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RESEARCH SUMMARY

THE FEDERAL RESERVE'S EXIT STRATEGY
Looming Inflation or Controllable Overhang?

The recent financial crisis led to substantial changes in the operations of the Federal Reserve (Fed), which now holds financial assets that are five times greater in value than before the crisis. The Fed has also increased the money supply through quantitative easing. Rather than using this money to make loans that put even more money into the pockets of Americans, banks have stockpiled it in their reserves. Many economists and commentators fear that, once the economy returns to normal and interest rates rise, banks will begin to increase the money supply with new loans—unleashing very high inflation.

In a new research paper for the Mercatus Center at George Mason University, economist Jeffrey Rogers Hummel explains that the concern over high inflation is likely unwarranted because of tools the Fed has at its disposal to restrain inflation. However, a realistic fear is that the Fed will not reduce its balance sheet after an economic recovery. Instead, it will allocate large amounts of credit within the financial system. When considering the Fed's exit strategy from quantitative easing, policymakers should keep this principle in mind: **Markets should allocate credit, not a financial central planner.**

To read the study in in its entirety and learn more about the author, see "The Federal Reserve's Exit Strategy: Looming Inflation or Controllable Overhang?"

NEW FED TOOLS

The Fed lacks congressional authorization to borrow money by issuing its own securities, but it has four tools that can accomplish the same objective:

- *Treasury loans*. In late 2008, the Fed's balance sheet swelled to nearly one and a half times the monetary base. The Fed accomplished this by using money borrowed from the general public through the Department of the Treasury and lending it to foreign central banks in liquidity swaps. While this practice was discontinued in 2011 due to concerns over the debt ceiling, it remains a viable option if needed.

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- *Reverse repos*. Even though the Fed cannot borrow by issuing its own securities, it can do essentially the same thing by borrowing through reverse repurchase agreements (repos): selling securities from its portfolio with an agreement to buy them back. This is a way to reduce the monetary base without selling off assets, and now, even government-sponsored entities such as Fannie Mae and Freddie Mac may earn interest by lending money to the Fed through a reverse repo.

- *Interest on reserves.* The Fed now pays interest to banks on their reserves, which discourages banks from using their reserves as backing for new money loaned to the private sector. The Fed created money, gave it to the banks, and then gets it back by paying the banks interest. This prevents reserves from becoming the basis for more money created through bank loans.

- *Term Deposit Facility*. Banks keep reserve deposits at the Fed, which are essentially the same as checking accounts. The Fed has created the Term Deposit Facility (TDF), which converts these deposits into a fixed maturity at a higher interest rate set by auction, similar to a Fed-held certificate of deposit. This mechanism drains reserves and keeps money on the Fed's balance sheet and out of the monetary base.

HOW THE FOUR TOOLS WILL BE USED TO KEEP INFLATION LOW

The Fed will use these four tools, with interest on reserves as the dominant one, to prevent an expansion of the monetary base, while also keeping the Fed's assets high. But will the Fed have sufficient information in enough time to use these tools to stop inflation? The answer is clearly yes. The Fed receives weekly reports from banks and third parties that give it a direct and indirect understanding of financial liabilities. The Fed has had a strong policy of low inflation since the mid-1980s, and will have little problem monitoring inflation and taking action if necessary.

Some have expressed a concern that as the Fed increases interest rates on reserves or sells securities before they mature, its repayments to the Treasury will fall to zero. A Fed staff study estimates that this could last as long as six and a half years. Doing this could be politically unpopular, and Congress may seek to intervene in a Treasury fiscal crisis even if the Fed remains healthy. This could threaten the independence of the Fed and force a new round of quantitative easing, leading to the very inflation that some fear.

CONCLUSION

The Fed's swollen asset portfolio consists of long-term securities, such as Treasury or mortgage-backed securities, which if sold would lead to capital losses. The Fed has four tools to avoid selling large amounts of these assets while still keeping inflation low. Three of the four drain reserves from the monetary base and keep them out of the hands of the private sector. The fourth, interest on reserves, induces banks to maintain high reserve ratios—also keeping money out of the private sector. The Fed will use these tools to prevent inflation, but in doing so, it has no need to normalize its balance sheet after a full economic recovery. An inevitable consequence of this strategy is that the Fed is becoming a financial central planner through quantitative easing. Markets, not a central bank, should allocate most of the credit within a financial system.