

The Fed's paying interest on bank reserves is a far knottier problem than the senator likely realizes.



POLITICAL ECONOMICS

Ted Cruz Stumbles on a Source of Monetary Madness

Talk about the right debate for the wrong reason. A relatively obscure bit of financial regulation has become a projectile in the Capitol Hill food fight over a five-course budget bill. Alas, the thrower of this missile is missing the target.

At issue is the central bank's practice of paying interest to commercial banks on the reserve balances they deposit at the Federal Reserve. Sen. Ted Cruz (R., Texas) tried to launch a debate about this earlier in June when he suggested that if Congress barred these interest payments in its budget bill, it would save the government \$1 trillion over 10 years.

Many voters might be surprised to discover the Fed is making such large payments to banks. When Congress in 2006 authorized the central bank to pay interest on reserve balances as of 2011, it seemed like an academic matter. The theory was that to satisfy regulatory reserve requirements, banks must forgo the income they otherwise would earn from that capital. That lost revenue constitutes a form of tax, and the Fed could soften the blow by paying interest on those reserve balances. *

The stakes appeared low. Before the 2007-08 panic, reserve balances tended to be relatively small, and one could argue that the "tax" was a fair price for banks to pay for access to Fed support in times of trouble.

But once the central bank started inflating its balance sheet in 2008 with emergency lending and then asset purchases under quantitative easing, the interest-on-reserves question became more pressing. As the Fed accumulated Treasuries and mortgagebacked securities on the asset side of its balance sheet, it needed to create offsetting liabilities. The easiest way to do this was to increase banks' reserve deposits: The Fed would buy Treasuries from banks, and then banks would hold reserve balances instead of Treasuries as safe assets. - Note

By mid-2008 these balances were climbing above the levels banks were required by regulatory diktat to hold, thanks to the Fed's early financialpanic interventions to inject liquidity into the system. The scale meant the "tax" implied by nonpayment of interest was much larger. And as the Fed prepared to launch QE, its new-look monetary policy wouldn't work if banks weren't willing to play along by holding these large reserves. Hence the Fed under Ben Bernanke prevailed on Congress to pull forward to 2008 the date when interest payments could begin, and to allow interest payments on excess reserves—those above regulatory requirements. *

This wasn't a modest policy tweak. It's at the core of the way the Fed operates now. For long periods after 2008 the interest rate paid on reserves had a greater effect on the financial system than the overnight fed-funds rate that the Federal Open Market Committee sets with great fanfare at each policy meeting, because the rate paid on reserves directly influenced banks' decisions. *

Nowadays the Fed finds it must pay interest on reserves to maintain the large-balance-sheet policy to which it's committed. Were these interest payments to stop, banks might prefer to hold interest-bearing Treasuries instead of the reserves that help balance the many assets in the central bank's possession. A decline in reserve balances (currently around 50% of the Fed's liabilities) might force it to accelerate quantitative tightening by selling off assets. *

There's a lot here for Congress to chew on. The interest-on-reserves policy has assumed an importance no one anticipated when it was introduced, because it allows the central bank to maintain a much larger balance sheet than Congress ever formally approved—a decision with profound financial, fiscal and economic consequences. *

Especially since the Fed is about to tweak rules governing banks' holdings of Treasuries in ways that could make the bonds an attractive alternative to reserves on banks' balance sheets. An important question in this environment is how big the central bank's balance sheet really needs to be. The Fed says it must be large because banks demand "ample reserves," but banks are just as likely to say they maintain those reserves because the Fed signals via interest payments that it wants them to. Which is it? ?

Mr. Cruz isn't making this argument now. His fiscal complaint—that the interest payments cost the taxpayer money—is only partly true. The Fed pays interest on reserves out of its own resources. Although the central bank currently is losing money as a result, this merely eliminates the remittances of profits the central bank used to pay to the Treasury. Treasury isn't receiving payments from the Fed, but taxpayers aren't writing checks to the Fed, either. *

Still, the wisdom or otherwise of paying interest on reserves is a string Congress could pull on to good effect. If lawmakers do, they might start unraveling many of the Fed's knotty policy innovations of the past 15 years. And we might finally get a serious political debate about what role exactly we want the Fed to play in our economy.

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