to tighten policy, and that it has the technical capacity and good judgment to tighten policy in a *timely manner* to facilitate a sustained, robust non-inflationary return to full employment and economic growth.

In light of the imperatives above, this essay develops three broad recommendations in terms of our three-way classification of Fed policy. First, to preserve its independence the Fed

should exit credit policy as soon as the recovery allows, with the help of the Treasury and the Congress if need be as we outline below.

Second, to guarantee its power to exit the zero bound on interest rate policy flexibly and precisely, the Fed should enlist the support of the Treasury and the Congress to modify the regulation of the federal funds market so that interest on reserves can put a floor under the federal funds rate, as central bank deposit rates abroad put a floor under their interbank interest rates.

Third, the Fed should not create non-monetary “managed liabilities” to drain reserves and tighten monetary policy in order to raise interest rates. Monetary policy would have to drain all but a small fraction of current bank reserves to have much effect on the federal funds rate. And the large-scale creation of managed liabilities on the Fed’s balance sheet would turn the Fed into a “financial intermediary,” opening the door to the use of non-monetary liabilities for perpetual funding of credit policy with adverse consequences for the Fed’s independence. Moreover, as recommended above, interest on reserves policy could raise interest rates reliably without first drawing down the stock of bank reserves.

DISTINGUISHING MONETARY POLICY, CREDIT POLICY, AND INTEREST ON RESERVES POLICY

As we define it, *monetary policy* consists of open market operations that expand or contract high-powered money (bank reserves plus currency) by buying or selling Treasury securities. Until the recent credit turmoil, the Fed satisfied virtually all of its asset acquisition needs in support of monetary policy by purchasing Treasury securities, a policy known as “Treasuries only.” The Fed did so to avoid carrying credit risk on its balance sheet.

Monetary policy works by varying the aggregate quantity of bank reserves to influence the spread between the federal funds rate and interest paid on reserves. For example, an open market operation in Treasury securities that drains reserves raises the federal funds rate relative to a given interest rate that the Fed pays on reserves.

Credit policy consists of changing the composition of the Fed's portfolio of assets between Treasury securities and credit to the private sector or to non-Treasury government entities in the form of loans or security purchases, holding high-powered money fixed. For instance, an expansionary credit policy action consists of the purchase of mortgage back securities with proceeds from the sale of Treasury securities.

Credit policy by itself has no effect on the federal funds rate because it does not change aggregate bank reserves or interest paid on reserves. Credit policy can be understood as debt financed fiscal policy. The Fed returns to the US Treasury the interest received on the Treasury securities that it holds. So when the Fed sells Treasuries to fund credit policy, it's as if the US Treasury finances credit policy by selling securities to the public.

Fed credit policy works by interposing the government between private borrowers and lenders, and exploiting the government's creditworthiness to lower borrowing costs and facilitate credit flows. All Fed lending carries some credit risk and involves the Fed in potentially costly and controversial disputes regarding credit allocation. The Fed must be accountable for its credit allocations and the returns or losses on its loans and security holdings. The public deserves transparency on Fed credit allocations beyond ordinary "last resort lending" to solvent depositories.

Interest on reserves policy consists of varying the interest rate that the Fed pays on bank reserves, while holding monetary and credit policy fixed. The Fed acquired authority from

Congress to pay interest on reserves in the autumn of 2008 to help put a floor under the federal funds rate in order to free monetary policy to fund credit policy.

Interest on reserves works in that regard because banks will not lend in the money market at interest below the rate they can earn on reserves held at the Fed. Even after the Fed created more than 800 billion dollars of reserves to fund its credit initiatives, and satiated the banking system's demand for reserves, banks would not lend into the money market below the rate the Fed paid on reserves. By late fall 2008 the Fed cut its intended federal funds rate to near zero, so the authority to pay interest on reserves didn't matter much then. However, as we discuss below, the Fed regards the potential for interest on reserves to put a floor under the federal funds rate as an important element of its exit strategy.

RECOMMENDATIONS FOR THE EXIT STRATEGY

The balance of the essay employs our three-way classification of policy to develop broad recommendations for the Fed's exit strategy—first with respect to credit policy, then for interest on reserves policy, and finally with regard to monetary policy.

CREDIT POLICY

As the economy recovers, credit initiatives on the Fed's balance sheet will come to be seen as credit allocation rather than emergency lending. The Fed should declare as part of its exit strategy the intention to return to "Treasuries only" with only occasional "last resort" lending to solvent depository institutions. The Fed should insist that its balance sheet not be used to allocate credit. Extensive credit policy beyond temporary last resort lending to solvent depository institutions *should* draw congressional scrutiny since it is debt financed fiscal policy.

The Fed should not let the presence of such credit policy assets on its balance sheet threaten its actual or perceived political independence, and thereby threaten the credibility of its exit strategy. Rather than incur a congressional audit, the Fed should ask the Treasury and the Congress to take the problematic credit assets off its balance sheet in exchange for Treasuries, so that the credit assets can be managed elsewhere in the government, perhaps in a special entity created for that purpose.

An added dividend of replacing credit policy assets with Treasuries on the Fed's balance sheet is that the Fed could then manage the federal funds rate with monetary policy as it has done for decades. Specifically, the Fed could raise interest rates as the economy recovers by selling Treasuries in the open market to drain reserves and shrink its balance sheet back to normal.

INTEREST ON RESERVES POLICY

Chairman Bernanke made clear in his written testimony for the July 2009 *Monetary Policy Report to the Congress* that the Fed regards the authority to pay interest on reserves as “perhaps the most important such tool” enabling it to raise the federal funds rate without first shrinking its balance sheet. However, in his July 21st *Wall Street Journal* op-ed, he noted that the federal funds rate slipped below interest on reserves in the fall of 2008 due to the fact that some large lenders in the federal funds market, notably government-sponsored enterprises such as Fannie Mae and Freddie Mac, are ineligible to receive interest on balances held at the Fed.

Thus, it is reasonable to worry that GSE lending in the federal funds market will impair the power of interest on reserves to put a floor under the federal funds rate again when the Fed tries to exit the zero bound on interest rate policy.

The *WSJ* op-ed points out that under normal financial conditions arbitrage by banks would tend to limit the extent to which the federal funds rate could fall below interest paid on

reserves. But what if financial conditions were to deteriorate once the appropriate federal funds rate target was well above zero? The op-ed argues also that the Fed has at its disposal other options by which it could immobilize reserves to help raise the federal funds rate. We argue below, however, that these other options are not without problems of their own.

Instead, we think that the Fed should work to *secure* the power of interest on reserves to put a floor under the federal funds rate. After all, the Fed's July 2009 *Monetary Policy Report to the Congress* points out on page 37 that interest paid on bank reserves by foreign central banks has worked successfully to put a floor under interbank rates abroad even as aggregate bank reserves expanded aggressively.

Given the demonstrated power of interest on reserves abroad, the Fed should enlist the help of the Treasury and the Congress to secure the power of interest on reserves to put a floor under the federal funds rate by modifying the regulation of the federal funds market to exclude all but depository institutions eligible to receive interest on reserves from lending in the federal funds market, or by allowing all institutions eligible to lend in the federal funds market to earn interest on deposits at the Fed. So strengthened, interest on reserves policy would provide the Fed with a precise, flexible, and reliable means of raising interest rates as the economy recovers.

MONETARY POLICY

According to our classification, the Fed's remaining options to raise the federal funds rate all involve monetary policy in the sense that they work by reducing aggregate bank reserves. In order to raise interest rates significantly with monetary policy, the Fed would have to drain hundreds of billions of dollars of reserves and return the stock of reserves near to where it was prior to the credit turmoil. Large-scale operations would have to be undertaken in advance over

time to pre-position monetary policy to take the modest operations needed to raise the federal funds rate precisely and flexibly as the Fed exits the zero bound.

The Fed contemplates publicly four options for draining reserves. Each has drawbacks. First, the Fed could reduce reserves by selling some of its holdings of Treasury securities. This option is limited by the stock of Treasuries currently available for sale from the Fed's portfolio. Second, the Treasury could sell securities and deposit the proceeds with the Fed. But, the Fed does not want to rely on the Treasury to achieve its policy objectives. Third, the Fed could drain bank reserves and absorb federal funds otherwise lent by GSEs and other institutions by arranging large-scale reverse repurchase agreements. Reverses involve the sale by the Fed of securities from its portfolio with an agreement to buy the securities back at a slightly higher price. Large-scale reverses, however, would expose the Fed to substantial counterparty risk that could complicate its management of financial markets, especially in times of financial turmoil. Fourth, the Fed could offer interest-earning term deposits to banks, analogous to certificates of deposits that banks offer their customers. Fed term deposits would compete with US Treasury bills and potentially create friction with the Treasury; and they could destabilize the demand for reserves and complicate targeting the federal funds rate with monetary policy.

More generally, we think that the utilization of non-monetary "managed liabilities" by the Fed is inadvisable because it would turn the Fed into a financial intermediary, open the door to the perpetual funding of credit policy with managed liabilities, and compromise the Fed's independence. Moreover, there is no reason for the Fed to issue managed liabilities if, as we recommend above, the federal funds market is regulated to secure the potential for interest on reserves to put a floor under the federal funds rate.