What Really is Happening at the Fed?

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Each time the Fed has met in recent months, financial markets have a mini stroke in the face of continuous increases in the fed funds rate. The whole idea of Fed policy is to tighten down on economic demand to reduce the current levels of inflation. By raising the cost of money (interest rates) the Fed believes that business activity will slow as a result. So far, that expectation has showed few, if any, signs of fulfillment. Is there a chance that Fed policy won't have the intended effect of slowing the economy?

In a recent edition of the Wall Street Journal, an article appeared titled: "Fed Pays Out More Than It Takes In." The essence of the article was that the Fed was paying a higher rate of interest to member banks on their reserve deposits at the Fed. The thrust of the article was that the Fed was operating at a loss and that continued losses would be bad for the Fed. Fortunately the article informed us that the Fed can create money via an IOU that can be incorporated into its balance sheet to be liquidated when the Fed begins to earn money in the future when payouts are substantially lower.

What we found interesting is that, up until recently, the Fed was "earning" over $100 billion a year and repatriating that money to the Treasury. In other words, the Fed was effectively acting as a tax collector and taking $100 billion out of the economy via interest rates paid on bonds that the Fed held in its inventory of financial assets. While the interpretation of Fed policy over the past ten years was that the Fed kept interest rates low to help the economy; it was, at the same time, acting as a major tax collector for the government. According to the chart that accompanied the article, it appears that the Fed collected "taxes" to the tune of over $1 trillion over the past ten years -- a time when the Fed's policy of quantitative easing was supposedly helping the economy.

The Fed's pivot this year to a tight money policy has had the reverse effect. While running in the "red," the Fed has been returning money to the private sector. By paying interest on bank deposits, bank income is rising. By allowing bonds to mature, the interest payments on those bonds are no longer ending up on the Fed's balance sheet and in the pocket of the Treasury. In other words, the Fed is now adding liquidity to the economy, not withdrawing it as is evidenced by it running at a "loss."

Over the next few months, the policies of the Fed to slow down the economy may conflict with the policy of paying banks higher interest rates on their deposits. A stronger economy, rising losses at the Fed and further interest rate increases by the Fed to slow the economy may have interesting consequences. Stay tuned!

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