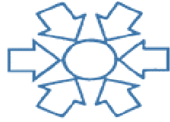

FedFin Client Report

Tuesday, May 17, 2016

Congress Considers IOER Benefits, Risks

Client Report: **IOER3**

Executive Summary

In what appears to be an initial hearing on interest on excess reserves (IOER), the FinServ Monetary Policy and Trade Subcommittee today assessed the role IOER plays in FRB monetary policy as a starting point for evaluating whether IOER should be recaptured from banks or otherwise addressed by Congress. Chairman Huizenga (R-MI) noted at the outset of the session that it had been cast by some on Wall Street as an attack on IOER, a point he did not refute even as he made it clear that this is just an opening salvo. Democrats strongly defended IOER, with Ranking Member Waters (D-CA) reversing her previous calls (see Client Report **IOER2**) for IOER to be taken from banks and used for affordable housing and similar purposes. Democrats also defended payment of IOER to foreign banks, an issue of concern to Chairman Huizenga. Although much of the session revisited issues considered in recent House legislation (see FSM Report **FEDERALRESERVE26**) on policies like the Taylor Rule, the session also served to lay out concerns on both sides of the aisle about the challenges to monetary policy and – from the GOP – the role IOER plays in permitting the FRB to engage in credit allocation and otherwise raise policy concerns. This report analyzes today's hearing.

Analysis

Opening Statements

Rep. Huizenga started by saying that foreign subsidiaries and large banks are the biggest recipients of IOER and noting that the statute does not permit IOER to exceed general short-term interest rates as he believes it now does. Even more worrying is that IOER permits, he believes, the FRB to allocate credit and exposes it to interest-rate duration risk.

Rep. Moore (D-WI) acknowledged that IOER has "horrible optics," but said she does not believe IOER to be a subsidy nor does she believe there is a credible

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alternative that can raise interest rates. Rep. Himes (D-CT) argued that expansionary monetary policy is necessary given what the majority of economists characterize as inadequate fiscal stimulus.

Testimony

Robert Eisenbeis of Cumberland Advisors said IOER should be evaluated in the context of the entire government's balance sheet (including the FRB), arguing that flawed government accounting allows FRB remittances to be counted as profits. He warned that high excess reserves limit the money multiplier and that the FRB should wind down its portfolio and decrease excess reserves. He added that subsidiaries and branches of foreign banks account for about 40 percent of excess reserves but only 10 percent of domestic deposits because they are not subject to deposit insurance assessments and also because of negative rates in Europe.

Todd Keister of Rutgers University said IOER does not cost the taxpayer since it is the FRB replacing Treasury payments on bonds, and that it is not a subsidy since banks pay interest and regulatory costs on deposits leading them to roughly break even. He argued that increased excess reserves reduce risk to the FRB and the taxpayer that result from payment overdrafts (which regularly occurred prior to 2008), and also that low excess reserves in the long run would complicate monetary policy and limit the effectiveness of prudential regulation.

George Selgin of the Cato Institute said IOER use has expanded well beyond its initial intended purpose and that its contractionary effect reduces the amount of spending in the economy. The increase in reserves has not resulted in an increase in deposits and incentives to shed reserves for other assets are lessened by IOER. Further, he argued that IOER increases the FRB's role in financial intermediation, which is not a job suited to central banks.

John B. Taylor of Stanford University noted that IOER is presently necessary due to the high levels of excess reserves. However, he said that over the long-term it turns the FRB into an increasingly discretionary institution rather than a rules-based one, making it thus capable of engaging in activities that should fall under the purview of fiscal policy. He also argued that IOER disconnects the interest rate set by the FRB and the amount of money in the economy and urged the FRB to clarify its normalization statement.

Q&A

Rep. Huizenga asked how the FRB could unwind its balance sheet and about the effectiveness of the Taylor Rule. Regarding who benefits from IOER and asset

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purchases, Dr. Taylor noted it does not provide an overall subsidy but that the FRB can enable one sector to benefit from its policies at the expense of another via the asset purchases enabled by IOER.

Rep. Moore asked if IOER still provides incentives to lend, and Dr. Keister agreed, saying the FRB's bond purchases result in new deposits from consumers that banks can use to lend.

Rep. Foster (D-IL) asked how quickly the FRB can unwind its balance sheet and why letting the assets run down may or may not be effective, with Reps. Emmer (R-MN) and Stutzman (R-IN) also pressing on the need to reduce the FRB's balance sheet. Rep. Pittinger (R-NC) asked about the damage the FRB may be doing to economic opportunity by maintaining its large balance sheet.

Rep. Himes defended IOER and asset purchases, noting that economists concur that fiscal policy has been lacking. He also defended the need for foreign banks to use IOER on grounds that some of them (citing TD) lend to consumers in his state.

Rep. Kildee (D-MI) asked how IOER is reflected in deposit rates. Prof. Keister said IOER drags up all market rates in part because banks will compete for deposits.

Rep. Schweikert (R-AZ) asked if the reverse repo program (RRP) drives up long-term mortgage rates. Mr. Keister said that hikes in short-term rates raise long-term rates. Rep. Schweikert then asked if the RRP drives out repo counterparties, leading to disagreement among the witnesses. Rep. Pearce (R-NM) asked the witnesses – who generally disagreed among themselves – about IOER's impact on lending, making it clear that he believes it does reduce incentives to lend.

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