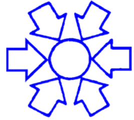 Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: March 19, 2021

On Wednesday, Jay Powell evinced an unusual bit of well-bred frustration, refusing to answer a reporter's question about the fate of the supplementary leverage ratio (SLR) exemption. No wonder – nothing upsets any of us more than avoidable mistakes. The fault at the Fed is not in the contentious SLR exemption with which the Fed has now dispensed, but in that the Fed put itself into this excruciating no-escape box due to the cumulative, unintended consequences of its ever-more complex monetary and regulatory actions.

Even before the pandemic redefined both fiscal and macroeconomic circumstances, the Fed's stubborn refusal to reckon with the structural consequences of excess reserves has been among its biggest failures. Two FedFin papers over five years ago show how this happened. The first demonstrates that, if riskless, wholly-liquid central-bank deposits come under the enhanced SLR, big-bank capacity to take deposits or hold other riskless assets is dramatically reduced. As we said then and see now, a high SLR mean that, under stress, banks save themselves, not the financial system. Sure, banks are resilient, but funds flee to MMFs and MMFs for sure are not.

A second paper the following year showed why banks put funds into excess reserves despite high capital costs related to risk. The Fed not only believed banks would continue to take deposits and house them in excess reserves if need be, but also that any such reserve balances would be temporary. Surely, its models told it, banks would go for assets with far higher return than provided by skimpy rates of interest on reserves at the Fed. This virtuous cycle would, so its mandarins believed, then stoke lending that would power demand that would lead to robust economic growth.

None of this of course occurred and it wasn't just because the March 2020 onset of COVID blew everyone's models to bits. As I've detailed elsewhere, the Fed's failure to understand America as it is – not as antiquated data analytics believed it to be – led to an unshakable faith that the U.S. economy after 2015 was in what the Fed keeps calling a "good place." It was for just a few, but it was the few who skew the data. Inequality breads slow growth and financial instability and thus it proved to be in the U.S. Earthquakes almost always come with warning tremors and the Fed had several well before 2020.

The biggest of these was the September, 2019 repo rout, a systemic calamity the Fed only averted with yet another giant bail-out. Little wonder that markets kept their ever-upward course to even higher risk after that shake-up, forcing the Fed into yet another enormous market rescue last March. Now, the Fed's portfolio stands at $7.5 trillion, bank reserves are $3.2 trillion, the Fed just bulked up its MMF backstop, and – as the latest FOMC statement makes all too clear – the Fed hasn't a clue about how to get itself out of this box.

2101 L Street, N.W. – Suite 300
Washington, DC 20037
Phone: 202.589.0880

E-mail: info@fedfin.com
Website: www.fedfin.com