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Is it Time to Revisit the FED's Strategies?

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The Federal Reserve Bank, the Fed, has assumed multiple crucial roles since its founding in 1913, but after the Great Recession and during this Pandemic, the current size and scope of its balance sheet has reached a level that may impede its ability to support economic growth and low inflation. Can it shed trillions of dollars of excess reserves from its balance sheet without disrupting the financial markets? Can it tame rising inflation without spiking interest rates?

As central bank and manager of the U.S. payment system, the Fed's responsibilities have expanded over time to include regulator of the banking system, financier of the Federal budget deficit, commercial bank, and mezzanine finance agency. Its non-Central Bank roles have assumed much greater importance since the Great Recession of December 2007 – June 2009, and more recently, during the Pandemic, starting with the recession last year.

FED's balance sheet: The size of the Fed's balance sheet, which surged during the Great Recession and again during the Pandemic, may have compromised its ability in the future to take extraordinary steps to support the economy during a crisis. Since the end-of-February 2020 through August 25, 2021, the Fed's balance sheet expanded by $4.2 trillion to reach $8.3 trillion in total assets. This represents about 34.2% of GDP, an exceedingly high percentage.

Guardian of the Payments System: If anything should keep Fed officials up at night, it is likely to be the integrity of the U.S. payments system, which is the main artery of the financial markets and is managed by the Fed. Practically all payments except for notes and coins, cryptocurrencies, and barter trade, are cleared through the Fed's payment system. A breakdown of the payment system could have catastrophic consequences for the financial system. Yet, in what was described as an "operational error" the payment system was down for two-plus hours on February 24, 2021; fortunately, quick-response by the Fed fixed the problem and they were able to clear the backlog of transactions through the late-night hours.

Financing the Federal deficit: One of the reasons for the Fed's asset bubble has been the need to finance the Federal government. Since the end of February 2020, $2.9 trillion of the increase in the Fed's balance sheet consists of net purchases of U.S. Government securities, in other words, financing of the deficit. Some analysts refer to the Fed's actions as supporting the economy by keeping long-term interest rates low; but I differ, at the present time, financing the fiscal deficit is the Fed's priority, which could be crowding out private sector access to financing.

Mortgage market investments: By August 25, the Fed was holding $2.4 trillion in Mortgage Backed Securities (MBS) traced back to the financial problems created by the last recession when the real estate market took a dive. Since the start of the Pandemic, the Fed has booked a net increase of $1.07 trillion in

MBS holdings to reach its current balance, which could have contributed to the surge in residential real estate values.

Mezzanine lender: As part of the CARES Act of March 2020, the Fed was to provide an additional $2.3 trillion in financing for businesses and households as well as projects undertaken by states and municipalities. Initially there were few takers to participate in its Main Street Lending Program, and so the program was terminated in January of this year.

Given the record-low interest rates prior to the Pandemic, monetary policy has been limited in its capacity to support the economy during the current health crisis, and so fiscal stimulus has played a bigger role. The cumulative total of fiscal support during the Pandemic, the CARES Act in March 2020, and its follow-up of extraordinary budget expenditures through year-end 2020, and the ARP Act in March 2021, is estimated so far at $6.0 trillion. The latest Congressional stimulus proposal calls for an additional $4.5 trillion-plus in physical and social infrastructure spending. However, excess fiscal stimulus backed by central bank financing can increase risks in the financial system.

The Fed's financing of the Federal deficit has kept yields in the bond market from rising. It has actively purchased U.S. Treasury securities to finance the huge Federal deficit, which reached $3.1 trillion in fiscal year 2020, where the spending that generated the deficits come from the Federal government, for example, the IRS checks that were sent to individuals as part of the CARES Act which ended up as bank deposits, and banks now have increased their excess reserves on deposit at the Fed to $4.2 trillion, with the Fed paying interest on those funds. The cost of the Fed's huge bank deposit liabilities is in part covered by its multi-trillion-dollar portfolio of MBS which pay significantly higher interest rates than what it pays on banks' deposits. In other words, the balance sheet of the Fed has become a large asset bubble, which does make a decent profit that the Fed then transfers to the Department of the Treasury but is also crowding out private sector access to financing.

The economy is now experiencing a resurgence of inflation. The economic recovery since last year led by consumer spending has aggravated supply chain bottlenecks across the globe that were created by the Pandemic, such as the scarcity of microchips that are an integral input in the production of automobiles, and this mix of factors has triggered an inflationary spiral, with the 12-month CPI inflation rate reaching 5.5% in July. With more inflationary pressures in the pipeline, the Fed recently signaled that they may start the "tapering" of purchases of U.S. Treasury securities sooner than later.

However, if the Fed stops financing the deficit who will step in to cover the Federal government's bulging deficits? The Fed's options are limited. In June 2017, the Fed revisited its Policy Normalization Plan aimed at deflating its balance sheet with specific monthly monetary targets for pumping excess liquidity out of the financial system; yet after a few months the Fed wisely cancelled its implementation due to concerns that the resulting increases in interest rates could derail the ongoing economic expansion. The Fed's balance sheet today is almost twice as big as it was in June 2017.

The Fed could encourage banks to use their excess funds deposited with the Fed to purchase U.S. Treasury debt, but that may create more risks for the banks. On the other hand, if the Fed allows its holdings of U.S. Treasuries to decline as they are paid down, it may take years to reach a normalization of their balance sheet. But if the Fed does not act as a backstop for the Federal deficit, rating agencies could downgrade U.S. Treasury securities due to difficulties that could arise in financing the fiscal deficit. The rating agencies may have already been holding back on a downgrade of U.S. Treasury debt, I believe, out of concern that a downgrade could have an adverse impact on financial markets.

Over the years, the Fed has had to step in to resolve numerous imbalances in the economy and in the financial system; but it may now be at a critical juncture. Should the Fed be the central bank for all? Should it continue to finance increasing fiscal deficits? Or should it narrow its scope and deflate its asset bubble? The answers to these questions may call for tough decisions.

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