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The August 9 FOMC Decision – Ineffective at Best, Dangerous at Worst

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The FOMC's decision to commit to holding its federal funds target in a range of zero to 25 basis points at least through mid 2013 strikes me as an ineffective way to accomplish one of its goals – full employment of the labor force -- and potentially dangerous with regard to another of its goals – stability in an index of goods/services prices.

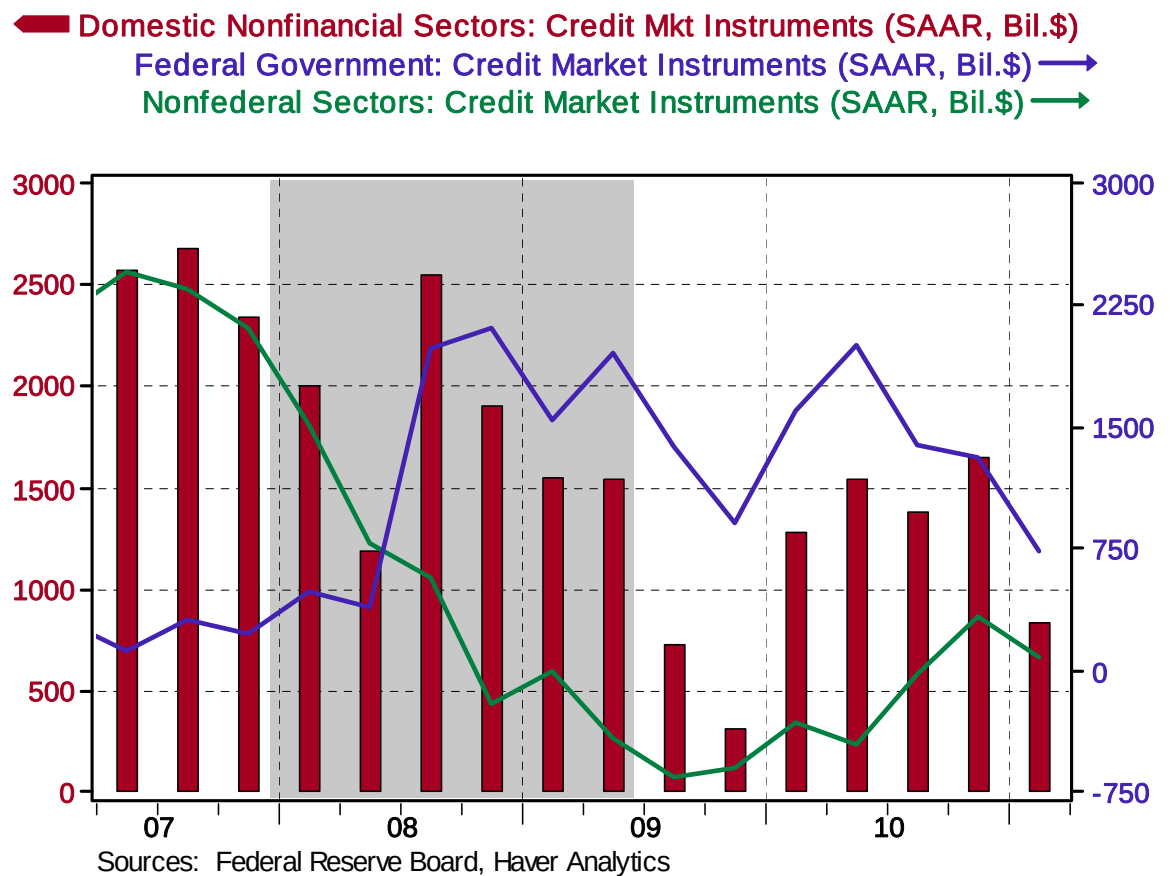
Let's start with the full employment goal. Although there undoubtedly are some structural issues keeping the unemployment rate high – e.g., the inability of unemployed mortgage brokers to quickly acquire the skills necessary to design new smart phones – the preponderance of evidence suggests that the foremost factor keeping the unemployment rate high is weak aggregate demand for goods and services in the U.S. Stimulating and curbing aggregate demand is what monetary policy is all about.

Under normal circumstances the Federal Reserve influences the pace of aggregate demand indirectly through the commercial banking system. If the Fed wants the pace of aggregate demand to speed up, it creates some credit figuratively “out of thin air” by purchasing securities in the open market from say, a government securities dealer. This creates some cash reserves in the banking system in excess of what banks would currently be required to and desire to hold. These excess reserves would push down the federal funds rate, which is the marginal cost of funds for banks. As banks' funding costs fall, they would lower their loan rates. The lower loan rates would induce an increase in the quantity of bank loans demanded. Bank credit, under normal circumstances, would then increase. Because our banking system is what is referred to as a *fractional*-reserve banking system, meaning that a bank is required to hold in the form of cash reserves only a fraction or percentage of the amount of outstanding deposit balances on its balance sheet, the amount of credit that the banking system is able to create under normal circumstances is some multiple of the amount of “seed” money provided to the banking system by the Federal Reserve in its purchase of securities from the dealer. The credit created by the banking system, like the credit created by the Federal Reserve in its purchase of securities, is credit created “out of thin air.” When credit is created out of thin air, the recipients of that credit are able to make new expenditures without the grantors of that credit having to cut back on their current expenditures. Thus, this process of the Federal Reserve initially creating some excess reserves in the banking system, leading to a decline in bank loan rates and then to an increase in bank credit will carry with it the presumption of a net increase in spending in the economy.

What I have described is what happens under *normal* circumstances. In recent years, normal circumstances have *not* prevailed. The Federal Reserve created the excess reserves to lower the federal funds rate to near zero, where it has been since mid December 2008. But bank credit has not increased. In the 135 weeks ended August 3, 2011, roughly 135 weeks since the end of December 2008, the compound annual change in commercial bank credit has been *minus 0.24%* -- i.e., close enough to zero for government work. These are *not* normal circumstances. Something appears to be wrong with the traditional transmission of Federal Reserve monetary policy through the commercial banking system.

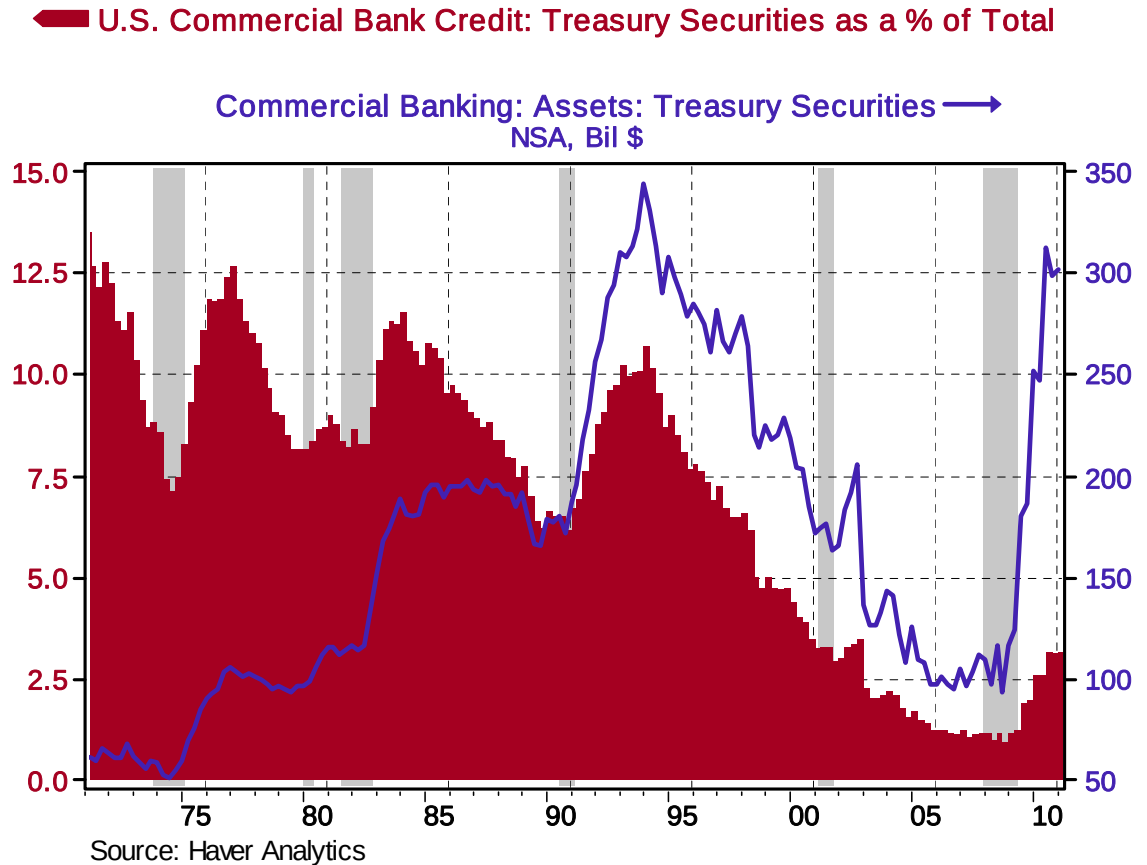
Why has not bank credit shown any net growth since the end of 2008? Some argue that there has been insufficient demand for credit. Although the demand for nonfederal nonfinancial credit may have been slack, there is no shortage of demand for credit by the federal government (see Chart 1). Although banks have loaded up on Treasury securities in *absolute* terms, relative to their total earning assets (bank credit), banks' holdings of Treasury securities at 3.21% at the end of Q1:2011 were quite low in an historical context (see Chart 2). Why have not banks purchased even more U.S. Treasury securities? After all, there has been no shortage of them to purchase.

Chart 1



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Chart 2



My hypothesis as to why bank credit has been stagnant on net for over 2-1/2 years is that many banks are reluctant to commit their *current* capital to support net new lending because of apprehension about their *future* capital adequacy. Some banks still hold “toxic” assets on their books in the form of residential and commercial mortgages. If they were to use their capital today to support new lending and at some later date had to write-down some of their assets, they could end up with insufficient capital for regulatory and/or market valuation standards. In addition, bank regulators have yet to finalize exactly what required capital and liquidity ratios will be going forward. As mentioned above, the traditional monetary policy transmission mechanism via the commercial banking system is temporarily impaired because of banks inability to create credit in a normal manner.

Enter a quantitative easing (QE) approach to monetary policy. If commercial banks are unable to create adequate amounts of credit, the Federal Reserve is able to take over this credit creation function until the banks are healthy enough to resume their traditional role. Although QE will have effects on the level of interest rates and exchange rates, these effects are the

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result of an increase in the credit created by the Federal Reserve. It is this creation of credit by the Federal Reserve that plays the leading role in stimulating aggregate demand, with resulting behavior of interest rates and exchange rates playing supporting roles.

Let's sketch out the transmission mechanism of monetary policy when QE is being used. The Federal Reserve implements QE by purchasing securities in the open market, just as it does when it wants to lower the federal funds rate in the conventional commercial banking system transmission mechanism. For simplicity's sake, let's assume that the ultimate seller of securities to the Federal Reserve is a pension fund. (The Federal Reserve would not purchase the securities directly from a pension fund, but rather through an intermediary securities dealer.) After this transaction, the pension fund now has an increase in its bank deposits and fewer securities. (The banking system also ends up with an increase in reserves equal to the dollar amount of securities purchased by the Federal Reserve. I will talk about this later). It is important to note that the increase in the pension fund's deposits appeared like "manna from heaven." No one else's deposit account was debited when the pension fund's account was credited. This increase in the pension fund's deposits was created "out of thin air." The pension fund is in the business of investing funds, not sitting on non-interest-bearing cash. So, the pension fund will likely replace the securities it just sold to the Federal Reserve (via the securities dealer) with some other securities. Again, just to make things as simple as possible, assume that a corporation is issuing some new bonds to fund the purchase of some new capital equipment. Further assume that the pension fund purchases these newly-issued corporate bonds. The increase in Federal Reserve credit has indirectly, via the pension fund, *created* some *new* credit for the economy that has, in turn, resulted in some new spending on goods and services. Under normal circumstances, this new credit would have been created by the banking system. But when banks are unable to create new credit, the Federal Reserve can step in with QE and create the credit.

Now, remember, under a fractional reserve banking system, when the Fed purchased securities to lower the federal funds rate and induce banks to make new loans, the amount of new credit created by the banking system was some multiple of the dollar amount of securities purchased by the Federal Reserve. When banks are unable to increase their loans and securities and the Fed engages in QE, the amount of new credit created for the economy is only the dollar amount of securities purchased by the Federal Reserve – *not* some multiple of that amount. Under these circumstances, rather than having a functioning *fractional* reserve banking system, we would have a *de facto* 100% reserve banking system.

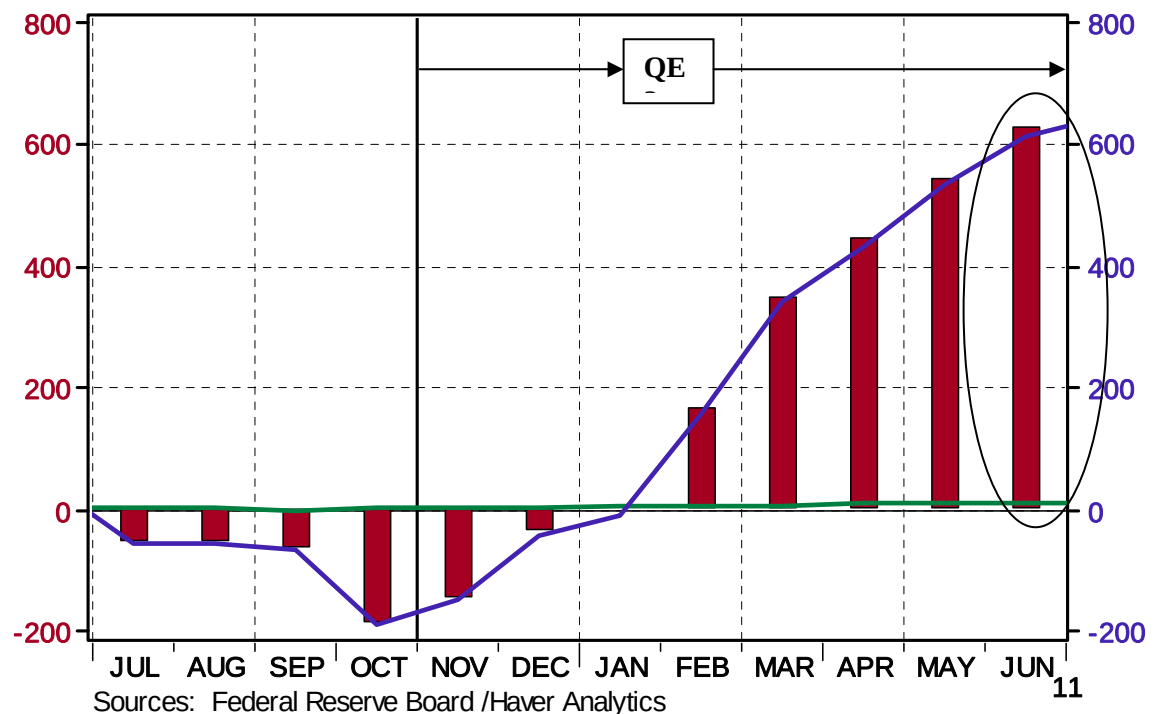
Speaking of reserves, when banks are unable to increase their loans and securities and the Fed engages in QE, what happens to those reserves created when the Fed purchases securities? As always, reserves in the banking system increase by the dollar amount of securities purchased by the Federal Reserve. A fraction of the increase in reserves gets classified as required reserves because of the increase in bank deposits associated with the Federal Reserve's purchase of securities. (Remember, the pension fund's deposits increased when the Federal Reserve purchased securities from it. Then, the pension fund transferred these deposits to the corporation when the pension fund purchased the bonds from the corporation. Then the corporation transferred these deposits to the capital equipment manufacturer. The *amount* of new deposits stayed the *same* after the Federal Reserve's purchase of securities. Just the *ownership* of these deposits *changed* as different transactions took place.) The bulk of the

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amount of new reserves created when the Federal Reserve purchased the securities from the pension fund would be classified as *excess* reserves on the books of banking system. This is illustrated in Chart 3, which shows the net dollar change in *total* reserves at depository institutions (commercial banks, S&Ls and credit unions), the net dollar change in *required* reserves and the net dollar change in *excess* reserves in the eight months ended June 2011, the eight months in which the Federal Reserve was engaged in QE. During this eight-month period of QE, the net change in total reserves was \$626 billion, which was distributed as \$615 billion net increase in excess reserves and an \$11 billion increase in required reserves. (If, under normal circumstances, the banking system were able to create credit by some multiple of the amount of credit initially created by the Federal Reserve, then there also would be an increase in deposits by some multiple of the deposit increase initially created by the Federal Reserve. This larger increase in bank deposits would change the *composition* of reserves in the banking system more toward required reserves and less toward excess reserves.)

Chart 3

8-Month Change in Total Reserves of Depository Institutions (\$ Bil.)
8-Month Change in Excess Reserves (\$ Bil.)
8-Month Change in Required Reserves (\$ Bil.)

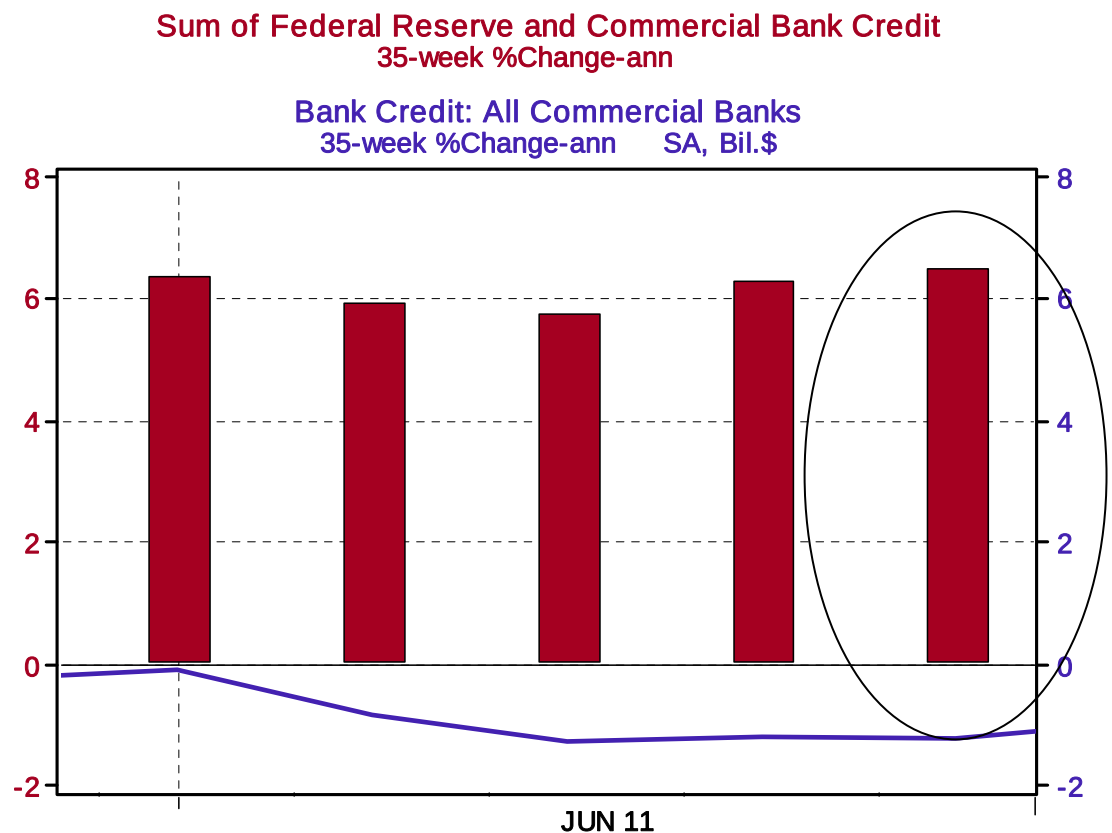


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Now you know the rationale for a QE policy and how QE affects spending in the economy. In a nutshell, under a QE policy, the Federal Reserve creates the credit to fund new spending in the economy that the banking system would otherwise do with some “seed money” from the Federal Reserve under ordinary circumstances.

The Federal Reserve’s second round of QE commenced at the beginning of November 2010 and terminated at the end of June 2011. This represented a 35-week period of QE. Chart 4 shows the 35-week annualized growth in the *sum* of Federal Reserve and commercial bank credit along with the 35-week annualized growth in commercial bank credit by itself. In the 35 weeks ended June 29, 2011, the annualized growth in the *sum* of Federal Reserve and commercial bank credit was 6.45%. Notice, however, the 35-week annualized change in commercial bank credit was *minus* 1.24%. Thus, during this period of QE, the increase in Federal Reserve credit accounted for *all* of the net increase in combined Federal Reserve and commercial bank credit.

Chart 4



Source: Haver Analytics

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Before moving on, let me make one additional comment about the Federal Reserve's approach to QE. As I have discussed above, what is important with regard to affecting aggregate demand for goods and services is the behavior of the *combined* credit created by the Federal Reserve and the commercial banking system. What is the growth in combined Federal Reserve and commercial bank credit necessary to promote full employment? I wish I knew. But what I can tell you is that the long-run average annual growth in this combined credit has been around 7%. Let's assume, after putting its *thousands* of crack economists on the case, the Federal Reserve determines that the optimal annual rate of growth in this combined credit aggregate is 5%. If the banking system is unable to create credit, then the Federal Reserve would want to pursue QE to the degree necessary to get *combined* Federal Reserve and commercial bank credit growing at a 5% annual rate. If banks later began to step up their credit creation, then the Federal Reserve would want to back off on the amount of QE it was engaged in so that *combined* Federal Reserve and commercial bank credit did not exceed 5% annualized growth. Optimally, this is how the Federal Reserve would determine how much QE to engage in. Rather than specifying a *dollar amount* of securities it planned to purchase during a time interval, the Federal Reserve would target a *growth rate* in *combined* Federal Reserve and commercial bank credit.

All of which brings us to the FOMC's August 9 decision to hold the federal funds rate in a range of zero to 25 basis through at least mid 2013. If banks were reluctant to extend net new credit before the FOMC's August 9 announcement, it is unclear as to why they would be any more willing to do so after the announcement. This is especially the case given that yields on U.S. Treasury securities declined precipitously after the FOMC announcement, making it even less profitable to lend to the Treasury rather than continuing to lend to the Federal Reserve overnight at 25 basis points. With the yield on a 3-year Treasury security hovering around 30 basis points, the pick up of 5 basis points in yield vs. lending to the Federal Reserve overnight at 25 basis points is hardly worth the interest rate risk. Unless a bank wants to take on a lot more interest rate risk by moving out on the yield curve to 5 years, where a Treasury security is trading around 95 basis points or unless a bank wants to take on more credit risk by purchasing shorter-term non-Treasury securities, there is little additional incentive for a bank to increase its loans and securities. Other than some increase in loans to speculators who are willing to take on additional interest rate risk, it is unlikely that the Fed's decision to hold the federal funds rate in its current range for the next two years will immediately do much to increase bank credit. Thus, the monetary policy implied by the FOMC's August 9 announcement is ineffective in accomplishing the Federal Reserve's goal of achieving full employment for the economy.

Why is the FOMC's August 9 decision to hold the federal funds rate in its current range for two years dangerous with respect to the Federal Reserve achieving its other goal of stability in an index of goods/services prices? A lot can change in the course of two years. Remember, as recently as June 22, the consensus view of the FOMC was that the pace of real GDP growth would be around 3-1/2% in the second half of 2011, would continue at this rate in 2012 and be somewhat higher in 2013. Apparently, by August 9, *less than two months later*, the FOMC's economic forecast had been lowered significantly. What if, in the next six months, banks believe that their future capital ratios will be strong enough to enable them to start lending again? Bank credit could take off. If the FOMC were to hold to its implicit, if not explicit,



pledge to keep the federal funds rate in a range of zero to 25 basis points through mid 2013, a highly inflationary environment could ensue.

In my view, the Federal Reserve should abandon an interest-rate targeting approach to monetary policy. Rather, it should adopt a quantitative-targeting approach – targeting the growth in the quantity of *combined* Federal Reserve and commercial bank credit. Of course, my quantitative-targeting recommendation is not new. A variation on my view was advocated over 50 years ago by Milton Friedman.

Paul Kasriel is the recipient of the 2006 Lawrence R. Klein Award for Blue Chip Forecasting Accuracy