Money in the Time of Coronavirus

O.P. Abello, Getting to Know a Brave New Fed

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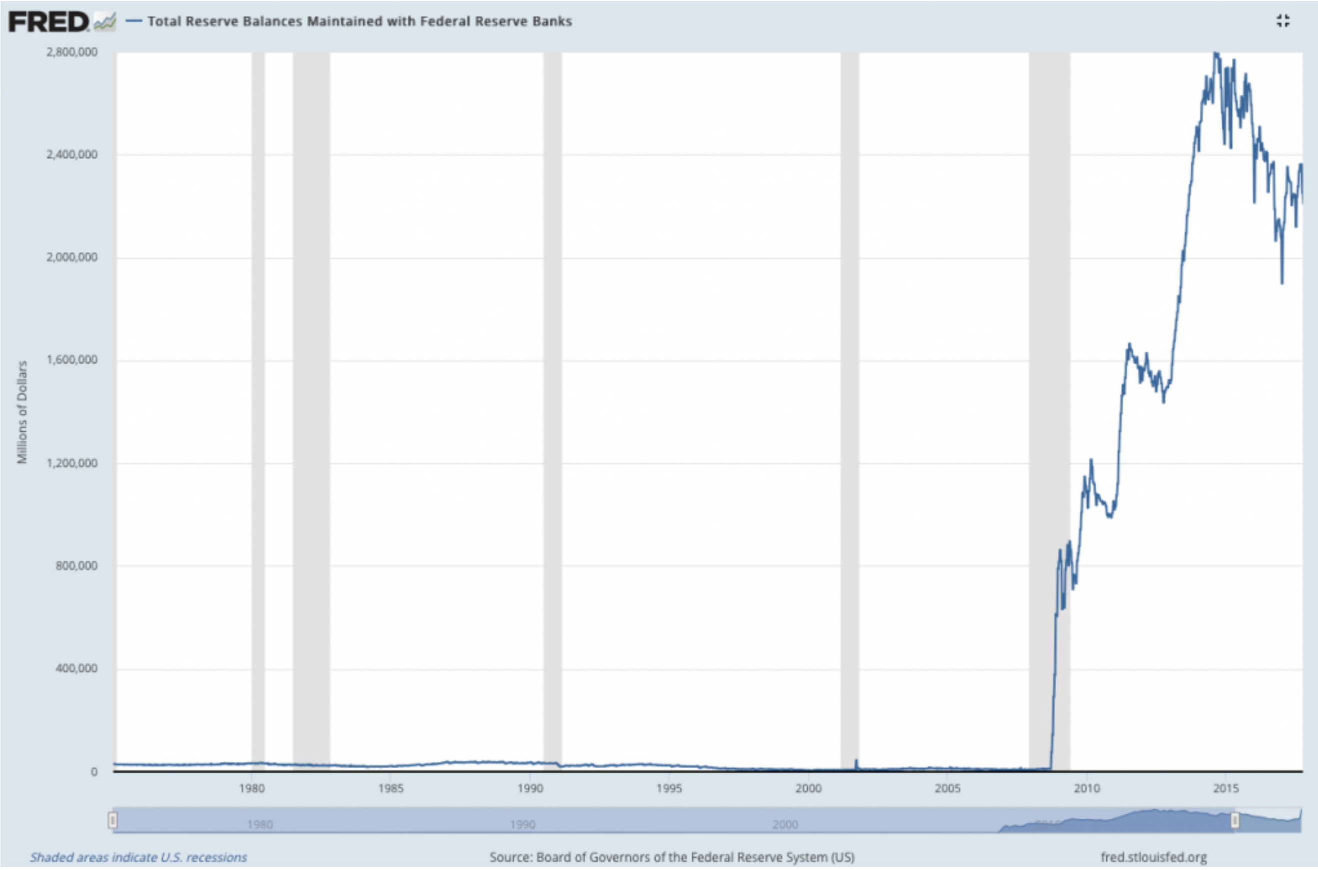
For me, as a journalist covering the economies of cities across the United States, this journey started maybe four years ago. That's when I first stumbled upon this chart, showing total reserve balances at the Fed.

Until October 2008, it had been relatively low and stable, consistent with what I had learned as an undergrad economics student – that banks are required to keep a certain level of reserve balances in their accounts at the central bank as part of a normally functioning financial system.

But then in October 2008, clearly something had radically changed. All of a sudden, reserve balances shot up to levels that seemed to make no sense, and then kept on going. And it was almost all excess reserves – orders and orders of magnitude beyond required reserves.



As a journalist covering the economies of cities, my instincts flared up. Was there some kind of insidious modern day redlining at work here? I wasn't sure at the time what it really meant, but at the surface level it certainly seemed plausible that banks were "sitting" on huge amounts of excess reserves at the Fed while every neighborhood I was writing about was struggling to get loans for homeownership or small business. But I wasn't going to go around making such wild accusations without backing it up with more evidence, data, and perspective.

So, I fired off a few emails to some of the most experienced community bankers I knew, but who had been several years retired from running a community bank. They weren't sure what was going on either. I couldn't figure it out in between deadlines, so I filed it away on the mental shelf for a while.

Then came Coronavirus. In response to the economic fallout from this pandemic, unprecedented in both the scale and speed of economic disruption, the Fed suddenly seemed determined to bully its way onto my beat. In just one day, March 23, it leapt into action in ways that took years after the onset of the last financial crisis.

The week after that, on March 31, I published my first story about the Fed, focusing on its latent powers to buy municipal bonds and how close it was to finally using them for the first time. Just a hint of what it could potentially do.

But that was just one story, and I needed to keep digging. For the sake of serving my readers, I needed to understand what the Fed was really doing and how it was going about its work.

I had a working understanding of how the Fed operates. But now that it was becoming more directly active as a player in my coverage area, I needed to understand it as intimately as I understood commercial banks and credit unions and loan funds and foundation endowments and private capital markets and public capital markets — all the pools of capital I had reported about over the past few years with a focus on how they reach some neighborhoods more than others.

I looked first where I look with every other financial institution — its balance sheet. And once again I came across the baffling fact that banks’ reserve balances made up the largest share of the Fed’s liabilities, even more than currency in circulation at that moment and for much of the previous decade.

It was at that point I finally understood that all those reserves on the Fed’s balance sheet clearly had something to do with all the things that were now popping up on the other side of its balance sheet and that seemed to be driving some experts mad with fears of inflation and general “running amok.”

My understanding evolved from my initial instincts. Banks weren’t sitting on cash they should have been lending out. As I have come to learn over the course of a few weeks, those reserve balances at the Fed were actually just a by-product of the central bank’s response to an economic crisis – some of it left over from the last crisis, and even more in response to this one.

Very little if any of this might be new to people who study the Fed all the time, but I needed to connect the dots in a way that worked for me as a journalist, so that I could later connect the dots for my readers.

Poring over papers upon papers, mostly from various research shops at Federal Reserve branches around the country, I eventually came across one 2009 paper from the New York Fed, the heart of it all, explaining how the overall level of reserve balances is based solely on the actions of the Fed, and not any decisions on the part of banks. It sounded crazy at first, but the paper explained everything using the thing that made the most sense to me as an economics journalist – balance sheets.

As that paper explained, even the Fed still needs to keep its balance sheet balanced. When the Fed began creating emergency liquidity facilities in December 2007, in order to balance its balance sheet, the Fed decided initially to sell off Treasury securities and replace them with the emergency liquidity facilities. That kept the initial changes only on the asset side of its balance sheet.

But by mid-2008, the crisis wasn’t even fully realized yet and it was clear things were already going to get worse before they got better. Lehman Brothers collapsed in September 2008. The Fed had already sold off a lot of Treasury securities and it was further expanding its liquidity facilities as the financial crisis got worse. The Fed wasn’t about to sell all its Treasury securities. So, the liquidity facilities started showing up on the other side of the balance sheet as bank reserve balances.

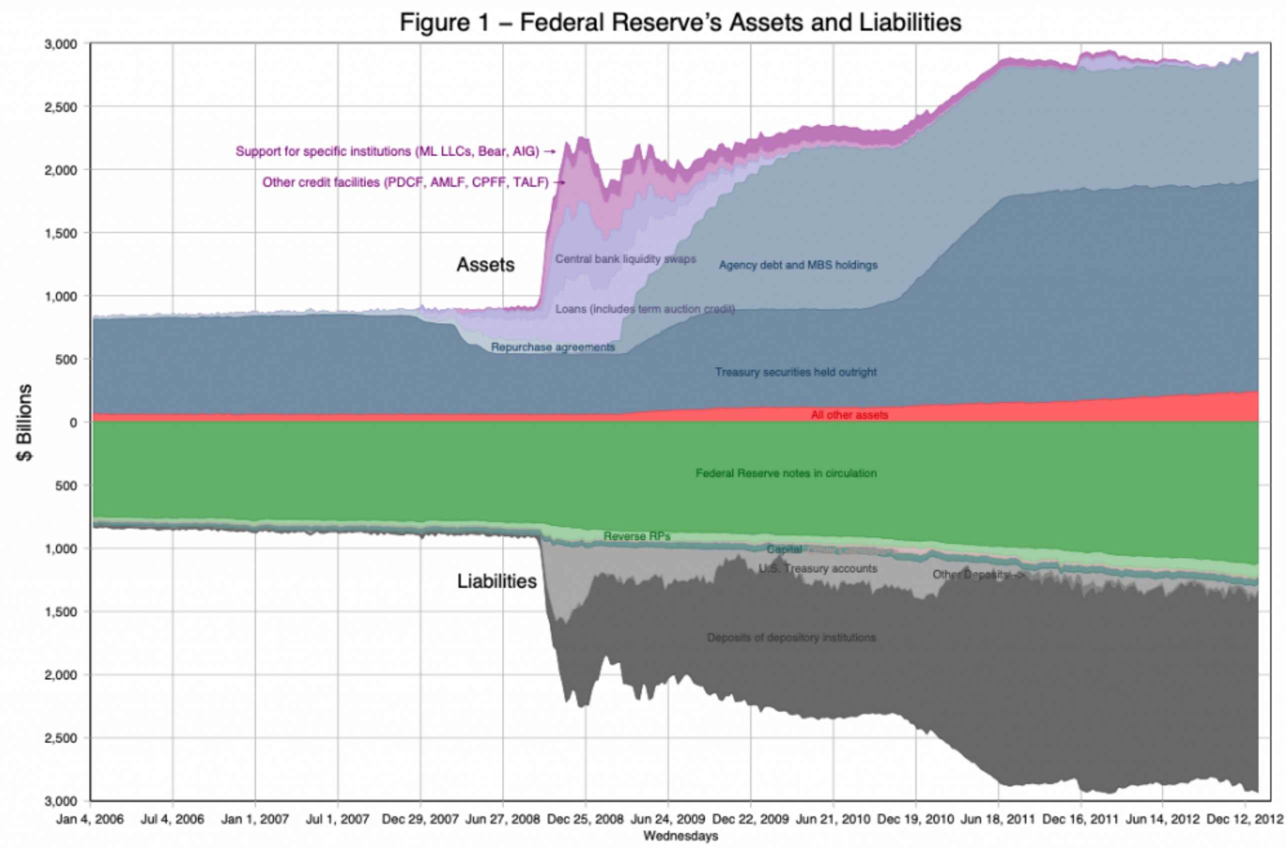
As the New York Fed paper also noted, for a little while the

Treasury tried creating a mechanism to drain some of the excess reserves on the liability side of the Fed's balance sheet, but even that mechanism couldn't keep up with the growth of the emergency liquidity facilities.

By October 2008, to use words that would become immortal half a decade later, the Fed finally decided to "let it go" – to just let the reserve balances start building up within the system and worry about it later.

And the Fed would need to really "let it go" with what would come next – quantitative easing. The first round, of course, started in December 2008.

While serving a different purpose than emergency liquidity facilities, the effect I could see on the liability side of Fed's balance sheet was the same. Quantitative Easing meant buying huge quantities of assets on one side – federally guaranteed mortgage-backed securities and longer-term Treasury securities – which in turn meant even more reserve balances started building up on the other side of the balance sheet. As I came to understand, the Fed was using its unique power to create deposit liabilities on its own balance sheet at a scale that was once thought purely theoretical and potentially disastrous in theory as a cause of rampant inflation. But those fears were all in theory.



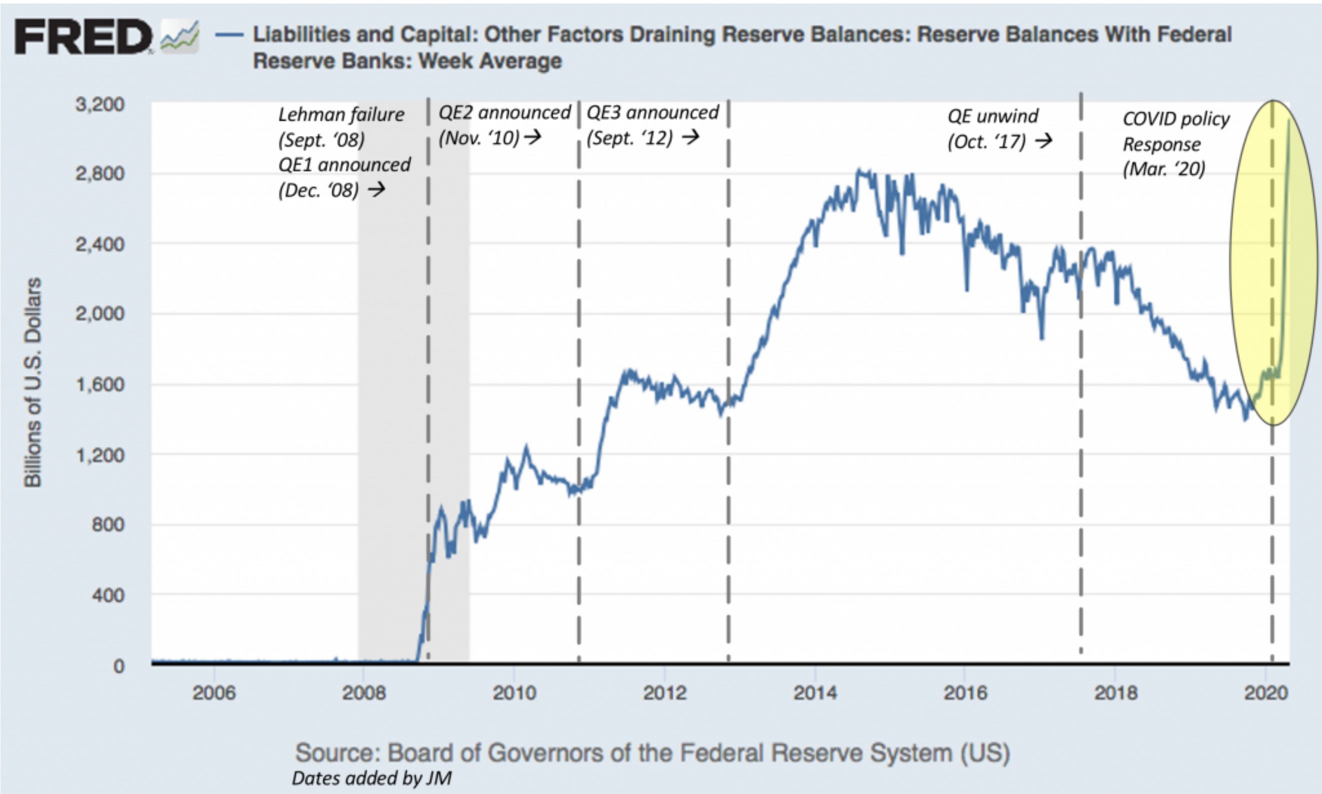
Source: Carpenter et al. (2013)

By October 2009, reserve balances broke $1 trillion for the first time ever. By August 2014, after three rounds of QE on one side of the balance sheet, reserve balances on the other side peaked at nearly $2.8 trillion. The Cleveland Fed wrote a 2015 briefing about it calling excess reserves, “Oceans of Cash.”

There was for a time a huge question of when or if the Fed would let reserve balances come back down, as assets on the other side of its balance sheet matured or the Fed sold them back to the market. From 2014-2019, that’s exactly what one paper from the Kansas City Fed showed was happening, quietly, smoothly, behind the scenes. That paper also gave a useful but very broad breakdown of which banks it was – foreign banks, large and smaller domestic – that had reserve balances built up and winding down in their accounts at the Fed. By September 2019, total reserve balances at the Fed were back down to $1.4 trillion.

Then came the economic disruption from the COVID-19 pandemic. Quantitative Easing, episode four, began on March 23 – “a new hope,” the St. Louis Fed called it. Between March 11 and April 1, total reserve balances went up a trillion dollars. On April 9, the Fed announced $2.3 trillion in emergency liquidity facilities that touched more parts of the economy than it has ever touched directly before, including small businesses, the corporate bond market, and the municipal bond market.

By April 22, total reserve balances broke $3 trillion for the first time. By now, whatever fears might have existed inside the Fed before 2008 about reserve balances building up within the system had either been re-educated away or retired or were being flat-out ignored. It seemed not to matter anymore. This was a brave new Fed.



Beyond the mechanics of what was happening with the Fed and its balance sheet, as a journalist it became important for me to connect the dots to the CARES Act. The political process had found a way of explicitly shaping the Fed’s liquidity facilities. While far from perfect, what political process is perfect?

The key was the $454 billion Emergency Stabilization Fund created under the CARES Act. Nathan Tankus, in his very helpful recent writings about the Fed, calls it an “accounting gimmick.” I don’t dispute his characterization of it from a technical perspective, but in another sense, those funds are the vehicle by which the political process is shaping the Fed’s crisis response.

Section 4003 of the CARES Act lays out the process for how the Emergency Stabilization Fund gets divvied up. The legislation directs the Treasury Department to use those dollars to make “loans, guarantees or other investments” into various emergency liquidity facilities, and the Federal Reserve comes in with its balance-sheet fire power to leverage the Treasury’s initial investment.

Subsequently, the Treasury allotted $75 billion for the two corporate bond market emergency liquidity facilities, which the Fed is leveraging up to $750 billion in bond-buying power. There’s $35 billion initial investment from the Treasury for the municipal bond market facility, which the Fed is leveraging up to $500 billion.

Most remarkable to me was the Main Street Lending Program. The Treasury Department allotted $75 billion from the Emergency Stabilization Fund for this facility, and the Fed is coming in with $600 billion behind that. That $600 billion will go out in loans to eligible businesses, under terms that include one year of deferred payments, accountability measures to retain employees, limits on executive compensation, and prohibitions on stock buybacks or paying off other debt using Main Street loan proceeds. The $75 billion will cover for any losses on the loans up to that amount before the Fed eats any losses.

Using loan participations, private lenders will underwrite and originate Main Street loans and the Fed will come in behind the scenes to supply 95 percent of the borrowed amount, leaving 5 percent on the private lender’s balance sheet to make sure they have some skin in the game. Having reported a lot recently about the Bank of North Dakota, the only state-owned bank in the country, loan participations by a public entity weren't so far-fetched to me, but I'm sure they would seem so to others around the country.

With a $1 million minimum loan size, the Main Street Lending Program is not quite accessible to most small businesses, but that minimum could go away later if the Fed and Treasury can be convinced of the need — or maybe Congress can straight up order them to eliminate the minimum. So, in summary, the Main Street lending facility is effectively one line on a term sheet away from being accessible to the vast majority of small businesses in the country, provided they were in good financial shape before the pandemic.

The municipal credit facility also seemed to have shortcomings, but not entirely unworkable, and outcries at initial terms and eligibility have already altered it. Initially it was only available to cities with at least one million people, or counties with at least two million people, leaving out a lot of hard-hit places. On April 27 those thresholds changed to counties with at least 500,000 people and cities with at least 250,000. Maximum maturity of two years initially seemed a bit shorter than ideal, and that changed to three years. The Fed is even considering allowing additional public entities to participate, like school systems, housing authorities, transit authorities and other public entities that issue revenue-backed bonds.

As a reporter, these were all brand new and fascinating lines of questioning about the ways that each facility works and how each would be received among the private financial institutions with the most potential to make them work for the most vulnerable communities.

The Fed is flexing muscles it never used before 2008. The next time around, people need to know, they can demand that

Congress make the Fed open up existing facilities to more people and places. They can demand that some of “Emergency Stabilization Fund 2.0” should be allocated to capitalize vehicles that do other things justified under the rubric of “stabilizing the economy in a crisis.”

What if, next time around, the Fed capitalized a small facility to make loans to black-owned businesses or to buy preferred equity shares in MDIs? A secondary capital facility for credit unions? Or a facility to acquire distressed residential or commercial real estate and sell it back to current occupants or to the market with deed restrictions for permanent affordability? What if there were a network of smaller facilities that would be administered by state or local governments — making them de facto public banks, with equity from Treasury as initial capital bases and leverage from the Federal Reserve?

It’s tempting to speculate about having the Federal Reserve’s balance sheet firepower behind priorities like those. But, as a journalist, I don’t have any horse in the race when it comes to which ideas or causes for advocates to back.

What I do have is a journalistic mandate to examine whether financial institutions, public or private, are able to support the people and places that, based on historical patterns, are most likely to be left behind in a crisis or a recession. The Fed is no longer just a systemically essential but distant player in that narrative; it was suddenly, squarely within my beat and doing new things that people deserved to understand better.

The Fed’s post-October 2008 way of operating implies new ways of making demands and holding public officials accountable. It changed in ways that needed to change how I worked, and should probably change how at least some of my readers work. People who care about economic justice and righting the wrongs of history need to know exactly how this brave new Fed works in order to understand more clearly what to demand and how to make demands of an institution that is supposed to be working on behalf of us all.