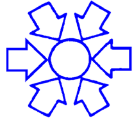 Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: January 4, 2021

On December 23, the Fed's portfolio held a jaw-dropping $7.4 trillion, beating its all-time high following the great financial crisis of $4.5 trillion and making its pre-2008 portfolio of about $800 billion seem downright quaint. Of course, that's not the only thing that now seems quaint about the old-world Fed. Once upon a time, the Fed held its portfolio to fund its own open-market operations; now, its huge book not only executes fiscal policy, but also exerts the FOMC's will via interest paid on trillions in bank reserves. On December 23, these stood at $3.2 trillion, almost double the $1.7 trillion parked at the Fed at the close of 2019. Congress has long been uneasy with interest on excess reserves (IOER). Even though the Fed now seeks to rebrand it with an "interest on reserves" (IRR) moniker, the interest paid to big banks will come under sharp and bipartisan attack as the Fed's portfolio grows ever larger and IRR amounts get still bigger. Much as many on the Hill respect the Fed, there's just so much money going to big banks that many of them won't let it pass unnoticed or unwanted.

In 2019, the Fed paid banks $35 billion, more than double the amount in 2016 when Congressional interest in recapturing these funds was so acute that we wrote an explanatory paper on the topic. The Fed hasn't released its 2020 IRR payments and it's hard to estimate them since reserves went up a lot while interest rates went down a lot. Suffice it to say for sure that the number will be eye-catching now and likely to become still more compelling shortly. A post from BPI's Bill Nelson finds that reserves may not only head to still higher levels, but also that the Fed may have to recalibrate IRR to unprecedented rates that beat the market to attract the still larger reserves the Fed must have to execute – or so it hopes – monetary policy in an era of nonbank intermediation and acute inequality.

The higher the IRR, the greater the ire. Progressives and populists – and more than a few Members of Congress in between – don't like IRR because they believe that banks would lend more if the Fed paid banks less. However, as we detailed in our paper, macroeconomic conditions, bank risk aversion, and capital rules – not IRR – dampen bank lending capacity. Banks would lend more if they felt it wise to do so because any loan would give them a better rate than the Fed – IRR now is 0.10 percent and pretty much any loan to anybody is better than that.

If banks cannot place funds with the Fed and conditions stay as is, they won't lend more. Instead, banks will curtail deposit taking to keep liabilities in line with acceptable asset-deployment options, charging fees or setting negative interest rates on funding inflows. This will drop IRR, but also push money under the mattress, propel it into a still more fevered financial market, or send it other places that do financial stability and economic equality no good whatsoever.

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The only exception to the way banks view IRR points to the policy-bending implications of IRR on its current scale. In 2018, investors filed an application to charter a bank that would do nothing but gather funds from institutional investors, park them at the Fed, and then pass a share of IRR back to its depositors, tidily beating market interest rates thereby. The Fed was so disquieted by this charter option that it put out a request for views on it even as it stalled a decision on the application with a court challenge. That case was dismissed this March in temporary favor of the Fed, but the issues this bank raises won't go away. As long as the Fed takes trillions from banks and pays them in return, demands will continue for a piece of action that's better for nonbank depositors than most other options available to them in these strange times.

It's of course possible that the Fed could find another way to set interest rates without IRR. That would indeed be more than desirable – as I've said before and as our ***EconomicEquality*** blog details, the bigger the Fed's balance sheet, the worse for sustained output and the better for equity prices and the economic inequality these diverging forces ensure. My forthcoming book will lay out another approach to equality-enhancing, effective monetary policy, but the Fed for now is stuck on IRR because it doesn't know any better way to set a floor on short-term interest rates. Without a floor on short-term interest rates, the U.S. sinks into nominal negative rates and that's even worse for the economy than when banks set negative rates on their deposits.

However, that the Fed now needs IRR doesn't mean that Congress will let it continue to pay IRR. The absence of a better policy will be a thoroughly unsatisfactory answer to a Congress facing very hard fiscal choices because the needs are so great, the sums involved are so high and the deficit is already so worrisome. A sharp economic recovery next year will alter the IRR projections outlined above, but recovery that strong and that fast seems most unlikely no matter how quickly vaccines roll out.

Congress has already taken billions from the Fed to fund highway infrastructure. It will do the same to IRR if it can't find an easier way because Democrats want more money from someone other than constituents and Republicans – especially Sen. Toomey – not only want a smaller deficit, but also a smaller Fed.

The Fed has ducked hard choices for more than a decade and it might still do so through the 2020s. However, the Fed conducted unconventional monetary policy through the 2010s in concert with a hands-off approach to fiscal policy. Now, it's neck-deep in fiscal policy and sure to stay that way for the foreseeable future. In 2020, Congress told it how to spend its balance sheet. In 2021, it could well tell the Fed also how to price it.