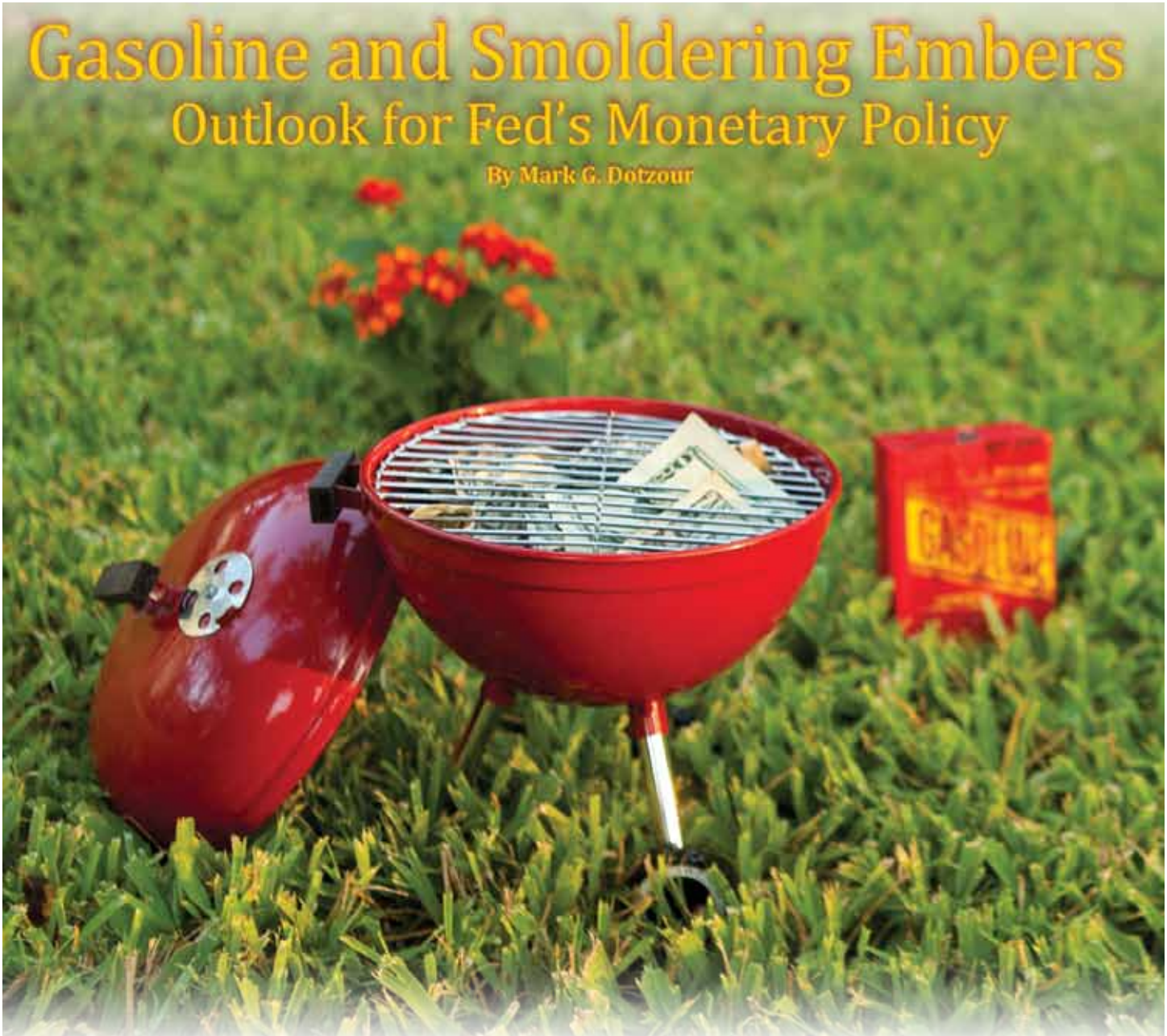
A Reprint from *Tierra Grande*

Gasoline and Smoldering Embers

Outlook for Fed's Monetary Policy

By Mark G. Dotzour



The Federal Reserve is charged with two missions: contain inflation and encourage job growth. Since the recession began in December 2007, the Fed has been working hard to stimulate the economy by providing an avalanche of low-cost money in hope that businesses would borrow and banks would lend. Instead, "excess reserves" have increased exponentially since October 2008.

For nearly 50 years, from 1958 to 2008, banks held virtually no excess reserves. From August 2008 to January 2009, excess reserves went from $1.8 billion to $797 billion (see figure). By March 2010, they peaked at $1,120 billion. This expansion of credit into the banking system is unprecedented and gargantuan. How will this affect future interest rates and inflation?

This build-up of excess reserves is akin to gasoline pooling in the bottom of a barbecue grill full of smoldering charcoal. The Fed has poured a massive amount of gasoline into the grill to try to reignite the fire. The trick is that once the coals reignite, the Fed will have to carefully manage its "exit strategy" before inflationary pressures explode.

Banks' reserves are categorized as either *required reserves* or *excess reserves*. Required reserves are funds that regulations require banks to hold against loans they have made. Excess reserves consist of money deposited into a bank's regional Federal Reserve Bank that is available for lending.

Typically, banks carry small balances of excess reserves. They earn their largest profits by making loans to consumers and businesses. They earn little interest on money parked in excess reserves at the Fed. This money is also referred to as fed funds, which banks borrow for short periods — as short as one day. These days, the fed funds rate ranges from 0 percent to ¼ percent interest.

These excess reserves represent a mountain of credit that banks could be lending to businesses. So why aren't they?

The Saint Louis Federal Reserve offers two possible reasons. First, the banks may view a risk-free return of ¼ percent as the best investment option available. Second, individual banks that are undercapitalized may prefer to hold relatively safe investments while they rebuild capital by cutting costs, raising fee income and hoping for economic recovery. So for the time being, the gasoline is pooling in the barbecue grill, not generating any heat in the economy.

With gold trading at over $1,200 per ounce, it is clear that some investors are anticipating high inflation. Inflation is not an immediate concern as the unemployment rate is high, and excess capacity exists in many manufacturing industries in the United States and around the world. At some point, the global and U.S. economies will turn the corner and begin to create jobs, which will in turn increase personal income. At that point, inflationary trends could begin to re-emerge.

What happens when the economy starts to rebound substantially? When the charcoal gets too hot and begins to throw off sparks, the Fed will have to siphon the excess gasoline from the barbecue before a spark ignites an explosion. One way the Fed can do this is by selling the assets off its balance sheet back to the banks. Making the banks repurchase loans from the Fed would soak up all the excess reserves. But if the Fed starts selling these assets — largely residential mortgages — back to the banks, mortgage rates might increase, undermining the economic recovery.

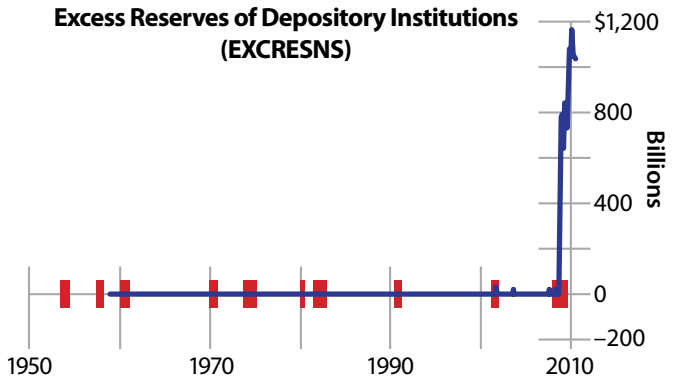
A second approach would allow the Fed to smother the inflationary effects of massive excess reserves without selling the loans back to the banks. Since October 2008, the Fed has had the authority to pay banks interest on their excess reserves. It can raise the interest rate paid on excess reserves to a point that banks prefer to keep the money idle at the Fed rather than loaning it to businesses.

In effect, the Fed can crowd out private borrowers by offering higher interest rates than businesses would be willing to accept. If the mortgage market is still weak when the Fed needs to start "tightening" the economy, it can raise rates on reserves rather than selling its massive mortgage portfolio.

Yes, the Federal Reserve has amped up its balance sheet by over $1 trillion dollars. Yes, traditional thinking might conclude that this could lead to higher inflation in the future. But the Fed's ability to pay interest on excess reserves is likely to mitigate the inflationary risk substantially.

The next time the Fed needs to rein in an expanding U.S. economy, it can raise the interest rate banks are paid for reserve deposits and keep these funds from reaching the businesses and consumers that would drive inflation.

Over time, if rates rose too high, this could become expensive for the Fed. Ultimately, it will have to sell these loans at the optimal time to minimize any losses and have minimal impact on interest rates.



Red areas indicate U.S. recessions.
Source: Board of Governors of the Federal Reserve System, 2010 research.stlouisfed.org

Dr. Dotzour (dotzour@tamu.edu) is chief economist with the Real Estate Center at Texas A&M University.

THE TAKEAWAY

Banks typically maintain almost no excess reserves, but since 2008, excess funds deposited with the Federal Reserve have grown from $1.8 billion to $1,120 billion. This unprecedented amount is money banks could be lending to businesses and consumers. Once the economy begins to rebound, the Fed will have to keep a sharp eye on the inflationary pressures that will no doubt occur.

MAYS BUSINESS SCHOOL

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031

Tierra Grande (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin. Photography/Illustrations: Polly Trant, p. 1.