THE LINNEMAN LETTER

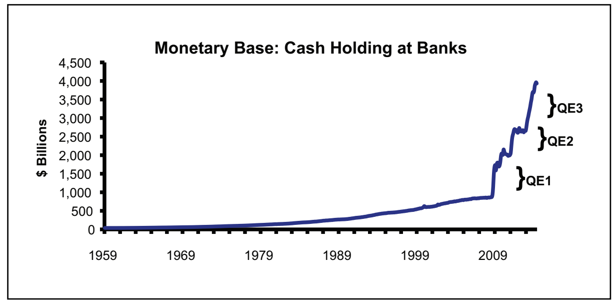
This is an excerpt from the Summer 2014 issue of *The Linneman Letter*.

Volume 14 Issue 2

Now What Are The Fed's Options?

By Dr. Peter Linneman, PhD
Chief Economist, NAI Global
Principal, Linneman Associates

The Fed continues its impersonation of the Great-and-All-Knowing Wizard of Oz. But as masterfully demonstrated in the brilliant deconstructionist version of this story, "Wicked," much damage flows from the acts of self-proclaimed wizards. In fact, the Fed's efforts have created growth-stifling capital market uncertainty due to concerns about "how it all ends." And in this regard, the Fed has very limited policy choices.



As QE continues, the outstanding monetary base continues to skyrocket. From an $800 billion monetary base at the start of September 2008, it now stands at nearly $4 trillion and is still rising by $40 billion a month. As we have repeatedly noted since this unprecedented monetary expansion began, almost all of this liquidity has been injected into 12 money center banks, resulting in a staggering increase in excess bank reserves held at the Fed by these 12 money center banks. While throughout history, excess reserves have typically been less than 1% of total bank reserves, since this flood of liquidity was unleashed by the Fed, nearly 95% of all bank reserves held at the Fed exceed statutory requirements. This means that while the fractional reserve system has historically meant that a $1 increase in reserves at the Fed resulted in a $7.30 increase in bank loans, since the beginning of QE2, a $1 increase in reserves at the Fed has led to almost no increase in bank lending. The result is roughly $21 trillion in untapped bank lending capacity, or about three times the amount of outstanding loans. If only a third of this lending capacity is used, it will represent a doubling of bank loans. And if only 10% is used, it will generate an increase in bank loans of more than 25%.

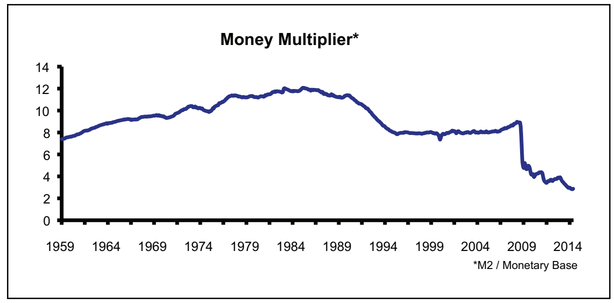
Perhaps the great unanswered question in capital markets history is whether this level of excess reserves will continue to be held at the Fed, or whether the 12 money center banks will eventually expand their lending. If the latter occurs, it will be massive. Even if these banks lend far less aggressively than in the past, they have such staggering unused reserves that it will represent unprecedented lending, which would result in staggering inflation for everything funded by this new lending. Since money center banks are not set up to lend to consumers for purchases of most consumer items, it is likely

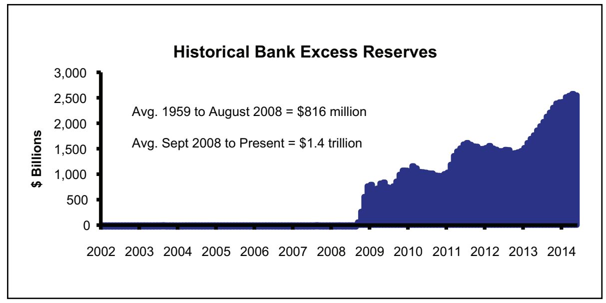
Table of Contents

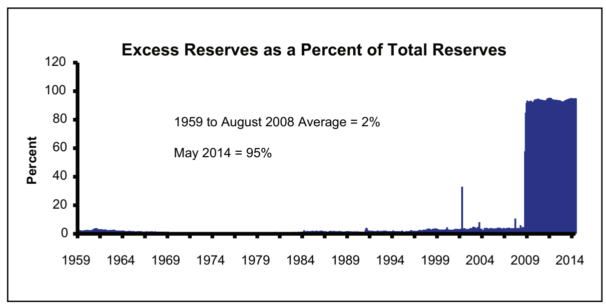
that this money would flow to specific assets such as commercial real estate, home mortgages, auto loans, business loans, and consumer loans via credit cards.

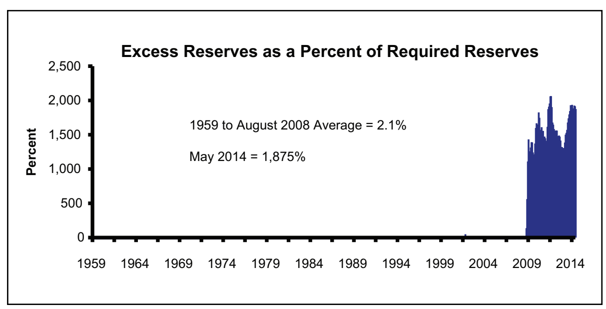
When pressed on how it will avoid such inflationary pressures if these banks begin to lend aggressively, the Fed responds that it has plenty of tools at its disposal to defuse such monetary expansion. However, on close inspection, the Fed's hands are actually quite tied. First, the Fed argues that if banks begin lending at inflationary rates, it will raise the Fed Funds rate. Recall that the Fed Funds rate is the rate at which the Fed stands ready to lend to member banks in order to ensure that banks have sufficient reserves on deposit at the Fed. Raising the Fed Funds rate to discourage these banks from lending their unprecedented excess reserves will have no impact on the 12 money center banks, as they have such extraordinary levels of excess reserves that they have no need to borrow from the Fed. Hence the borrowing rate charged by the Fed is irrelevant for these money center banks. Meanwhile, the increase in the Fed Funds rate will be extremely punitive for the other roughly 3,500 banks, as they never received monetary injections; hence their reserves at the Fed are basically just sufficient to satisfy statutory standards. The result would be that smaller banks contract lending, while money center banks continue to flood the market with loans, rendering the increase in the Fed Funds rate not only impotent, but counterproductive.

The Fed replies that a second tool at its disposal is to increase the interest rate that it pays banks to hold excess reserves at the Fed (from its current level of 25 bps). By paying a higher interest rate on bank deposits at the Fed, the Fed will encourage banks to continue to hold their excess deposits at the Fed rather than to make loans. But as money center banks begin lending, the Fed will have to raise its rates to extraordinary levels in order to halt lending. Further, the Fed must have the ability to pay this interest from its income (rather than by printing more money), because if it pays interest by printing even more money, the money supply will continue to rise, requiring the Fed to pay even more interest, etc. But paying high interest on reserves will not only further expand the money supply — encouraging banks to lend even more — but will create the untenable outcome of 12 banks receiving extraordinary amounts of interest payments from the Fed for literally doing nothing with the piles of dollars the Fed gave them via quantitative easing. For example, if the Fed were to pay 5% interest on the roughly $3 trillion in excess reserves held by the 12 major banks, it would amount to a $150 billion per year gift to these 12 banks for doing nothing. The political and media outcry will — appropriately — be extraordinary if these banks are getting paid such sums for doing nothing. Furthermore, the other 3,500 banks will benefit little from this policy, as their reserves remain near statutory minimums. This would set the









stage for a congressional inquiry into a federal government subsidy of nearly 1% of GDP annually to 12 banks, which was never debated, much less approved, by Congress. It is questionable whether an independent monetary authority would survive the accompanying political fallout.

A third policy alternative is for the Fed simply to increase the required reserve ratio. For example, the Fed could dictate that all currently held reserves of the 12 money center banks are now required reserves. While this would halt money center bank lending, raising requirements to such a percentage would crush the 3,500 banks that currently hold very low levels of reserves at the Fed. That is, the smaller banks would find that their current holdings of reserves at the Fed would be inadequate and would require them to call in most of their loans to meet the reserve requirement ratios associated with those of the money center banks. Alternatively, the Fed could set up a two-tiered reserve requirement, with the smaller 3,500 banks required to hold massively lower reserve ratios at the Fed versus money center banks.

The fourth option is for the Fed to sell its massive balance sheet, deducting the proceeds from the excess reserves held by money center banks that purchase these assets. However, as the Fed sells $3 trillion worth of mortgages and U.S. government bonds, the demand for these assets will plummet, causing interest rates to rise rapidly. While this would reduce bank lending of their excess reserves by depleting these reserves, it would cause interest-rate spikes in both the mortgage and U.S. government bond markets. Furthermore, the collapse in the prices of these assets would render most banks insolvent. As such, this is not an attractive policy option, particularly in light of the fact that the dominant purchaser of both mortgages and U.S. government bonds over the past five years has been the Fed.

The final alternative is for the Fed to allow the money center banks to lend their massive excess reserves, tempered by the need to pass “stress tests” and tolerate the inflation of asset prices and select consumer prices that will occur in its wake. While the Fed claims to be the guardian against such inflation, it could hide behind the fact that it has the dual policy mandate of spurring economic growth. Such inflation would be disastrous for those on fixed incomes, as well as lenders and the owners of fixed interest-rate assets. However, it would be a massive windfall for debtors — like the U.S. government — and those holding real assets. This policy option would be highly beneficial to highly leveraged real estate owners with fixed interest-rate long-term mortgage holders. And remember that American homeowners (basically 70% of the electorate) fit this description, as do most commercial real estate owners.