

## **Monetary Policy: The Liquidity Risk Remains**

By Jane D'Arista

The continuing round of responses to the financial crisis has pushed up the combination of capital injections, loans and guaranties extended on the tab of the U.S. Treasury and Federal Reserve to an amount some estimate to be more than half of U.S. GDP. Even at this level, however, many do not think the risk of yet another collapse has been defused. It is widely believed that the financial sector is sliding into insolvency; that monetary policy is useless at this point and only fiscal policy can address the increasingly pervasive effects of the credit crunch on the real economy.

That view discounts the very real dangers that remain if a path to reviving liquidity in financial markets remains elusive. The government's capital injections may have helped delay the implosion for a time but they failed to generate new capital from other sources and it is likely that more institutions, large and small, will face collapse. Without a more aggressive effort to supply the needed liquidity and stabilize the prices of a vast array of frozen assets, the meltdown in the capital of the financial system is likely to continue, wiping out what the Treasury (and taxpayers) contributed with it. .

What is needed is a substitute for capital – a liability that can be created and supplied by the government without the use of taxpayers' money. The ideal vehicle for creating this substitute is the reserves that the Fed created and extinguished in its implementation of countercyclical monetary policy before it abandoned their use in the deregulatory sweep of the 1990s. Banks lobbied for their removal because reserves were held as non-interest-bearing assets that reduced earnings and the competitiveness of domestic banks compared with other financial institutions and their own unregulated branches in offshore markets. If, however, reserves were supplied as liabilities – carried on the same side of financial institutions' balance sheets as capital and customers' funds – they would recreate a mechanism for central bank countercyclical operations that would be far more effective than any tool in the Fed's history to date.

Using reserves as a substitute for capital by flipping the balance sheet of financial institutions (and the Fed) addresses the problem of “pushing on a string” that the Depression-era economist, Irving Fisher, identified as he watched excess reserves pile up in the banking system in the early 1930s without generating new loans. The new reserve management system proposed here would allow the Fed to buy assets in the open market or directly from any financial institution and pay for them by crediting reserves to that institution's account with its regional Federal Reserve Bank. The central bank's actions would result in an imbalance for the financial institution: its purchases would reduce the bank's holdings of assets while the additions to its reserve account would supply new liabilities of equal value, providing a powerful incentive for the institution to make new loans or buy more assets.

Given the recognition of the systemically-important nature of sectors other than banks, any federally regulated institution, regardless of label, must be eligible to hold reserves with the Fed. And, since the Fed has already expanded the range of assets it buys and the maturity of its lending facilities, it should build on that experience by entering into term repurchase agreements (the Fed's new liabilities) with the private financial sector, collateralized by whatever instruments it believes need the liquidity its purchases will provide.

As it does now when it buys Treasury and other securities, the Fed will be part of - and assist in - the process of price discovery. But it will do something even more important: it will introduce new liabilities (reserves) that retain their face value in a time of declining prices. Because they would retain their value, allowing all financial sectors to use reserve accounts as a means of payment or as collateral for borrowing within the financial sector would be a critical step toward restoring the necessary confidence in inter-systemic transactions.

Despite the extensive re-writing of the central bank rule book already underway, this proposal will seem radical to some – especially those who continue to think of the U.S. financial system as a traditional, bank-based system. But banks' on-balance-sheet assets have dropped by more than half over the last three decades to less than a quarter of total outstanding credit. During this period, households moved their savings into pension and mutual funds – a trend that set off a migration of the bulk of borrowing by households and businesses to the capital markets. Banks both originated and invested in the mortgage and other asset-based securities that began to dominate credit markets in the 1980s and increasingly relied on other banks and financial institutions to supply the funds that supported their on- and off-balance sheet positions. Like other institutions, the larger banks increasingly engaged in trading to acquire both assets and liabilities. The result is a market-based system operating under the very different rules that govern trading as opposed to those that apply to the traditional depositing and lending activities of banks.

As this evolution got underway, U.S. and other G10 authorities agreed to rely on capital adequacy rules for banks as the key tool for restraint in a stripped-down regulatory system. The question that was never asked was how using bank capital to govern credit expansion and contraction and to bolster soundness would fit in with the rules and culture of a market regime. Requiring that assets be marked-to-market results in charges against capital. The resulting loss of capital lowers credit ratings, raises the cost of funding and makes it less likely that capital can be replenished. Financial institutions will not lend to one another – and thus won't begin to regenerate the flow of funding needed to extend credit to the real economy – because any decline in the prices of assets backing those loans will reduce the capital of both the borrower and the lender.

However, since trading is the means to price discovery in the opaque, over-the-counter markets that now dominate the system, relaxing the requirement for "haircuts" would only perpetuate the freeze on inter-systemic lending and exacerbate financial institutions' loss of confidence in one another. Hoarding capital by not lending seems a rational response at the level of the individual institution but is a disaster at the systemic

level. The failure to lend keeps downward pressure on asset prices, on the capital of the financial system as a whole and transmits the downward spiral from the financial sector to the real economy.

As the Fed continues to play by old, bank-based rules, it has created additional reserves for banks through its lending facilities that perpetuate the freeze on lending because they are held as assets. Unable to attract the capital needed to support more lending, bank reserves crowd out other assets - particularly now that the Fed pays interest on them - much as Treasury securities crowded out the trade bills that were the only instruments eligible for discount in the early 1930s. No wonder monetary policy - then as now - is dismissed as useless in a severe downturn. Nevertheless, the Fed's decision to increase reserve holdings suggests that it is beginning to understand their value in the current crisis even if it has not yet understood how important it would be to engage in the aggressive creation of reserves as liabilities.

The argument that reserves be created as substitutes for financial sector capital is, in a sense, an effort to restore the monetary cushion that was lost in the process of deregulation. Before the 1980s, the systemic cushion for the U.S. financial sector was bank reserves. Requiring banks to hold reserves against deposits with their regional Reserve Banks was one of the major reforms of the 1913 Act and gave the System the tools to develop the countercyclical strategies it used from the mid-1930s forward to maintain stability. In 1951, when banks held 65 percent of financial sector assets and liabilities, their reserve balances amounted to over 11 percent of their deposits and constituted a remarkably comfortable cushion for a segmented financial system in which banks loaned to other financial sectors with which they were not then in competition. By year-end 2001, that bank-based system was gone. Banks' credit market assets had fallen to less than half the share they held fifty years before, their reserve balances had shrunk to 0.2 percent of their deposits and they had come to rely heavily on the financial sector itself for funding.

The missing monetary cushion has weakened individual financial institutions and the system as a whole. Restoring that cushion will require rebuilding a publicly created, renewable source of systemic funding that is transferable and available to all financial sectors in a downturn. It is a strategy that can channel the liquidity needed to prevent ongoing insolvency in the financial system. It will not repair the damage that has been done nor protect against all potential losses posed by the unwinding of leveraged positions. Nevertheless, it is the step that must be taken to get this crisis under control.

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