Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Among the unmourned victims of 2022 is to be found modern monetary theory. Although it seemed clear from the start that MMT was a product of magical thinking, it engendered insouciance that kept fiscal deficits rising ever higher. Now, Republicans will press for fiscal austerity. Democrats will fight back, but they too will seek as much fiscal constraint as compatible with gaining power in 2024. Congress thus will look for new revenue sources that aren't taxes and quickly find one at the Fed on which both sides agree: cutting payments to the nation's biggest financial institutions.

It is difficult to calculate just how much the Fed is sending back over the transom into the financial system. One recent paper estimates it as over $100 billion a year and this might well be the case once interest on bank reserves is totaled up with the interest the Fed pays within the gigantic overnight reverse repo program (ONRRP). Whatever the sum now, it's large and it will only go up in 2023. The more rates rise, the more the Fed pays out even as it is still saddled with billions of low-yield portfolio assets.

These interest payments are already on the radar of at least one conservative analyst. His arguments channel those Republicans raised when these interest payments were last on the fiscal chopping block, a time when Democrats also said pretty much the same about wanting billions for taxpayers, not banks.

To be sure, nothing came of all these calls to recapture Fed interest. When battles raged over what was then called interest on excess reserves in the mid-2010s, Republicans and Democrats were briefly united in wanting all the money paid to banks, but this bipartisan agreement quickly broke down once Democrats decided not to attack Jay Powell over IOER as the Fed chair battled Donald Trump on the macro front.

This wholly political Democratic call won't be repeated in 2023. Then the Fed was inviolate to most Democrats; now, it's anything but even as Republicans mount an attack on the Fed's disproportionate role in financial markets in tandem with their CBDC opposition. The Fed's interest payments will thus be part of open season on the U.S. central banks.

Does this make these payments a legitimate target? In 2016, we wrote a paper explaining IOER. In the mid-2010s, the U.S. economy was still emerging from the great financial crisis and the nation's banks were rebuilding their battered balance sheets. The Fed continued to flood the financial system with cash via the quantitative easing it couldn't bring itself to taper, loan demand was low, banks were hard-pressed to find capital, and ultra-low interest rates often made the loans banks could do either unprofitable or unsafe. QE's bonanzas thus flowed into the equity markets with grave inequality consequences and from banks right back to the Fed's balance sheet.

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It was clear then that cutting interest on reserves would not have stoke more lending and that the better course was for the Fed to step back and allow markets to normalize in terms of both liquidity and rates. The Fed of course did anything but step back, in part because Congress looked the other way even though funds flowed to banks because QE was still a net blessing for the federal budget. At the time, the Fed was pumping close to $100 billion back to taxpayers from all the interest it earned on the Treasury and agency obligations it monetized.

Now, as I've noted, the Fed is operating at a net loss to taxpayers even as it shells out billions by the dozens to financial institutions that now include not just big banks, but also humongous MMFs and other financial institutions. The political and budget balance has thus tipped back in favor of interest recapture and so many on both the left and right will argue in the New Year.

However, Congress will hit a hard, hard wall of implacable fact when it tries to shut down interest on central-bank deposits and Fed reverse repos: pulling so big a plug will send a formidable shock wave though financial markets grown used to the Fed's formidable, hands-on role.

Under current conditions, banks without interest on reserves will stop taking deposits and MMFs without an ONRRP will curtail investment. Either way, the economy weakens because the central bank will have no way to stop this unless it goes back to super-accommodative policy that makes the financial system still more leveraged in thrall to an even more dominant central bank.

Inequity wrought of huge payments of taxpayer funds to private financial institutions results from a central bank so sure of itself that it refused to relinquish control over asset prices when it could have gradually stepped back to let markets fend for themselves. Unconventional is a polite word for untested policy that was radically innovative at the outset of the great financial crisis but drastically distortionary once the economy began to recover and markets started to stabilize in 2013. A decade on, the Fed owns every macroeconomic misstep and taxpayer have no option but to pay their price until the Fed realizes that the turbo-charged economic powerhouse it has become is running the financial system in dangerous, inequitable, and ultimately self-destructive directions.