Yellen faces a logistical nightmare

*The impending transition from Ben Bernanke to Janet Yellen at the US Federal Reserve is taking place at a particularly sensitive time, argues **David Rowe** – the new chair faces the logistical nightmare of unwinding a massive increase in the central bank's balance sheet*

Public discussion of US monetary policy over the past five years has been remarkably ignorant. Critics of Ben Bernanke often claim that, under his chairmanship, the Federal Reserve has been destroying the integrity of the dollar and encouraging runaway inflation. This seems to be based on a misunderstanding of how fractional reserve banking works.

Understanding Fed policy since late 2008 requires some familiarity with the extended debate among economists about the causes of the Great Depression of the 1930s – a subject to which Bernanke dedicated a great deal of his academic career.

An important contribution to the debate was presented in the landmark study authored by Milton Friedman and Anna Schwartz, *A Monetary History of the United States, 1867–1960*. The study's central argument was that a cyclical correction turned into a decade-long depression because the Federal Reserve allowed the money supply to collapse. Bernanke – then a member of the Federal Reserve Board, but not yet its chairman – alluded to this argument at a celebration honouring Friedman's ninetieth birthday in 2002. "Regarding the Great Depression," he said, "you're right – we did it. We're very sorry. But thanks to you, we won't do it again." The Fed's monetary policy since late 2008 can be viewed as a determined effort to honour that pledge.

Bernanke succeeded – steadily growing money supply throughout the crisis – but it proved a harder task than even he must have imagined. Figure 1 illustrates the success of this effort, as well as its awkward residual consequences.

Looking at the historical chart for the broad US money supply – known as M2 – steady growth in the money supply has clearly been maintained.[1] This is remarkable in light of the massive financial and economic upheaval the world has experienced.

But it has left the banking system awash with liquidity. Prior to 2008, excess reserves in the banking system were often less than 10%, and seldom more than 20%, of required reserves. In effect, banks were 'loaned up' to their legal limits most of the time. Since 2008, however, excess reserves have gone from a modest fraction of required reserves to double-digit multiples thereof. For the first three quarters of 2013, excess reserves were almost 18 times required reserves.

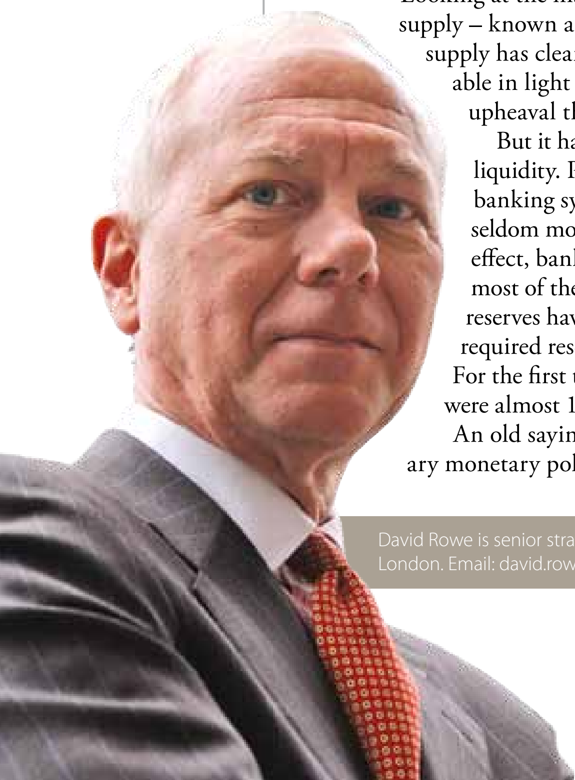
An old saying among economists is that expansionary monetary policy can be like pushing on a string. For many years, that complaint seemed so irrelevant that it was almost forgotten – clearly it came back with a vengeance.

This leads us to the challenge facing Janet Yellen, the nominated replacement for Bernanke. She is unusual in coming to the job with a reputation as a monetary policy dove, who feels the central bank needs to worry more about supporting output and employment than about the dangers of inflation. With the recovery still sluggish, her view is shared by many others. The real test will come when the economy eventually returns to more vigorous growth and loan demand picks up. Given demand to borrow and banks' willingness to lend, the system is positioned for an explosive expansion in the money supply unless the Fed steps in quickly.

This will be a massive logistical problem for the central bank. Withdrawing reserves from the system by selling the huge inventory of bonds the Fed has accumulated risks creating a spike in interest rates that chokes off the recovery. Presumably, some temporary increases in reserve requirements to constrain excessive lending – probably accompanied by payment of interest on reserves – will be part of the mix. The logistics of the operation will inevitably be complicated by politicians clamouring to let the good times roll.

Yellen is old enough to remember the inflationary spike of the 1970s and its economically wrenching aftermath. One can only hope she will act to avoid a repeat of this episode – and that her reputation for concern about output and employment will give her the credibility to face down politicians with a less clear-eyed view of history. ■

[1] *In the five years from the third quarter of 2008 to the third quarter of 2013, M2 grew at an annual average rate of 6.7%. This compares with a 6.3% annual growth rate during the previous 10 years*



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1 US money supply (M2 – left scale) vs total bank reserves (right scale)