The Fed’s Pre-Crisis Monetary Policy Framework Is Well-Suited for a Free Society

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Outline

- Argue that the Fed’s pre-crisis monetary policy implementation framework was well-suited to a free society.

- Review several of the critical decisions that drove the Fed to its current framework, in most cases because of unintended and unforeseen consequences.

- Describe how the Fed can return to conducting policy in its pre-crisis manner.
The Fed conducted Treasury purchases and relatively small repo operations with primary dealers.

Those transactions adjusted the quantity of reserves balances so as to keep the federal funds rate near its target.

The dealers were not reliant on the repo transactions with the Fed for funding, and the Fed was largely indifferent to the repo rate.

Banks transacted with each other in the federal funds market, not with the Fed.

The Fed was counterparty to only a small number of relatively inconsequential financial transactions each day.
In 2008, the Fed allowed the Treasury to switch from keeping most of its cash at commercial banks to keeping all of its cash in the Treasury’s General Account at the Fed. Doing so saved taxpayers money during the six year period when interest rates were near zero.

Other Important Decisions that Led to a Large Balance Sheet Framework

- **QE-Infinity**: Committing to purchase $85 billion in Treasury securities and agency MBS each month until there was a “substantial improvement in the outlook for the labor market.”
  - Fed staff originally projected the program to finish in June 2013 and accumulate $750 billion in assets.
  - However, purchases lasted until the end of October 2014, 15 months later than originally projected.
  - In total, the Fed bought $1.75 trillion in MBS and Treasury securities — more than double the amount originally projected.

- The Fed changed its plans to normalize its balance sheet because of the massive size of QE3.
  - Rather than sell MBS as planned, the Committee announced it would just allow the portfolio to shrink as assets matured.

- The Fed opened a standing overnight reverse repurchase agreement facility.
  - The facility effectively enabled the Fed to pay interest on deposits to a broad set of nonbanks.
Is a Large Balance Sheet Really Necessary?

- Early this year the FOMC announced that it intended to continue implementing monetary policy using a framework that requires a large balance sheet and abundant reserves.
  - In order to conduct monetary policy “without needing to actively manage the supply of reserves.”

- The quantity of reserves that the Fed has judged to be necessary for reserves to be abundant has grown steadily over time.
  - The current estimate is probably $1\frac{1}{2}$ trillion; $1\frac{3}{4}$ trillion when including a buffer to absorb volatility.

- Why have reserve forecasts risen steadily over time? In short, banks’ demand for reserves grew as the banks and their supervisors took actions that locked in those high levels.

- The Norges Bank realized this dynamic in 2010 and as a result decided to switch from a system with abundant reserves to a system with scarce reserves:

  “When Norges Bank keeps reserves relatively high for a period, it appears that banks gradually adjust to this level…With ever increasing reserves in the banking system, there is a risk that Norges Bank assumes functions that should be left to the market. It is not Norges Bank’s role to provide funding for banks…If a bank has a deficit of reserves towards the end of the day, banks must be able to deal with this by trading in the interbank market.”

  Norges Bank, October 2010
Three Steps the Fed Needs to Take to Return to its Pre-Crisis Framework

1. Control the volatility in reserve balances, especially those caused by swings in the Treasury General Account.
   - In the near-term via large high-frequency repos, in the medium-term Treasury needs to leave its cash at commercial banks.

2. Conduct a reeducation campaign for bankers and supervisors to eliminate the bias towards deposits at the Fed to meet liquidity requirements.
   - And that it is appropriate to incur daylight overdrafts and borrow occasionally from the discount window.

3. Restart the gradual decline in the securities portfolio.
   - The resulting upward pressure on short-term interest rates relative to the IOER rate will lead banks to economize on their holdings of reserve balances.
Virtuous Cycle

- Reduced volatility of reserves will allow the Fed to shrink with less risk of turmoil in money markets.

- Greater willingness to substitute Treasuries for reserve balances for purposes of meeting liquidity requirements will allow the Fed to shrink further.

- The increased opportunity cost of keeping deposits at the Fed will lead banks to find alternatives and supervisors to be more comfortable with those alternatives.
Eventually, once money market rates the Fed will have returned to conducting monetary policy in essentially its pre-crisis manner.

The fed funds market will recover as banks again seek to economize on their end-of-day balances at the Fed.

The Fed will be able to close the standing reverse repurchase agreement facility.

The marginal transaction in the fed funds market will again be between two banks rather than between a bank and the Fed.