

Applying the Brakes

The Four Long and Winding Monetary Policy Routes
Available to the Federal Reserve in
“Normalizing” U.S. Interest Rates

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The Long and Winding Road to Normalcy

It is highly likely that this week will see the Federal Reserve's Open Market Committee elect to increase the Fed Funds policy rate of interest for the first time since June of 2006, and after slashing the rate to the lowest level in history—approaching the so-called zero lower bound.

But the return journey to interest rate policy rate normalcy will be a long and winding one. The ability to influence longer term interest rates, over which the Fed has no direct control, will be even more limited (in fact we believe, that after the Fed's move and any interim market volatility, long term interest market interest rates are likely to fall if the global economy maintains its present trend).

Yet it is very clear that the policy makers at the Fed are quite anxious to regain the control over monetary policy that they very much lack at the zero lower bound—if only to be able to do something when a new recession emerges.

Here, then, are the four routes that the Fed may choose to head down in order to achieve interest rate normalization, and our opinion of how effective (or ineffective) each policy is likely to be if implemented.

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- **The Policy Rates—Fed Funds and the Discount Rate**

How it works

- The Federal Reserve Banks are the banks to the banking industry. When a bank is short of liquidity (generally overnight) it can obtain loans from the Fed, based on the quality of its balance sheet and/or the pledge of specific assets (discounting). The Fed sets a target rate for each of these policy rates and, in normal times, these rates often act as a benchmark for banks' own short term lending to clients, as banks lend at a margin to their own cost of funding.

Effectiveness in Current Environment

- When lending activity is brisk, and bank liquidity is tighter, the Fed Funds rate (and, to a far lesser extent, the discount rate, as discounting is far less common) can have a substantial impact on market interest rates. But today, banks are awash in surplus liquidity. Even if a bank needs an overnight injection of liquidity, it can easily find that from another bank, happy to lend the money rather than leave it idle. The banking system in the aggregate has over \$2 trillion of excess reserves (vs. mandatory reserves), most of which is on deposit at the Fed itself. So raising the Fed Funds rate will have no real effectiveness other than psychological.

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- **Paying Banks Interest on Bank Reserves**

How it works

- Prior to the financial crisis, whatever small amounts (less than \$200 billion) that the banking industry had on deposit at the Fed earned no interest. In the distress of the crisis, in one of the many ways that the Fed bailed out the banking system, the Fed commenced paying interest on reserves at 25bps per annum. In theory, of course, paying interest to banks to have their funds sit idle is contractionary. But income was far more important to banks in the crisis and reserves were building at a frantic pace relative to lending opportunities. If the Fed were to tighten by increasing interest paid on reserves, it could – in theory – slow (or raise the cost of) market lending.

Effectiveness in Current Environment

- Here we get into a “through the looking glass” sort of policy world. Why, with the economy less than robust, would the Fed want to discourage or limit bank lending in the first place? Yet, the whole purpose of monetary tightening is to do exactly that in order to lessen the chance of the economy overheating in the future (as well as, at the zero bound at which we now find ourselves, to enable the Fed to regain control of monetary levers). But here too there is a problem in assuming that such a move would be effective. There simply isn’t a lot of loan demand by creditworthy borrowers. Sure, there are plenty of non-creditworthy borrowers out there who would love to have money, but lending to them is (at least post-financial crisis) not the business of banking. So paying more interest on reserves (while certainly welcome by the banks) is unlikely to force up market rates all that much.

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- **Reverse Repurchase Agreements**

How it works

- As most everyone knows, the Fed was on a five+ year buying binge to acquire U.S. Treasury and Mortgage Backed Bond Securities, beginning in 2009. It now owns trillions of dollars of government debt and government-guaranteed debt. The easiest way to force interest rates higher (which would be traumatic at this time) would be to simply dump those securities back into the market (see next slide). Instead, the Fed can pull money (cash) out of the system by “borrowing” against the securities it holds on a short term basis to banks and non-banks with excess cash. As it offers more of these securities for overnight or short term “repo” it would at some point push the rates it pays on the repo contract higher, because it will reduce the availability of excess cash laying around.

Effectiveness in Current Environment

- At this time, reverse repos constitute the Fed’s greatest hope for managing interest rate policy. They have the advantage of being flexible and very reversible if things go downhill in the economy. The NY Fed’s open market operations unit can offer fewer or more repo contracts each day to adjust market interest rates. Furthermore, since the Fed owns securities of varying maturities, it can play up and down the yield curve, in theory. The problem is, this has never been done before in scale and no one knows how it will really play out, or—of greater importance, perhaps--how the market will work to “game” the Fed’s repo activity in order to better profit from it.

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- “Quantitative Tightening”

How it works

- As alluded to above, the Fed – in theory – could simply sell back to the market the enormous volume of government securities it acquired post-financial crisis. This would be a blunt instrument of the highest order. If they sell enough securities, it would push interest rates higher by draining cash from the system.

Effectiveness in Current Environment

- This method is anathema in the Fed’s current thinking. It could only be reversed by a resumption of quantitative easing and would push interest rates much higher and very rapidly. This is a supply and demand issue. The Fed holds the largest inventory of U.S. government bonds on the planet and if the market believes that inventory is going to be dumped, the price of bonds will plummet, driving interest rates higher and the economy of the U.S., if not the world, into a nose dive.