The Third and Final Transformation of Monetary Policy

By John Mauldin | April 26, 2015

The Fed Funds Rate: R.I.P.
San Diego, Raleigh, Atlanta, New York, New Hampshire, and Vermont

The law of unintended consequences is becoming ever more prominent in the economic sphere, as the world becomes exponentially more complex with every passing year. Just as a network grows in complexity and value as the number of connections in that network grows, the global economy becomes more complex, interesting, and hard to manage as the number of individuals, businesses, governmental bodies, and other institutions swells, all of them interconnected by contracts and security instruments, as well as by financial and information flows.

It is hubris to presume, as current economic thinking does, that the entire economic world can be managed by manipulating one (albeit major) subset of that network without incurring unintended consequences for the other parts of the network. To be sure, unintended consequences can be positive or neutral or negative. This letter you are reading, which I've been writing for over 15 years and which reaches far more people than I would have ever dreamed possible, is partially the result of a serendipitous unintended consequence.

But as every programmer knows, messing with a tiny bit of the code in a very complex program can have significant ramifications, perhaps to the point of crashing the program. I have a new Microsoft Surface Pro 3 tablet that I'm trying to get used to, but somehow my heretofore reliable Mozilla Firefox browser isn't playing nice with this computer. I'm sure it's a simple bug or incompatibility somewhere, but my team and I have not been able to isolate it.

However, that's a relatively minor problem compared to the unintended consequences that spill from quantitative easing, ZIRP, and other central bank shenanigans. We have discussed the problem of how the Federal Reserve has pushed dollars on the rest of the world and is playing havoc with dollar inflows and outflows from emerging markets. More than one EM central banker is complaining aggressively.

My good friend Dr. Woody Brock makes the case that an unintended consequence of QE is that the Federal Reserve's normal transmission of monetary policy through periodic changes in the fed funds rate has been vitiated. He contends that soon we will no longer care about the fed funds rate and will be focused on other sets of rates.

This is an important issue and one that is not well understood. Woody has given me permission to reproduce his quarterly profile. For Woody, this is actually a fairly short piece; but as usual with Woody's work, you will probably want to read it twice.

Woody is one of the most brilliant economists I know, and I make a point of spending time with him as our schedules permit. We are making plans to get together at his Massachusetts retreat in August. He is restructuring his business in order to spend more time writing and less time traveling, and he intends to lower the price of his subscription. It will still be pricey for the average reader, but for funds and institutions it should be a staple. You can find his website at www.SEDinc.com or email him at SED@SEDinc.com.

Before we go to Woody's letter, if you're going to be at my conference this coming week, you've already made arrangements. I know a lot of people wanted to go but just couldn't work it into their schedules. I won't say it's the next best thing to being there, but you can follow me on Twitter, where my team and I will be sending out real-time tweets about the important ideas and concepts we are hearing, not just from the speeches but from all the conversations that spring up during the day and late into the evening. If you're curious as to who will be there, here's a page with the speakers. If you're at the conference, look me up.

The Fed Funds Rate: R.I.P. – The Third and Final Transformation of Monetary Policy

By Woody Brock, Ph.D.
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The policy announcements of the US Federal Reserve Board are dissected and analyzed more closely than any other global financial variable. Indeed, during the past thirty years, Fed-Watching became a veritable industry, with all eyes on the funds rate. Within a few years, this term will rarely appear in print. For the Fed will now be targeting two new variables in place of the funds rate. One result is that forecasting Fed policy will be more demanding.

To make sense of this observation, a bit of history is in order. During the last nine years, US monetary policy has been transformed in three ways. To date, only the first two have been widely discussed and are now well understood. The third development is only now underway, and is not well understood at all. To review:

First, the Fed lowered its overnight Fed funds rate to essentially zero, not only during the Global Financial Crisis of 2008–2009, but throughout nearly six years of economic recovery thereafter. The average level of the funds rate at the current stage of recovery was about 4% during the past dozen business cycles. It was never 0% as it is in this cycle. In past essays, we have argued that this overutilization of "ultra-easy monetary policy" reflected the failure of the government to utilize fiscal policy correctly (profitable infrastructure spending with a high jobs multiplier), and to introduce long-overdue incentive structure reforms. It was thus left to monetary policy to pick up the pieces after the global crisis of 2008. This development was true in most other G-7 nations, not just in the US.

Second, the Fed inaugurated its policy of Quantitative Easing whereby it increased the size of its balance sheet five-fold from $900 billion to $4,500 billion. Such an expansion would have been inconceivable to Fed watchers during the decades prior to the Global Financial Crisis. In the US, QE is now dormant, and the only remaining question (answered below) is how and when the Fed will shrink its bloated balance sheet back to more normal levels.

Third, the way in which the Fed conducts standard monetary policy (periodic changes in the funds rate) is currently undergoing a complete makeover. In particular, the traditional tool of changing the funds rate via Open Market operations carried out by the desk of the New York Fed no longer works. For as will be seen, the vast expansion of the size of its balance sheet (bank reserves in particular) has rendered traditional policy unworkable. From now on, therefore, the Fed will conduct monetary policy via *two* new tools that were not even on the drawing board of the Fed prior to 2008.

Summary: In this ***PROFILE,*** we explain in Part A why traditional (non-QE) monetary policy has been vitiated by QE. In Parts B and C respectively, we discuss the two new tools that will be used in the future to conduct standard (non-QE) monetary policy: what exactly are these tools, and how do they work? In Part D, we discuss why these new tools will not be required by the European Central Bank, which has a different institutional structure than the US Fed. Finally, in Part E, we turn to QE and discuss when and how the Fed will shrink its balance sheet back to a more traditional size in the years ahead.

In this write-up, we largely rely on the remarks set forth in a recent paper by Fed Vice Chairman Stanley Fischer, formerly chief economist of the IMF, Governor of the Central Bank of Israel, and professor of economics at MIT. We also benefitted from clarifications by Professor Benjamin Friedman at Harvard University.

Part A: So Long to Setting the Funds Rate via Open Market Operations

Prior to the financial crisis, bank reserve balances with the Fed averaged about $25 billion. With such a low level of reserves, a level controlled solely by the Fed, minor variations in the amount of reserves via Fed open market sales/purchases of securities sufficed to move the Fed funds rate up or down as desired. Analytically, the market for bank reserves (Fed funds) consisted of a *demand curve* for bank reserves reflecting the nation's demand for loans, and a *supply curve* reflecting the supply of reserves by the Fed. The so-called Fed funds rate is the point of intersection of these two curves (the interest rate). If the Fed targeted, say a 2% funds rate, it achieved and maintained this rate by shifting the supply curve left or right by adding to/subtracting from the quantity of reserves. As the Fed was a true monopolist in the creation/extinction of reserves, it could always target and sustain any funds rate it chose.

These operations constituted "monetary policy" for many decades. But this is no longer the case, as was first made clear in a FOMC policy pronouncement of September 2014. To quote Dr. Fischer in his 2015 speech, "With the nearly $3 trillion in free bank reserves (up from pre-crisis reserves averaging $25 billion), the traditional mechanism of adjustments in the quantity of reserve balances to achieve the desired level of the Federal funds rate may not be feasible or sufficiently predictable." What new mechanisms will replace it? There are two.

Part B: The Use of Interest Rates Paid by the Fed on Free Bank Reserves

"Instead of the funds rate, we will use the rate of interest paid on excess reserves as our primary tool to move the Fed funds rate." The ability of the Fed to pay banks an interest rate on their free reserves dates back to legislation of October 2008. This rate has been set at 0.25% during the past few years. ("Excess" or "free" bank reserves are defined as the arithmetic difference between total reserves and required reserves. Currently, as of March 30, required reserves were $142 billion, and total reserves were $2.79 trillion.)

The Logic: Whatever the level of the reserve interest rate that the Fed chooses, banks will have little if any incentives to lend to any private counterparty at a rate *lower* than the rate they can earn on their free reserve balances maintained at the Fed. The higher the reserve remuneration rate is, the greater will be the upward pressure on a whole range of short-term rates.

Part C: The Use of the Reverse Repo Rate

"Because not all institutions have access to the excess reserves interest rate set by the Fed, we will also utilize an overnight reverse repurchase purchase agreement facility, as needed. In a reverse repo operation, eligible counterparties may invest funds with the Fed overnight at a given interest rate. The reverse repo counterparties include 106 money market funds, 22 broker-dealers, 24 depository institutions, and 12 government-sponsored enterprises, including several Federal Home Loan Banks, Fannie Mae, Freddie Mac, and Farmer Mac."

The Logic: Fischer continues: "This facility should encourage these institutions to be *unwilling* to lend to private counterparties in money markets at a rate *below* that offered on overnight reverse repos by the Fed. Indeed, testing to date suggests that reverse repo operations have generally been successful in establishing a soft floor for money market interest rates."

Summary

Due to the explosion of the size of its balance sheet (bank reserves in particular), the Fed has been forced to abandon management of the Fed funds rate via traditional open market operations. This activity is now being replaced by two new policy tools, both of which are somewhat "softer" than the older tool. First, bank's free reserves now earn an interest rate on excess bank reserves which is available to banks with access to the Fed's reserve facility. Second, financial institutions such as money market funds lacking access to the reserve facility will be able to lodge funds overnight (not necessarily merely one night) at the Fed and receive the reverse repo rate offered by the Fed.

Part D: Irrelevance of these Developments to the European Central Bank

Interestingly, the European Central Bank does not need and will probably not implement the policy innovations now being implemented by the US Fed. The reason is that in Europe, lending is dominated by banks far more than here in the US. Moreover, most all European financial institutions can in effect deposit funds with the central bank. Finally, the ECB has long been able to vary the reserve remuneration (interest) rate that it pays for excess reserves. As a result, the ECB does not need to utilize the reverse repo rate tool that the Fed is introducing.

One final point should be made. Whereas Professor Fischer above asserts that the primary tool of the Fed will be variations in the reserve remuneration rate applicable to banks, other scholars believe it is the reverse repo rate that will be the primary tool of US monetary policy. This is partly because of the ongoing reduction of the role of banks in lending to private sector borrowers, a longstanding development that has accelerated with the new regulations imposed on banks since the Global Financial Crisis.

Part E: Will the Fed Shrink its Balance Sheet Back Down? If So, How?

Professor Fischer answers this point directly. Yes, the Fed will shrink its balance sheet, but not to the size of yesteryear. More specifically:

"With regard to balance sheet normalization, the FOMC has indicated that it does not anticipate outright sales of agency mortgage-backed securities, and that it plans to normalize the size of the balance sheet primarily by ceasing reinvestment of principal payments on our existing securities holdings when the time comes... Cumulative repayments of principal on our existing securities holdings from now through the end of 2025 are projected to be $3.2 trillion. As a result, when the FOMC chooses to cease reinvestments of principal, the size of the balance sheet will naturally decline, with a corresponding reduction in reserve balances."

Hopefully these remarks have helped clarify past and future changes in Fed policy—changes that amount to a thoroughgoing transformation of US monetary policy that would have been unimaginable a decade ago.

In the future, we suspect that the press will refer to the Fed's targeting of the "reverse repo rate" in place of the Federal funds rate when analyzing prospective monetary policy.

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I am excited about going to the 2015 Strategic Investment Conference on Tuesday. If for some reason you get there early on Wednesday, I intend to be in the gym at the hotel about 2:30, so come by and let's work out together. Again, don't forget to follow me on Twitter while I'm at the conference.

In the middle of May I go to Raleigh to speak for the Investment Institute and then on to Atlanta, where I'm on the board of Galectin Therapeutics. I'm going to New York the first week of June, then up to New Hampshire, where I will be speaking with a number of friends at a private retreat. I will then somehow get to Stowe, Vermont, to meet with my partners at Mauldin Economics. The rest of the summer looks pretty easy, with a few trips here and there.

Next week I intend to share my speech at the conference, or at least the gist of it. I have been thinking about it and working on it for some time. I had dinner this week with Mari Kooi, former fund manager who has become deeply imbedded with the Santa Fe Institute, an intellectual hotspot famous for its maverick scientists and interdisciplinary work on the science of complexity. Some of their people are working on something called complexity economics, which is an attempt to move on from the neoclassical view of general equilibrium. If you wonder why the theories and models don't work, it is because traditional economists are still busy trying to describe a vastly complex system by assuming away all the change except for that they believe they can control with the knobs they twist and pull. Their model of the economy resembles some vast Rube Goldberg machine where, if you put X money in here at Y rate, it will produce Z outcome over there. Except that they don't really know how the actions of the market will play out, since the market is made up of hundreds of millions of independent agents, all of whom change their behavior on the fly based on what the other agents are doing. Not to mention the effects of herding behavior and incentive structures and a dozen things beyond the ken or control of economists. There is only equilibrium in theory.

And that's why it is becoming increasingly difficult to predict the future. The agents of change are multiplying and changing faster than we can keep up. But next week I will throw caution to the wind (unless I give up in despair), and we'll see what my very cloudy crystal ball suggests lies in our future.

I am really looking forward to seeing old friends and making new ones at the conference. Have a great week.

Your trying to find simple in a complex world analyst,

John Mauldin

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