

Recent Monetary Developments with respect to Bank Reserves

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I have suggested that the single best measure of monetary policy has been the Federal Reserve Bank of St. Louis series on “adjusted” bank reserves. The adjustment that the St. Louis Fed makes allows for changes in reserve requirements. The idea underlying this “adjustment” is that a change in required reserves will change the amount of reserves used to support loans and investments, hence bank deposits and hence, most traditional measures of the money supply.

The St. Louis series goes back to 1918 and is the best monetary measure I have found for assessing the impact of Fed policy on the economy. In my past two annual reports I show how a slowdown or decline in this measure of bank reserves has been related to almost every recession for the past ninety years. I also show that the magnitude of the shift in bank reserves in recent years was related to the collapse in spending and the recent financial crisis.

Beginning in late 2008, the Federal Reserve increased bank reserves by ten times in an effort to provide liquidity. In conjunction with this increase, there was also a tenfold increase in excess reserves (reserves that banks keep with the Fed that are over and above what the Fed requires).

Since excess reserves are not being used to support loans or investments, they stifle the normal multiple expansion of bank credit. In doing so, excess reserves limit the creation of bank deposits and therefore most traditional measures of money.

I have argued that subtracting excess reserves from total reserves provides a more accurate

picture of monetary policy during the past 1½ years.

In addition to adjusting bank reserves for changes in reserve requirements, the St. Louis Fed also adjusts its series for seasonal factors. As the *not seasonally adjusted* chart below shows, the monthly data prior to late 2008 have a clear seasonal pattern with an increase of roughly \$5 billion every January or roughly 5% of the series.

With the recent massive increase in reserves, the seasonally adjusted numbers have actually been more erratic than the not seasonally adjusted numbers. This should not be the case. Seasonal adjustments are supposed to smooth data not make them more volatile. This suggests that there are serious problems with the seasonal adjustment methodology.

The issue has become particularly important because the two series are currently showing a dramatically different pattern. Seasonally adjusted numbers show a collapse in reserves during December and January. Such a collapse would normally mean problems for the economy. However, not seasonally adjusted numbers show a fairly steady increase. This would tend to point to a further rise in the pace of spending going into the spring and summer months.

I have been unable to resolve this apparent discrepancy with my contacts at the St. Louis Fed. Until doing so, I view the unadjusted numbers as a more accurate description of the current thrust of monetary policy. This means that the odds point to a further acceleration in the pace of spending this spring and summer.

Adjusted Bank Reserves less Excess Reserve

Not seasonally adjusted



Adjusted Bank Reserves less Excess Reserves

seasonally adjusted

