

Total Reserves, Excess and Monetary Policy

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Beginning in September, 2008 the Federal Reserve initiated a policy that produced an explosive increase in bank reserves. This policy created a number of unusual monetary developments that have important implications for the economy and future inflation.

Since the creation of bank reserves is the first step in the process whereby the Fed creates money, the massive increase in these reserves has led to concern that they would soon be followed by a rapid increase in spending as well as rapid inflation.

I have suggested that one the reason the increase in bank reserves was not quickly followed by increased spending is because banks initially held more reserves with the Federal Reserve than the Fed created. Between August, 2008 and January, 2009 St. Louis Fed data show an increase in adjusted bank reserves of \$774 billion. Over the same period, banks increased their holdings of excess reserves at the Fed by \$796 billion.

I have argued that this buildup in excess reserves at the Fed negated much, if not all, of the stimulus from the increase in reserves. Hence, for purposes of interpreting monetary policy the focus should be on “net reserves” or reserves after allowance for excess reserves.

I also suggested that the buildup in excess reserves at the Fed could make it much more difficult for the Fed to control the relevant measure of new liquidity—bank reserves after allowance for excess reserves.

A new analysis by staff members at the Federal Reserve Bank of NY shows how the buildup in excess reserves can be directly related to the Fed’s new initiatives that led to the increase in bank reserves.

The analysis is important because it strongly suggests that the buildup in excess reserves is controlled more by the Fed’s initiatives than by decisions at individual banks. This conclusion is further supported by the relatively close relationship between bank reserves and in excess reserves since last September. The analysis implies that as the Fed unwinds the activities that have led to the massive rise in bank reserves, much of the rise in excess reserves will also disappear. <http://www.newyorkfed.org/research/staff-reports/sr380.pdf>

The Fed’s analysis suggests that it has more control over the behavior of excess reserves than if the banks themselves were totally dictating the levels.

The staff analysis also explains why the growth in traditional monetary measures, M1, M2, etc. have not increased as rapidly as bank reserves. The answer is that excess reserves have replaced one lending mechanism with another.

The main implication of the staff’s analysis is that the seven or eightfold increase in bank reserves that has occurred over the past year does not have the inflationary impact that would normally be associated with such an increase. The coincident rise in excess reserves, which have dampened the impact of the increase in reserves, is a byproduct of the Fed’s action.

This revelation makes it readily apparent why it’s necessary to subtract these excess reserves in assessing monetary stimulus. It also suggests that the explosive rise in bank reserves is not a reliable guide to future inflation. Rather, in assessing the longer-term threat of inflation the focus should continue to be on “net reserves.”