End Interest on Bank Reserves
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End Interest on Bank Reserves

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In Volume 3 of *Law, Legislation, and Liberty*, Friedrich Hayek describes how government agencies, after being granted new and special powers during an emergency, retain and continue to use them, much to society’s detriment, long after the emergency ends.

In fact, the Federal Reserve received authority to begin paying interest on reserves in an emergency, during the financial crisis of 2008. Consistent with Hayek’s prediction, the Fed continues to pay interest on reserves, even now, and seems unlikely to abandon the practice anytime soon.

Interest on reserves interferes greatly, however, with the Federal Reserve’s ability to use its traditional monetary policy tools to maintain a favorable environment of stable prices and maximum sustainable employment. It also threatens the efficiency of our financial system and even the Fed’s own independence, by allowing the central bank to allocate credit on a large scale, possibly under pressure from the political system. The American people should therefore ask Congress to revoke the Fed’s ability to pay interest on reserves as soon as possible.

Ironically, the best way to understand the problems that interest on reserves causes today is to remember why the Fed received emergency authorization to pay interest on reserves in the

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first place. This happened in October 2008, when the Fed was conducting extremely large-scale emergency lending in response to the failure of AIG and Lehman Brothers.

Remember this from your freshman-year introduction to macroeconomics course: when the Fed makes an emergency loan, it credits the borrower’s account with newly-created reserves. That works to increase the supply of reserves, just like a more traditional open market purchase of government bonds does.

Remember, as well, that back in 2008, inflation – not deflation – was the Fed’s biggest monetary policy concern. Gas prices were soaring in those days, and threatened to push overall inflation higher too. The original idea behind interest on reserves was to expand banks’ demand for reserves to meet the increased supply generated through emergency lending, without triggering the unwanted rise in inflation.

In retrospect, therefore, two aspects of the 2008 decision to pay interest on reserves stand out. First, interest on reserves was designed to allow the Fed to increase the supply of reserves without causing inflation. Second, interest on reserves was designed to allow the Fed to conduct emergency lending on an unprecedented scale. With all this in mind, consider now the two biggest challenges facing the Fed today.

The first challenge is that, despite years of extremely low interest rates and wave after wave of large-scale asset purchases, inflation remains stubbornly below the Fed’s two-percent target. But should anyone really be surprised that the Fed has increased the supply of reserves greatly, without creating much inflation, when the whole point of interest on reserves was to allow the Fed to create massive amounts of reserves without also creating inflation?

The Federal Open Market Committee’s most recent amendments to its Statement on Longer-Run Goals and Monetary Policy Strategy take one step forward, by recognizing the
damage that can be done if inflation runs persistently below target for years or even decades. As these one-sided misses cumulate over time, they push the actual level of prices farther and farther below the level that consumers and business expected when they signed long-term contracts, including those for long-term loans. This redistributes wealth, unexpectedly and arbitrarily, away from borrowers and to creditors.

But the FOMC’s Statement also takes a clear step backward, by suggesting that the way the Fed creates higher inflation is by pushing unemployment lower first. This reflects a major conceptual error: it misinterprets the Phillips curve – a statistical correlation between unemployment and inflation that sometimes holds in the data – as representing, instead, an exploitable mechanism through which lower unemployment actually causes inflation to rise.

The bitter history of the 1970s shows that when central bankers try to actively exploit the Phillips curve, they deliver the worst of both worlds: high unemployment and inflation. If the Fed wants to bring inflation reliably back to two percent and keep it there, it should instead make basic changes to its operating procedures that will allow policy-induced movements in the supply of bank reserves to have more consistent effects on prices. It should start by abandoning interest on reserves – again, a tool that the Fed adopted, at first, to prevent changes in the supply of reserves from affecting prices.

In addition to the problem of low inflation, the second challenge to the Fed involves threats of “mission creep” and lost independence. Perhaps it was right for Congress to authorize, through the CARES Act, a myriad of emergency lending and asset-purchase programs to help insulate American households and businesses from the disruptions associated with the Covid-19 pandemic. But all of those programs would have more appropriately been administered by the Treasury, or some government-sponsored agency like those that already allocate substantial
amounts of credit through mortgage, student, and small business loans. Instead, the Fed agreed to play that role.

Now, it’s clear for everyone to see: The Fed’s ability to pay interest on reserves allows it to purchase any kind of asset and make any kind of loan, on an extraordinary scale and at a moment’s notice. This power is enormous and open to abuse. Do Americans want the Fed to stick to its traditional role as our nation’s central bank, responsible for managing the supply of bank reserves to keep inflation low and stable? Or would they rather turn the Fed into a gigantic state-run financial intermediary, which through its sheer size and influence would crowd out private competitors and replace market forces with political ones? So long as the Fed retains its authority to pay interest on reserves, it has the ability to act as a state-run bank, making lending and investment decisions at the behest of Congress.

Surely, Hayek would offer strong advice to the American people. They should ask Congress to revoke the Fed’s power to pay interest on reserves.