

Why Is Fed Considering Paying Banks Not To Lend To Main Street

By [MIKE COSGROVE](#)

The Federal Reserve created a monster \$4.3 trillion balance sheet, up by \$3 trillion from 2008, through quantitative easing.

QE ends this fall. Now the Fed is trying to figure out what to do with this monster. Their thinking seems to be that they can maintain control over it by paying banks more money to not make loans.

So let's get this right. Households and businesses are attempting to borrow money from banks.

But the Federal Reserve may eventually pay banks \$100 billion per year not to lend to Main Street. Politicians will have a field day with that. The Fed's scheme could work in the short term, but its mechanism for controlling short-term interest rates and inflation will eventually end up in the wastebasket of politicians.

Since 2009, Fed officials have argued that QE was needed to encourage faster economic growth. But Fed officials knew from the get-go that slow growth in the U.S. economy reflected Obama administration income redistribution and regulatory policies. Short-term interest rates have been at essentially zero since late 2008.

But Fed officials kept on churning out more rounds of quantitative easing. QE kept interest rates low to provide cheap financing for huge government deficits.

The federal deficit was over \$1 trillion per year not that long ago. Now it takes two years of federal government operations to generate that \$1 trillion of deficit spending and the financing of those deficits remains cheap.

Now the Fed, because of QE, is thinking about how to unleash another new experiment on the U.S. economy — altering the interest rate paid on \$2.6 trillion of excess reserves. Their hope is that changing that interest rate will lead to changes in the level of other short-term interest rates.

Has this been done before? No. Will it work? More hope and change is ahead from the central bank.

The U.S. economic expansion is starting on its sixth year, and the Fed is just getting around to making public the process they might use to normalize interest rates.

The implication, in the July 9 FOMC minutes, is that they will likely increase the interest paid on excess reserves when it comes time for the Fed to raise interest rates. Their thinking seems to be

that this mechanism will serve an equivalent function of what the federal funds rate did before QE.

The current interest rate on bank excess reserves is 0.25%. But if the Fed needs to eventually raise that to 2% or above to control inflation expectations, it becomes politically unpopular.

Why? At 2% the Fed would pay financial entities \$52 billion per year to hold excess reserves. At 4% it becomes \$104 billion.

That means the Fed remits \$50 billion or \$100 billion less to the U.S. Treasury each year. Financial entities have been under constant attack since 2008 by the current administration.

Attacks by populist politicians will only grow if the Federal Reserve pays banks \$50 billion or \$100 billion per year that would, in effect, fatten bank profits in order to not make loans to Main Street.

The federal funds rate is out because that would require the Fed to shrink its balance sheet of \$4.3 trillion, perhaps significantly, to once again have control of the federal funds rate. Fed officials have made clear they do not intend to shrink the balance sheet in the foreseeable future. Other mechanisms to eventually raise interest rates were also considered but apparently discarded.

Capital markets don't have much guidance as to when the Fed will raise interest rates as there is no clear answer at the Fed itself on when that might occur. Some Federal Reserve bank presidents think it could be as early as year-end 2014 or early in 2015. Others think it may be 2016.

The Fed typically responds to incoming data before making policy shifts. The Fed's preferred inflation measure is running just below 2%.

This measure, the personal consumption expenditures deflator, could be closer to the 2.5% number before the Fed needs to move, according to recent comments by Charles Evans, President of the FRB of Chicago.

Great — that would mean not only slow economic growth but that the Fed would be losing control of inflation expectations. Chair Janet Yellen seems to think that macroprudential regulation may also be beneficial in helping the central bank to achieve its objectives. That's another unknown for investors to absorb.

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