How the Fed Is Hedging Its Inflation Bet

By Phil Gramm and Thomas R. Saving
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Federal Reserve Chairman Jerome Powell last month told the House Banking Committee "it would be a mistake" to tighten monetary policy "at a time when virtually all forecasters" believe that inflation "will come down" on its own. His message couldn't have been clearer: Mr. Powell isn't in a hurry to start paring the Fed's monthly purchases of $120 billion in Treasurys and mortgage-backed securities, and the Fed plans to continue monetary easing into 2022.

In monetary policy, as in all else, actions speak louder than words. The Fed has expanded its reverse-repo borrowing to an unprecedented $1.26 trillion at the end of June from $272 billion in April, pulling almost a trillion dollars of liquidity out of the financial system. Reverse-repo borrowing has reduced bank reserves, even as the Fed has continued to buy Treasurys and mortgage-backed securities.

Not surprisingly, money supply growth is starting to moderate. The growth of the M2 money stock fell from around 25% in 2020 to around 10% on an annualized basis in the first six months of 2021. It was less than 4% in the last quarter. Remarkably in an economy awash in money, Fed action to reduce liquidity by $1 trillion in three months has thus far gone largely unnoticed, but this stealth action represents a dramatic change in monetary policy. The magnitude of the explosion in reverse-repo borrowing is roughly the equivalent of the impact of selling rather than buying $120 billion of securities to the public a month for more than eight months.

If all this seems confusing, remember: This isn't your father's Fed. The central bank has bought (or offset by buying similar-maturity mortgage-backed securities) 76.4% of all the federal debt issued during the pandemic, almost nine times the share of federal debt purchased by the Fed during World War II. The Fed now holds 33.6% of all publicly held federal debt, roughly the same percentage of the debt held by all other American investors combined. The Fed also holds 35% of all federally insured mortgage-backed securities.

The commercial banking system has been profoundly transformed as the Fed balance sheet has exploded. By paying interest on reserves, the Fed has made reserves an interest-bearing asset for the banking system and a liability of the Fed, allowing the Fed to borrow from banks to acquire securities without expanding the money supply. The private banking system now holds more interest-bearing reserves than it has outstanding commercial and industrial loans. Remarkably, the Fed is now borrowing more money from the private banking system than all private commercial borrowers combined.
Not since the U.S. left the gold standard in 1933 has a policy change had so profound an impact on the commercial banking system as Congress's 2008 decision to allow the Fed to pay interest on reserves. Paying interest on reserves was initially used during the subprime crisis to allow the Fed to inject liquidity into the banking system without risking a rise in inflation. During subsequent monetary easings, the payment of interest on reserves allowed the Fed to borrow money from the banking system to buy Treasurys and mortgage-backed securities without inflating the money supply.

When the Fed increased its securities holdings between 2008 and 2014 from $900 billion to $4.5 trillion, many economists predicted inflation, only to be proved wrong. They were wrong because the Fed offset its securities acquisitions by borrowing $2.6 trillion from the banking system over the same period. As a result, the M2 money supply grew at a tame 7% a year.

Progressives saw the enormous purchase of government debt by the Fed, with no resulting inflationary pressures, as confirmation of what is now called modern monetary theory, or MMT. Advocates claim that deficits and monetary expansion don't matter in a sovereign country with fiat money. Yet those who predicted inflation and advocates of MMT alike missed something that is seldom understood to this day: While these Fed asset purchases would have inflated bank lending and the money supply before the payment of interest on reserves, the resulting reserves were sterilized by banks' lending to the Fed through holding interest-bearing reserves rather than lending to private borrowers.

Since March 2020, the Fed has responded to the pandemic shutdown by buying $4 trillion of securities, producing a 94% increase in its already inflated balance sheet. With the interest rate on reserves competitive with short-maturity Treasurys, banks have held most of the resulting increase in interest-bearing reserves, effectively sterilizing the bulk of the impact of the Fed's security purchases. But the injection of new money into the banking system from the Fed's security purchases exceeded the expansion of reserves, so the money supply grew three times as fast in 2020 as it did in 2008 during the financial crisis.

Mr. Powell assures us that the inflation spike is temporary and interest rates won't rise until 2023. Yet the Fed has raised both the interest rate it pays on reverse-repo borrowing and on reserves. If market interest rates start to rise, the Fed must raise the rate it pays on reserves and reverse-repo borrowing, engage in huge open-market security sales, or raise reserve requirements to stop the money supply from exploding as banks use the overhang of excess reserves to increase lending.

The good news is that the Fed is already using its capacity to borrow in the reverse-repo market to reduce money supply growth. But the excess reserves of the private-banking system are still almost $4 trillion. The bad news is that if the inflation problem doesn't go away and market interest rates start to rise, the reserve overhang has the potential to cause a money-supply eruption. The use of any of the Fed's powers to stop the growth in the money supply and inflation will only send interest rates higher.

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