

Workshop Summary Remarks

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Before the global financial crisis, the implementation of monetary policy was focused only on one thing--achieving the FOMC's target for the federal funds rate; and the techniques for doing so relied on very small changes in the supply of excess reserves, which were in minimal demand by banks because they were not remunerated. A number of developments during the crisis and the slow recovery thereafter have substantially altered the approach to this critical objective and opened up new potential objectives and challenges for open market operations and the Federal Reserve's portfolio. First, the Congress speeded up the authorization for the Federal Reserve to pay interest on reserve balances, and the Fed took advantage of this in the implementation of policy as its portfolio rose above the level consistent with minimal excess reserves. Second, the securities portfolio grew exponentially as the FOMC undertook repeated rounds of large-scale asset purchases (known to everyone else as QE) and the composition of the portfolio shifted to include MBS and agency securities in addition to Treasuries and RPs. Third, the Federal Reserve began dealing with a much wider range of nonbank counterparties than the primary dealers to which it had previously confined its operations, including money market funds, opening a reverse RP facility to these counterparties that helped put a floor under the federal funds rate. Fourth, new regulations on capital and liquidity have constrained the way banks and traditional Fed counterparties have transmitted FOMC targets to other markets. And fifth, the experience of the crisis and slow recovery at very low rates has suggested that the Federal Reserve may well need to be ready to deal with the zero lower bound on its policy interest rate in the future.

The workshop dealt with these changes and their possible implications for monetary policy implementation by the Federal Reserve and other central banks. The Fed's larger portfolio along with the expanded list of counterparties in particular has pointed to potential avenues to combine monetary policy implementation with efforts to reduce or deal with risks of financial instability. The workshop presentations had several important messages: spelling out the objectives of policy implementation carefully, especially where those objectives went beyond the traditional goal of achieving the FOMC's policy rate objective; explaining those objectives and the use of the portfolio to the public and the Congress; dealing with governance--delineating clearly who is responsible for achieving a policy objective

and how they will be held accountable; and assessing the costs and benefits of using the Fed's portfolio as a tool to achieve a policy objective relative to other tools.

One set of complications that called for careful coordination with other agencies and full public discussion were the possible implications of an expanded portfolio for fiscal policy, for debt management, and for credit allocation. Although monetary policy always has had some fiscal impact through increases and decreases in interest rates, these traditional effects seemed to be well understood by the Congress and administrations over the years. But the expanded portfolio implied new types of fiscal effects and risks derived from the portfolio itself. Even a portfolio of all Treasury securities carries duration risk when it is concentrated in longer-term securities. And such a portfolio interacts in complex ways with the Treasury's responsibility for determining the maturity structure of the debt in the hands of the public--debt management. A portfolio with shifting proportions of mortgage-related debt in it affects credit allocation—an area the Federal Reserve had tended to avoid with its open market operations in the past.

Full public discussion of policy implementation and objectives seems particularly important in the current political environment. Discomfort with Federal Reserve actions during the crisis and recovery together with political polarization and gridlock has made clear, understandable, transparent explanations and rationales for any changes in Federal Reserve operating techniques or objectives especially important to forestall further erosion of public and legislative support for the Federal Reserve and for its independent conduct of monetary policy.

What do you need for minimal monetary policy implementation—achieving the FOMC's rate target?

Even before the crisis, the Federal Reserve had begun to consider the implications for policy implementation of the ability to pay interest on reserve balances. Many central banks ran corridor systems in which the policy rate lay between a floor of the deposit rate at the central bank and a ceiling of the rate for bank borrowing from the discount window. This type of system might be established in the US, but it requires that excess reserves once again become quite scarce—that the Fed's portfolio shrink to the minimum necessary to achieve the policy objective-- so that banks can profitably do the small amount of arbitrage required to keep the rate inside the corridor.

The regulatory response to the crisis has complicated the implementation of monetary policy. The supplemental leverage ratio will be binding or potentially binding for several large banks and bank affiliates who traditionally have arbitrated money markets to transmit the FOMC's target to other money market rates. In current circumstances, the rate on excess reserve balances held by banks at the Federal Reserve, which should be a floor for market rates, no longer serves that purpose, because bank players incur a capital charge when they borrow in the open market to deposit at the Fed (and such arbitrage transactions may also increase

their FDIC insurance fee.). Other players who do not incur such a capital charge—for example money market funds or GSEs—also cannot hold deposits at the Fed nor earn interest on excess reserves. As a consequence, the Federal Reserve has been implementing policy with in effect two floors—the IOER rate for those who can make deposits, and the RRP rate for those who cannot. The combination of capital charges and FDIC fees for those who can earn interest on balances at the Fed and a lack of access to IOER for those who are not subject to such charges and fees has meant that the IOER rate has been a soggy floor and federal funds have traded around 12 basis points below it.

The new liquidity coverage ratio, which incents banks to hold high quality liquid assets of 30 days or less and discourages bank borrowing for fewer than 30 days poses a further complication to arbitrage and transmission of FOMC target rate changes to other money markets. The Federal Reserve needs to keep a careful eye on the effects of this requirement on market rates, particularly further out the money market yield curve, and it may need to adjust the maturity of its own operations to ensure it is having the effect on market rates consistent with FOMC objectives.

Although a corridor system with reserve scarcity will probably work in the future after the Fed's portfolio is much smaller, as long as excess reserves are plentiful, a floor system, with the IOER rate was equal to the RRP rate and both aligned at the FOMC target, should also allow open market operations to achieve the rate objective of the FOMC. Such a system can be used temporarily until the portfolio shrinks or more permanently if a decision is made to keep a larger portfolio. But in a floor regime, the Federal Reserve would retain a much larger presence in the money markets than it had before the crisis. For example, money market funds and GSEs lending to the Federal Reserve in RRP's would likely replace some portion of their lending to banks and nonbanks in the CD and CP markets. But in turn, these nonbank entities likely would be the marginal arbitragers between the FOMC's target and the rest of the money markets, in effect replacing or supplementing the interbank market where volumes and rate relationships have been affected by regulation.

The Federal Reserve's ability to pay interest on reserve balances is critical to either the corridor or floor system. That ability has been challenged in Congress, in part because of the appearance that an IOER rate above the federal funds rate is a subsidy to the banks holding the excess reserve deposits. It is not because those deposits need to be funded in part by new capital, which is far more expensive than federal funds. But the Federal Reserve must do a more convincing job of explaining both why interest on reserves is so important and why it is not a subsidy, but rather the reduction of a tax that had in the past gave incentives for economically inefficient avoidance.

Should the Federal Reserve's portfolio be used for financial stability purposes?

A floor system with a larger central bank portfolio opens up the possibility of using the size and composition of the portfolio for other purposes—especially for financial stability. Several suggestions were discussed at the workshop involving two broad channels--utilizing the composition of the portfolio to affect spreads between assets and utilizing the RRP to provide an abundance of safe, liquid assets.

With regard to spreads, the balance between MBS and Treasury securities in the Fed's portfolio could be altered to affect mortgage rates and the residential real estate cycle, which has been the source of episodes of financial instability even before the most recent crisis. Sales of MBS when the housing market became exuberant and purchases in severe downturns might help to damp the cycle and mitigate its effects on financial stability. Likewise, the Federal Reserve might want to use its portfolio to operate on the spread between short and long-term rates under some circumstances. For example, concerns that low long-term rates were contributing to excessive risk taking might be countered by selling long-term Treasuries or agencies in favor of shorter term holdings to raise term premiums without greatly affecting the basic trajectory of monetary policy, just as buying long-duration securities after the crisis helped to induce portfolio shifts to longer term and more risky assets. As noted, these sorts of transactions raise questions about fiscal risk, credit allocation, and debt management responsibilities that should be explored and discussed openly.

A large portfolio "financed" by RRP and reserves would increase the Federal Reserve's supply of short-term liquid assets to market participants. Purchases of Treasuries to provide reserves would not increase the supply of high quality liquid assets for the banks to meet regulatory requirements, but it might reduce the premium on safe money like assets. Demands for these assets were one of the factors that led to the creation of supposedly very safe assets prior to the crisis by the private sector—assets that turned out to be less than safe in a panic.

Pursuing financial stability objectives in the US is complicated by the multiplicity of agencies with overlapping authority, the role of the Financial Stability Oversight Council with the Secretary of the Treasury as its chair, and the resulting lack of a clear mandate and accountability for financial stability aligned with control over instruments. Before using the portfolio in this way, the Federal Reserve should lead a discussion of alternatives—is the portfolio the right, most efficient and effective tool for the purposes intended; who will define the objectives; who will make decisions (within the Federal Reserve as well as among agencies); and who will be held accountable.

What are the Federal Reserve's plans for policy and policy implementation at the zero lower bound?

The experience of the past several years in the US and elsewhere suggests that monetary policy makers will find themselves in the future with their target rate

at or very close to zero and wanting to ease financial conditions further to bolster employment and keep inflation near its target. Any future framework needs to be adaptable to the ZLB.

To prepare for this possibility, the Federal Reserve could usefully engage in a discussion of the tools it might employ. Should it be thinking about negative interest rates and does it have the legal authority to put this into effect? What role would liquidity facilities play under what circumstances in a return to the ZLB? How does the Fed evaluate the effectiveness of the various tranches of LSAPs and forward guidance it utilized in the crisis and slow recovery? What do its plans and intentions imply for how it will implement policy away from the ZLB?

In my view, such a discussion would yield considerable benefits to the Federal Reserve, its congressional overseers, the financial markets trying to anticipate the Federal Reserve's actions, and to the public at large. Those benefits would be further enhanced and the Federal Reserve's reputation for transparency greatly increased if some of that evaluation of past actions were carried out by nonpartisan outside experts, as is done in a number of other countries.