GRANT'S
INTEREST RATE OBSERVER®
Vol. 31, No. 15a Two Wall Street, New York, New York 10005 • www.grantspub.com JULY 26, 2013

Demobilizing the reserves

One day soon, banks will have on deposit at the Federal Reserve $2 trillion more than the rules require them to hold, a mountain of excess reserves that could, at the outer limit of what is theoretically possible in money and banking, support $20 trillion of new lending. Now under way is a speculation on the meaning of this imminent fact.

All agree that $2 trillion is a large and complicating figure. Chairman Bernanke insists that it isn't a troubling one. But unless we miss our mark, the Fed will miss *its* mark. It will overstay its inflationary course until it can't reel in the dollars it has so generously paid out. We think the die is already cast.

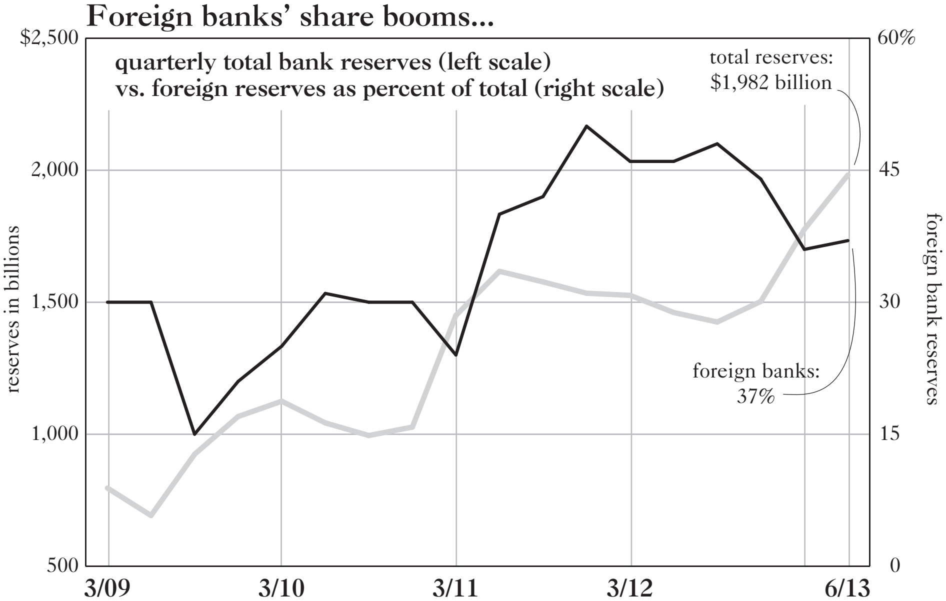
For signs that the Fed will stay too easy for too long, look no further than the bond market. On talk of a mere "tapering" in asset purchases (never mind cessation, still less of outright sales), the yield on the 10-year Treasury note vaulted to 2.74% from 1.63% in the course of only 46 trading days. World markets shuddered, and the FOMC probably shuddered along with them ("*Holy mackerel, we did that?*"). Buying securities with newly issued dollars is not only the path of least resistance, it is also, to many policymakers, the path of prudence, conscience and duty. It will be hard for the Bernanke Fed to abandon it, and a Yellen Fed would find it no easier.

In modern central banking, the learned practitioners do not just print money (or withhold their printing). They also "communicate," and the burden of what they communicate these days is usually the assurance that they will remain accommodative. Thus, on Feb. 11, 2011, Rep. Mick Mulvaney (R., S.C.) asked Bernanke—the chairman was then testifying before the House of Representatives—why the Fed had decided to buy $600 billion of Treasurys in its second round of quantitative easing instead of, say, $500 billion or $750 billion? "We estimate that the impact on the whole structure of interest rates from $600 billion is roughly equivalent to a 75 basis-point cut [in interest rates]," Bernanke replied, the funds rate being zero. "So, on that criterion, it seemed that that was about enough to be a significant boost, but not one that was excessive."

QE was tantamount to a rate cut: Such was the message two years ago. But in his Humphrey-Hawkins testimony last week, Bernanke tried to explain why ending, or tapering, QE would not be tantamount to a rate hike. "[E]ven after purchases end," said the new and revised version of the Bernanke text, "the Federal Reserve will be holding its stock of Treasury and agency securities off the market and reinvesting the proceeds from maturing securities, which will continue to put downward pressure on longer-term interest rates, support mortgage markets and help to make broader financial conditions more accommodative."

Possibly, the chairman means to communicate a yield-curve stratagem. Other things being the same, the greater the distance between funds and 30s, the brighter the prospects for

Foreign banks' share booms...



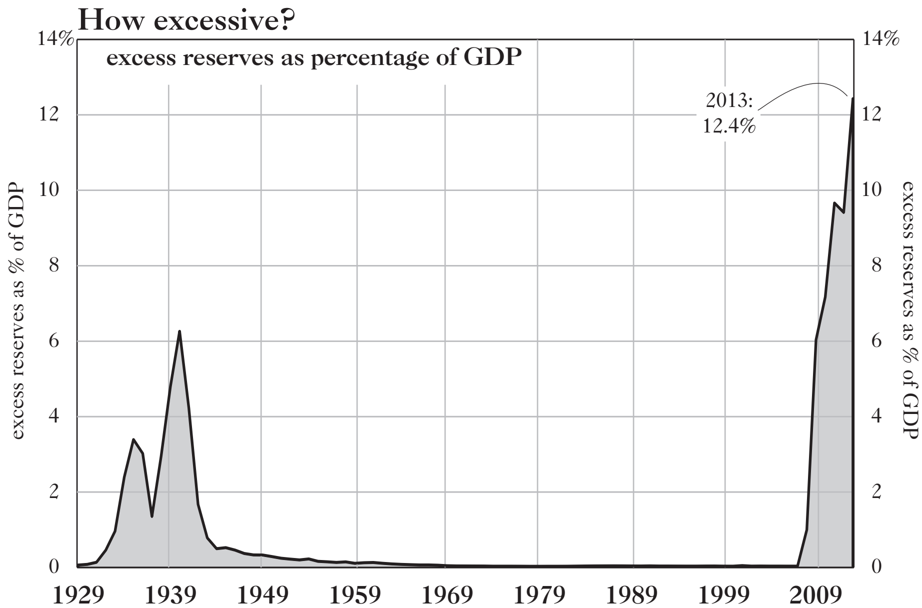
source: Federal Reserve

economic growth. By pledging to hold the funds rate at zero while letting the long-bond yield lift, the Fed might be hoping to bring about the good things a steeper curve could help to deliver. Then, again, how would the Fed muscle down the funds rate except by the inflationary monetization of government securities? It's a conundrum.

Some would interject that even $2 trillion of excess reserves present no inflationary threat if the apparatus of lending and borrowing is impaired. In that money and banking class you wish you had not slept through, the professor explained that banks may lend and relend these funds up to the inverse of the reserve ratio. Thus, a 10% reserve ratio would provide scope for $10 of new credit for each $1 of excess reserves—assuming a normally fluid banking situation. But when borrowers aren't borrowing, latent lending power goes unused. (A slightly technical point: To the banks in whose Fed accounts the money is deposited, "excess reserves" are cash, a perfectly suitable asset for use as collateral in futures and derivatives transactions. So that $2 trillion may not be entirely idle after all.)

The chairman, a scholar in his previous life, values punctilious accuracy in speech and writing (the Fed does "not literally" print money, he helpfully pointed out last week; the Bureau of Engraving and Printing is the one with ink on its fingers). So, in support of the cause of accuracy, we note that the Fed has retired the *datum* excess reserves; under a new rule, banks keep reserves within a range above and below the required level. But the concept of excess reserves lives on, and so—in a do-it-yourself fashion—does the calculation of the now-retired figure. Thus, as of July 10, such balances amounted to $1.983 trillion, within shouting distance of $2 trillion. As recently as year-end 2007, they totaled a mere $1.8 billion (with a "b").

"As a percentage of GDP," relates colleague Evan Lorenz, "excess reserves stand at a never-before-seen 12.4%. Total domestic nonfinancial credit amounts to 254% of GDP, which means that banks are sitting on the potential to increase total credit in America by half. Between 1929 and 2007, excess reserves averaged just 0.5% of GDP (as a rule, of course, bankers prefer not to sit on idle balances, but to make their money sweat). As a percentage of GDP during the unprosperous 1930s, excess reserves peaked in 1935 at 3.4%. They spiked to 6.2% of GDP in 1940, the year Paris fell to Hitler."



source: Federal Reserve Bank of St. Louis, Bureau of Economic Analysis, Banking and Monetary Statistics 1941-1970

Just as noteworthy as the level of excess reserves today is their composition. Of that almost $2 trillion, $738 billion, or 37% of the total, is credited to American branches of foreign banks. Interest-rate arbitrage is one reason for this striking fact. Desire by the managements of foreign banks to accumulate reservoirs of dollars with which to stock the home office in times of need is another reason. Suffice it to say that if the Fed finds it necessary to jack up the interest it pays on reserve balances—today's rate is 25 basis points—Congress will surely demand to know why the taxpayers are enriching the stockholders of non-American financial institutions.

There is another item of background information that bears on the curious distribution of excess reserves. Ever since 2011, the FDIC has dunned its member banks not on the size of their insured deposits but on the difference between their assets and tangible equity. In the case of Bank of America Corp., for instance, the change raised the assessed base to $1,968 billion (that being the difference between assets and tangible equity) from $1,006.8 billion (those being the bank's American deposits). The BofA's assessable base was effectively doubled. Though all banks, foreign and domestic, earn one-quarter of one percent on their deposits at the Fed, American banks wind up paying the FDIC between five and 45 basis points on those same deposits (the exact levy depends on the regulators' assessment of a particular bank's safety and soundness). For many of these institutional depositors, it's a break-even proposition, at best.

Because the American branches of foreign banks are not so inclined as homegrown institutions to lend in the 50 states, the excess reserves that the foreign banks control are less likely to find their way into the American financial bloodstream than are the American banks' balances at the Fed. So let us set aside the foreign banks' share of that nearly $2 trillion figure. Still, that leaves $1.2 trillion in excess balances in the accounts of American-chartered banks, equivalent to 7.8% of GDP. That, too, is a record-high reading.

Anyway, apologists for the Fed argue, there is no realistic risk of these immense sums doing inflationary mischief. With the power to pay interest on excess reserves (granted by an act of Congress in October 2008), the central bank is the master of the dollars it conjured. If it chooses to bottle them up inside the Federal Reserve System, it can simply pay the banks not to withdraw them. Problem solved, or so the argument runs.

Yet the banks, as noted—the American ones—are earning little to nothing on those balances at the current, 25 basis-point deposit rate. How little becomes clear when one compares one-quarter of 1% with the 4.61% that the banks are earning today on jumbo mortgage loans to prime borrowers (see *Grant's*, July 12). If the Fed would manipulate the banks with high deposit rates, the very same Fed has committed to medicate the labor market with low deposit rates.

"Besides," Lorenz observes, "the Federal Reserve is earning the same rock-bottom interest rates that Bernanke et al. have stuck the rest of us with. In 2012, the system's earning assets delivered a return of 2.9%, down from 3.3% in 2011 and 3.7% in 2010. Maybe the yield is on its way to 2.5% (no disclosure on this point till year-end). It wouldn't be surprising in view of the Fed's continued purchase through QE of $85 billion a month of low-yielding Treasurys and MBS.

"The yield is meaningful because it defines how much the Fed can pay on reserves before it pays out all its earnings," Lorenz continues. "If the Fed were earning 2.5%, the top interest rate it could afford to pay would be 4.3%. At 2%, it could afford to pay only 3.4%. You ask: Why couldn't the central bank simply buy more Treasurys and more MBS with which to earn the income from which it could bribe its member banks not to withdraw their deposits to feed a new inflation? Well, it could. But where would it stop? And what would Mr. Bond Market say about a new adventure in quantitative easing at what would arguably be exactly the wrong time?"

For that matter, what would the House, the Senate and the White House say? Over the past three years, the Fed has contributed mightily to the federal budget. Its QE-generated earnings have chipped in an average of about $3\frac{1}{2}$% of annual federal receipts. How would it fly in sequester-minded Washington if the former monetary sugar daddy announced that it was not, after all, remitting funds to the Treasury, because it was paying out those billions instead to its banking clientele, not forgetting the foreign cohort?

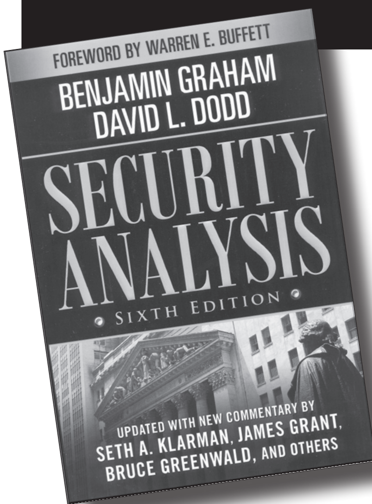
The Bank of Bernanke can be seen as a prisoner in a monetary jailhouse of its own construction. Interest rates and the yield curve will block the exits. So will budgetary politics. One day—timing, as usual, uncertain—the chairman or his successor will try to neutralize, sterilize or immobilize the excess reserves that today lie idle (more or less) in the system's computers. We say that those dollars will prove harder to squelch than they were to create.

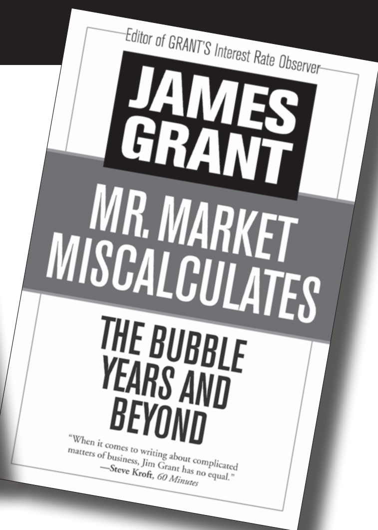
In 1934, the economics faculty of Columbia University organized publication of a big fat book entitled, "The Banking Situation." Excess reserves were then a concern, just as they are today. But they would not necessarily prove inflationary, wrote one of the contributors to the volume, Louis Shere, since they would not be mobilized until the demand for business credit picked up. But, Shere went on, a central bank in conscience could create only so many reserves, "because it is quite conceivable that if a huge amount of credit is created in the lean years, perhaps when the money lever is more or less inoperative, the Federal Reserve Banks could not 'mop up' the supply in early revival without breaking the bond market. Under these circumstances, the foundation would be laid for the next collapse."

In point of fact, the bond market in the 1930s went unbroken. But as for the 2000s, we say: Stand by!

•

Choose one free gift with your new subscription...






"Will you marry me, going forward?"

Subscribe to *Grant's*®

and get your choice of ***either*** a free copy of one of the books above, *autographed by Jim Grant*, ***or*** a reproduction of a classic *Grant's* cartoon.*

**You must pay for your subscription by Nov. 27, 2013, to be eligible. Cartoon is a matted reproduction of a Grant's cartoon. See our site for more details.*

Don't wait. Go to www.grantspub.com/0913R

Once there, you can finish reading the articles begun here by downloading a complete, oversized PDF.
OR, you can simply join us right away and subscribe. You have four ways to join:
(1) Go to the URL above. (2) Call 212-809-7994. (3) Fax the form below to 212-809-8492.
(4) Mail the form below to Grant's, Two Wall Street, New York NY 10005

❑ **Yes, I want to subscribe.**
Enclosed is my payment (either check or credit card).
***Free offer good until November 27, 2013.**
Subscription offer good until December 31, 2013.
Understand that as a paid-up subscriber, you may cancel at any time for a prorated refund on the remainder of your subscription.

❑ 1 year (24 issues) for ~~$1,025~~ **$965**
❑ 2 years (~~48 issues~~) **50 ISSUES for $1,855 (Best value!)**
❑ TRIAL - **8 ISSUES for $389**
Group rates available upon request.
❑ Check enclosed (Payment to be made in U.S. funds drawn upon a U.S. bank made out to Grant's.)

#____________________ Exp.______
Credit card number

Signature ____________________

CV number ______ (3-digit code on back of VISA/MC/Disover; 4-digit code on front of AMEX)

Choose one of the following as your free gift:*
❑ **Security Analysis** *OR* ❑ **Mr. Market Miscalculates**
OR ❑ **the Grant's cartoon, "Will you marry me, going..."**

Name ____________________

Company ____________________

Address ____________________

Daytime Phone (required) ____________________

E-mail ____________________

0913R

TWO WALL STREET • NEW YORK, NEW YORK 10005-2201 • P:212-809-7994 • F:212-809-8492 • WWW.GRANTSPUB.COM