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New Study Finds that Fed Interest on Excess Reserves is Necessary for Stability until Recovery is Assured

IOER is now the most critical Fed tool for keeping a floor under short-term Interest rates. Without it, the Fed could not reliably raise rates and otherwise normalize U.S. monetary policy without sparking inflation and threatening still-fragile financial-market stability.

WASHINGTON, DC, December 20, 2016 – With the Fed's decision to raise U.S. interest rates on December 14 comes an increase also in the interest on excess reserves (IOER) held by banks with the Federal Reserve. In recent years, these excess reserves have become sizeable – $2 trillion as of the most recent data. Some have thus demanded an end to IOER, a call likely to grow louder in tandem with rate hikes. A new study from Federal Financial Analytics, a financial-sector analytical firm based in Washington, D.C., analyzes IOER's role in U.S. monetary policy and the broader financial system.

This study finds that IOER must be continued until U.S. credit demand recovers under more normal interest-rate and growth conditions. Sudden termination of IOER would take the floor out from under short-term interest rates, creating strong inflationary pressures at a particularly uncertain time in U.S. monetary and fiscal policy, the study concludes.

The primary tool the Fed would have without IOER to prevent undue drops in U.S. rates would be sudden sales of its own asset holdings – sales sure to destabilize global capital markets and result in significant taxpayer loss. IOER has become an indispensable Fed tool because banks are flush with deposits even as loan demand remains soft and new rules mandate higher capital and less risk.

"Long years of slow growth and ultra-low interest rates have shown how hard it is for the Fed to ensure sustainable U.S. employment and price stability. Knocking the bottom out of the Fed's now limited ability to control short-term rates would be dangerous to both financial-market stability and recovery," said Karen Shaw Petrou, Federal Financial Analytics' managing partner. "Although there is significant partisan and academic dispute over how best to ensure U.S. recovery, there is no disagreement over the fact that sudden Fed actions – voluntary or forced by Congress – could make the 2013 'taper tantrum' look like a playpen spat," she continued.

Based on academic and central-bank research and on the recent, very negative experience in nations that have tried to end IOER, the study demonstrates that IOER must continue in line with the Fed's desired fed funds rate until financial-market conditions stabilize in a robust-growth economy.

Because of the controversy surrounding IOER, some have suggested that Congress simply prohibit the Federal Reserve from paying IOER. This study assesses the impact of any such action, demonstrating that revenue recovered by ending transfers from the Fed to banks would not create new revenues for U.S. budget-deficit reduction or additional spending.

It is further shown that ending IOER for banks while continuing to rely on a similar facility established by the Fed for non-banks such as Fannie Mae and Freddie Mac would create what Petrou calls a "shadow monetary-policy transmission system." Although this non-bank facility – the overnight reverse-repo program – backstops IOER as a short-term rate floor, sole reliance on it would mean that the Fed would influence rates only through entities largely exempt from prudential regulation and without access to its emergency-liquidity window. "If the Fed is forced to do without

IOER and instead relies on large non-banking institutions, investors will expect the Fed to bail out these non-banks," Petrou said. "We would thus come full circle after the crisis, creating a new class of TBTF companies even as significant progress has been made to ensure that no big bank ever gets a bail-out."

We are grateful to the American Bankers Association for funding this research. It reflects solely the views and conclusions of Federal Financial Analytics, which retained editorial and methodological control over this work.

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