

It's Time to Rein In the Fed

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The economic crisis that has gripped the US economy since 2007 has highlighted Congress's limited oversight of the Federal Reserve, and the limited transparency of the Fed's actions. And since a Fed promise is ultimately a Treasury promise that carries the full faith and credit of the US government, the question is, Should the Fed be able to commit the public purse in times of national crisis?

In late 2008, after much discussion and debate, Congress approved a fiscal stimulus package of approximately \$800 billion. While a much bigger and better-targeted intervention was desirable, we commend Congress for the transparency of its actions, and believe that the downturn would have been substantially worse without the stimulus.

By contrast, the Fed's actions took place mostly behind closed doors. For example, while Congress openly debated the merits of bailing out the automobile companies, the Fed met in secret with Wall Street firms to devise a rescue of AIG. We found out only later (after Congress mandated an audit of the Fed's books) that much of the funds provided to AIG were directly passed on to some of the biggest banks—and even to foreign banks—to cover their exposure to AIG dollar for dollar. And unlike the congressional response to the crisis, the Fed's interventions have been ineffectual. The Fed committed as much as \$20 trillion in the form of bailouts, loans, and guarantees, all in the name of saving financial institutions so that they would resume lending—supposedly a prerequisite of economic recovery. And yet, for all the trillions committed, there is very little evidence that the Fed's actions have had much economic impact.

And now the Fed has announced a third round of interventions into financial markets, or QE2 (quantitative easing). In the first phase, called credit easing, the Fed provided liquidity through its discount window and open market operations, later supplemented by a number of extraordinary facilities created to provide reserves as well as guarantees. The main result was to cut the federal funds rate target close to zero (0–25 basis points). In the second round (QE1), the Fed bought \$1.75 trillion in housing agency securities and longer-term US Treasuries. This was based on Chairman Bernanke's thesis that once monetary policy has pushed the overnight interest rate toward the zero bound, it can still stimulate the economy by increasing excess reserves. Asset purchases under QE1 resulted in \$1 trillion in excess reserves in the banking system. QE2, which is designed to purchase another \$600 billion in longer-term Treasuries, will add even more.

All of this is based on a misconception. The theory is that, if banks have lots of excess reserves that pay very low interest rates, they

will increase lending in order to earn higher rates. But banks do not and cannot lend reserves. Reserves are like a bank's checking account at the Fed, and a bank can only lend them to another bank (in the fed funds market). Since there is already \$1 trillion in excess reserves in the system, there is no demand by banks to borrow more.

The only other avenue through which QE might be expected to work is the interest rate channel: as the Fed buys long-term assets, it pushes up their price and lowers the long-term interest rate. A detailed study by the Federal Reserve Bank of New York estimates that QE1 lowered the long-term rate by about 50 basis points. Even using optimistic estimates of the responsiveness of borrowing and spending to interest rates, such a small reduction cannot have had much effect. Based on the New York Fed's estimates, QE2 will lower rates by only 18 basis points—clearly not enough to stimulate spending even in the best of times.

Finally, it's truly remarkable that, three years into the crisis, the Fed still has not learned that monetary policy is about price, not quantity. The Fed is buying \$600 billion in long-term Treasuries in the hope of bringing down the long-term rate. Yet, if it really understood monetary operations, the Fed would instead announce that it is standing ready to buy *as many Treasuries as necessary* in order to lower the long-term rate by a desired amount. For example, if it wished to lower the rate by 200 basis points, it would simply set the corresponding price it would pay for Treasuries. The Fed might end up buying more, or even less, than \$600 billion worth, but it would quickly and with certainty achieve the interest rate it wanted, because the markets know that the Fed can spend as much as necessary to hit the target.

We conclude: the Fed's crisis interventions have been ineffectual, largely executed in secret, and not subject to congressional approval. The massive, mostly off-budget support of Wall Street has proven a tremendous barrier to formulating another fiscal stimulus package for Main Street. Yet in terms of committing Uncle Sam, there is no difference between a guarantee for Wall Street and a guarantee for Main Street. It's time to rein in the Fed.

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