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The punch bowl, the party, the exit

Though weather of the sort usually reserved for Minneapolis, Chicago, and Cleveland kept Chairman Bernanke from delivering his message in person, **a message was sent** on Wednesday of last week nonetheless regarding one of the central monetary policy questions of the moment. That is, in terms of the nuts and bolts, what exactly is the Fed's "exit strategy?" Chairman Bernanke provided a general description in this excerpt:

> "Although at present the U.S. economy continues to require the support of highly accommodative monetary policies, at some point the Federal Reserve will need to tighten financial conditions by raising short-term interest rates and reducing the quantity of bank reserves outstanding. We have spent considerable effort in developing the tools we will need to remove policy accommodation…"

A summary of thoughts on Chairman Bernanke's comments is provided by the *Wall Street Journal's* **roundup of economist's reactions** to the testimony. If you have ten minutes to spend, an interest in the federal funds market and how interest on reserve policy works, and the desire to hear a lecture that would usually cost you good money, I further commend to you the **Mark Thoma's video at MoneyWatch.com**.

Here's the way *I think* about the options addressed by the Chairman in his prepared remarks. Let's start with a well-traveled metaphor for how "policy accommodation" works:

Step 1: The Fed fills up the punch bowl (by buying assets and lending funds to financial institutions, which corresponds to a like quantity of liabilities on the central bank's balance sheet, which includes bank reserves).

Step 2: Bankers spike the punch (by leveraging the quantity of bank reserves outstanding into a multiple quantity of loans to the private sector).

Step 3: The party's on (as businesses and individuals support production and consumption from the credit provided).

What does the Federal Reserve have against a party? Nothing, of course, and the provision of liquidity and specialized support in various parts of the financial system was exactly the point of filling up the punch bowl in the first place:

> In addition to supporting the functioning of financial markets, the Federal Reserve also applied an extraordinary degree of monetary policy stimulus to help counter the adverse effects of the financial crisis on the economy… A range of evidence suggests that these purchases and the associated creation of bank reserves have helped improve conditions in private credit markets and put downward pressure on longer-term private borrowing rates and spreads.

The concern, of course, is that, as the economy recovers, so much stimulus increases the potential of the party getting out of hand:

> "The FOMC anticipates that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period. In due course, however, as the expansion matures the Federal Reserve will need to begin to tighten monetary conditions to prevent the development of inflationary pressures."

There is nothing new about this issue. This is exactly what monetary policy decision is always about: When is the appropriate time to apply monetary accommodation, and when is the appropriate time to reduce it.

What is different this time is that the usual approach—drain the punch bowl by selling assets on the Fed's balance sheet—might well cause very large sales that could work at cross-purposes to the objective of maintaining orderly function in the financial markets that policy is still trying support:

> "I currently do not anticipate that the Federal Reserve will sell any of its security holdings in the near term, at least until after policy tightening has gotten under way and the economy is clearly in a sustainable recovery… Although passively redeeming agency debt and MBS as they mature or are prepaid… the Federal Reserve may also choose to sell securities in the future when the economic recovery is sufficiently advanced and the FOMC has determined that the associated financial tightening is warranted. Any such sales would be at a gradual pace, would be clearly communicated to market participants, and would entail appropriate consideration of economic conditions."

If "gradual pace" implemented with "appropriate consideration of economic conditions" does not provide sufficient scope for removing monetary stimulus as the need arises, are we simply stick with a party that is destined to spin out of control?

To me, this is where the alternative tools emphasized by Chairman Bernanke come into play. These approaches would work not by altering the overall size of the balance sheet but by altering the composition of the balance sheet in important ways.

One strategy mentioned by the Chairman—reverse repurchase, or repo, agreements—looks a lot like the standard old drain the punch bowl approach. In outright sales, to put it in simple terms, the Fed sheds assets that are paid for with money (think of it as reserves) that the central bank simply takes out of circulation. A reverse repo does very much the same thing, except that it comes with a promise to repurchase the assets—putting more money back into the system—at some future date. Because this approach has more the character of renting assets versus selling them, the overall asset side of the Fed's balance sheet stays the same, but the liability side shifts from providing reserves today to an agreement to provide reserves in the future. As long as repurchase agreements are rolled over, the quantity of bank reserves is reduced and monetary stimulus is managed.

Another strategy mentioned by the Chairman was the issuance of term deposits to banks. No need to stretch our imagination too much here. The basic economic intuition is really just like that for reverse repos, except that bank reserves are being exchanged for something like certificates of deposits issued to banks instead of mortgage-backed securities or the like.

The payment of interest to banks for the reserve balances they hold with the Fed, also mentioned, and in fact highlighted, by the Chairman, has a slightly different nature. Like reverse repos and term deposits, the amount of punch provided by monetary policy is not altered. What is altered is the incentive for banks to spike the punch by expanding the quantity of loans.

There is a good argument for the case that there is no need to alter those incentives in the current environment. As Mr. Bernanke indicates:

> "The FOMC anticipates that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period."

But once the party heats up, the need to restrain credit expansion through the various tools available will be essential. On this, the Chairman gets the last word:

> "… we have been working to ensure that we have the tools to reverse, at the appropriate time, the currently very high degree of monetary stimulus. We have full confidence that, when the time comes, we will be ready to do so."

Update: Jim Hamilton adds **his thoughts**.

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