October 7, 2008

"Why is the Fed Paying Interest on Excess Reserves?"

That's the question that perplexes Alex Tabarrok. But he has a theory (which is endorsed by William Polley):

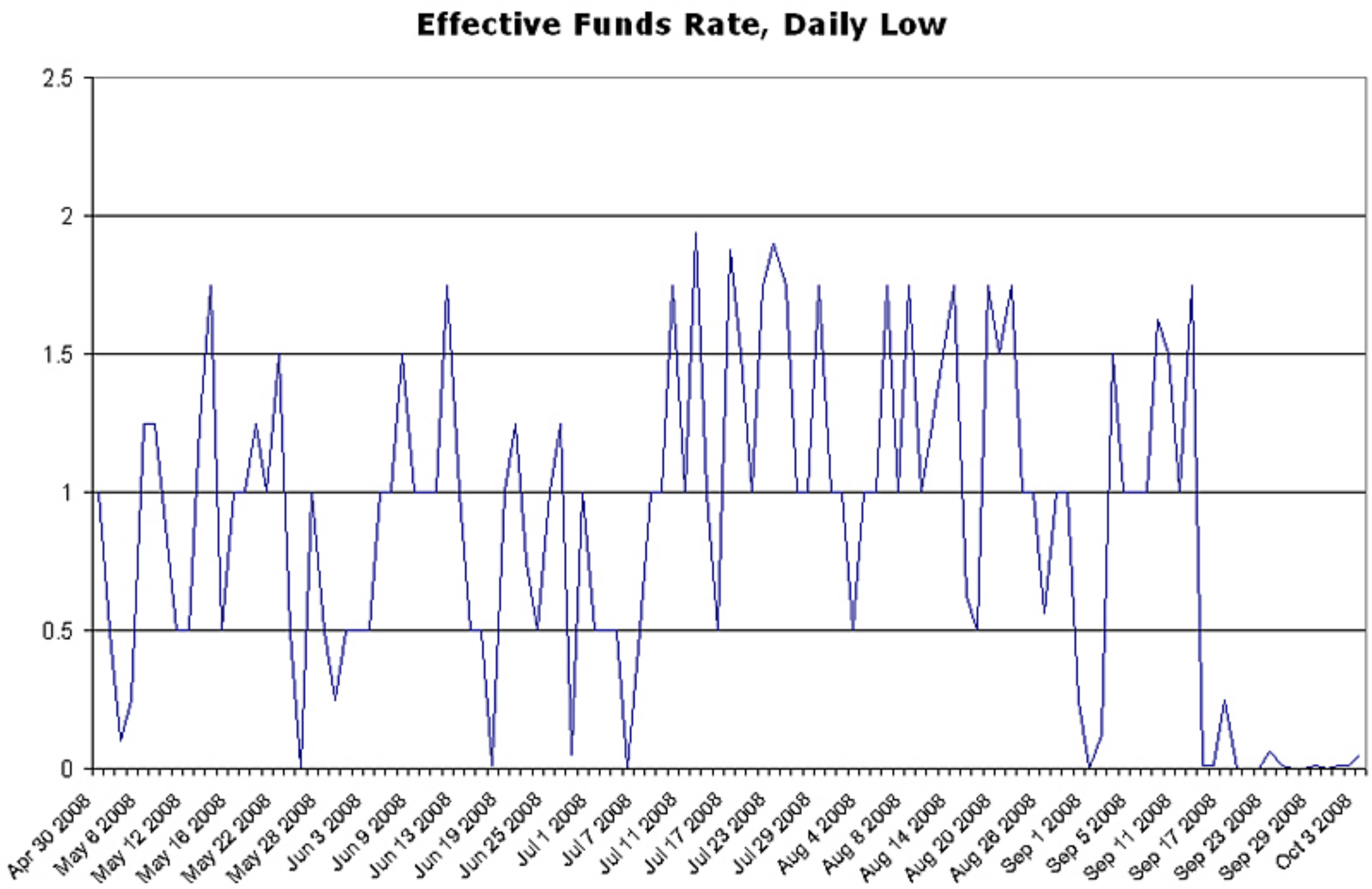
> "Today the Fed starts to pay interest on reserves. The zero interest on required reserves was an opportunity cost to banks, a tax if you like, so paying interest lifts the tax…
>
> "More interesting is why the Fed will pay interest on excess reserves. In the long run, there are again efficiency gains but why would the Fed want to make it more profitable for banks to hold excess reserves now when we want every dollar in the credit markets? My best guess is that the Fed wants to play more Operation Twist and in Brad DeLong's terms this gives them an additional tool to do it on the Pan-Galactic scale."

Operation Twist refers to monetary policies deliberately aimed at manipulating the prices of particular assets. The idea is for the central bank to "buy" the targeted assets with central bank money—reserves—or short-term government debt. In the original instance of Operation Twist, the targeted assets were long-term government debt. In the present instance, the assets are presumably the various classes of illiquid private assets that have been targeted by various Federal Reserve lending facilities.

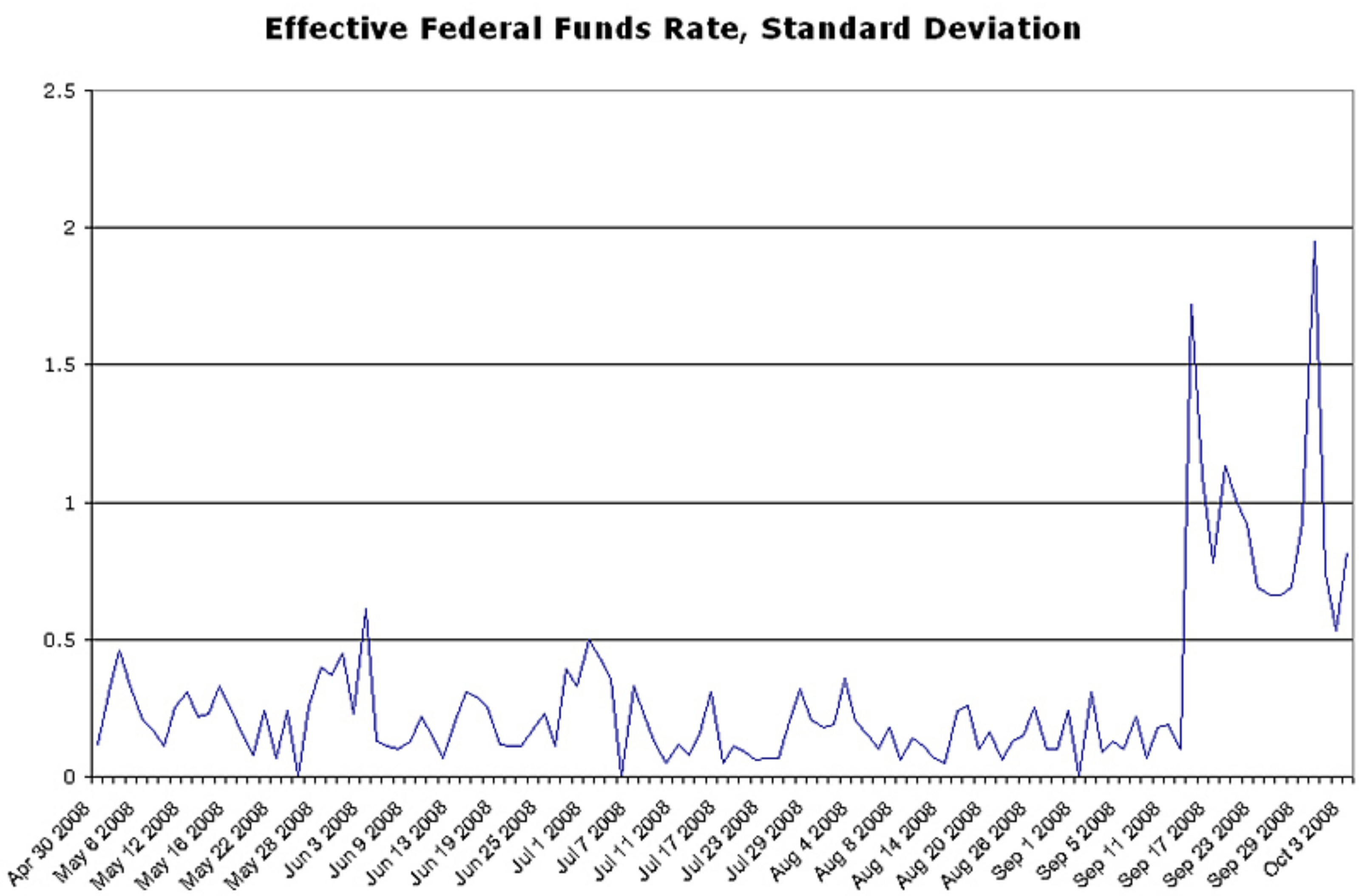
To me, that explanation is just a little too complicated. We like to make it clear that we here at macroblog do not speak for the Federal Reserve, but in this case the Federal Reserve (Board) spoke for itself in a questions and answers document on interest on reserves:

> **"Why does the Federal Reserve want to pay interest on excess balances?**
>
> "Paying interest on excess balances should help to establish a lower bound on the federal funds rate by lessening the incentive for institutions to trade balances in the market at rates much below the rate paid on excess balances. Paying interest on excess balances will permit the Federal Reserve to provide sufficient liquidity to support financial stability while implementing the monetary policy that is appropriate in light of the System's macroeconomic objectives of maximum employment and price stability. For more information about the implementation of monetary policy with the payment of interest on required reserve balances and excess balances, please see the Federal Reserve Bank of New York's website at www.newyorkfed.org."

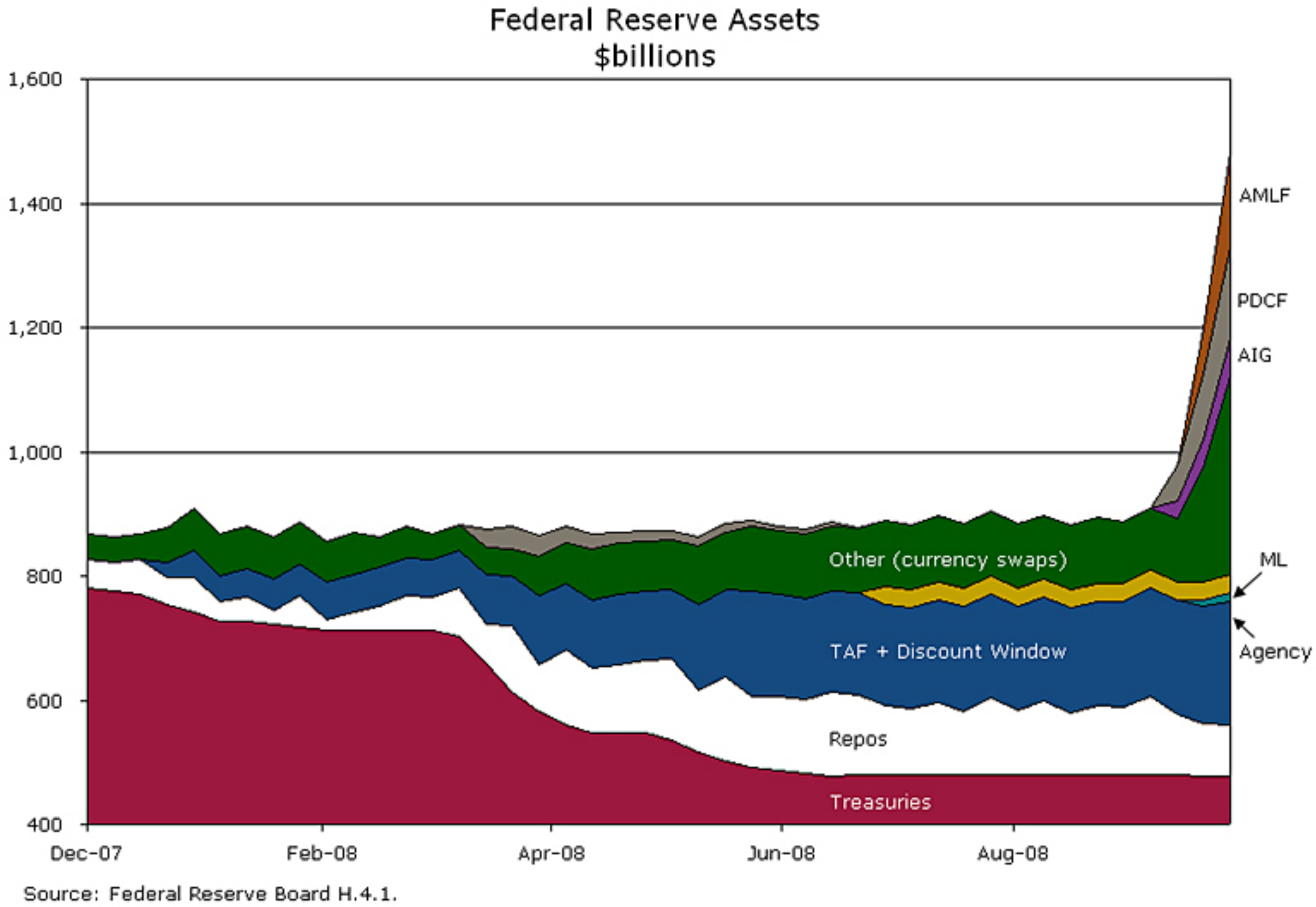
A quick look at the data reveals pretty clearly why establishing the lower bound on the funds rate might be of particular interest at the moment. Below is a graph of the daily low in the effective federal funds rate since the end of April (when the federal funds rate target was cut to 2 percent, its current level)…



… and a graph showing the standard deviation of the daily rate over the same time period.



As these pictures clearly illustrate, since mid-September the daily effective funds rate lows have been consistently very low, often hitting zero, and the intraday volatility unusually high. This period corresponds to an accelerated use of the various Federal Reserve lending facilities—acquisitions of the Bear Stearns-related Maiden Lane LLC (ML), liquidity assistance to AIG, the Primary Dealer Credit Facility (PDCF), and the Money Market Mutual Fund Liquidity Facility (AMLF), in particular—which have expanded the reserves available to the banking system:



As [noted at Real Time Economics](#)…

> "The change will encourage banks to leave more money on deposit at the Fed, and that'll give the Fed more maneuvering room to lubricate the financial system and lend to troubled institutions without increasing the total supply of credit in the economy and pushing down the federal funds interest rate, the Fed's key interest rate tool."

This description is just another way of saying what the Federal Reserve said in its questions and answers document released yesterday: "Paying interest on excess balances will permit the Federal Reserve to provide sufficient liquidity to support financial stability while implementing the monetary policy that is appropriate in light of the System's macroeconomic objectives of maximum employment and price stability."

Sometimes the simple explanation is the best one.

UPDATE: William Polley follows up.

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