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Central banking in the credit turmoil: An assessment of Federal Reserve practice ☆

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ABSTRACT

Central banking is understood in terms of the fiscal features of monetary, credit, and interest on reserves policies. Monetary policy – expanding reserves by buying Treasuries – transfers all revenue from money creation directly to the fiscal authorities. Credit policy – selling Treasuries to fund loans or acquire non-Treasury securities – is debt-financed fiscal policy. Interest on reserves frees monetary policy to fund credit policy independently of interest rate policy. An ambiguous boundary of responsibilities between the Fed and the fiscal authorities contributed to economic collapse in fall 2008. "Accord" principles are proposed to clarify Fed credit policy powers and secure its independence on monetary and interest rate policy. The Fed needs more surplus capital from the fiscal authorities to be fully flexible against both inflation and deflation at the zero interest bound.

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1. Introduction

The credit market turmoil that began in August 2007 and precipitated the Great Recession challenged central banks around the world as never before. Central banks increased aggregate bank reserves enormously, and lowered targeted short-term interest rates to zero in many countries. For instance, the Federal Reserve grew bank reserve balances from around 10 billion dollars in early September 2008 to over 1 trillion dollars as it drove the federal funds rate nearly to zero.

Central bank lending expanded to facilitate private credit flows. For instance, Federal Reserve loans to depository institutions stood at over 400 billion dollars at the end of April 2009. Previously, the most expansive, prolonged Fed lending was a loan of roughly 5 billion dollars to Continental Illinois Bank from May 1984 until February 1985.[1] The Fed extended its credit reach well beyond depository institutions. By April 2009, the Fed had purchased around 350 billion dollars of mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae; and the Fed had extended around 200 billion dollars of loans to a special purpose vehicle created to purchase commercial paper.[2]

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[1] For a brief period following 9/11 Fed lending to banks rose above 30 billion dollars. Fed lending discussed throughout the text refers to overnight loans.

[2] Federal Reserve Statistical Release H.4.1 "Factors Affecting Reserve Balances."

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