Tools of the Fed: Playing with Fire?

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Member banks of the Fed borrow and lend very short term funds often over night in the Federal Funds Market. The Fed itself does not participate in this market although its Target Federal Reserve Rates gets wide publicity. However, since the Fed began to pay interest on its holdings of the reserves of member banks, it has become an effective major price setter in this market. I propose to describe how this works and its consequences.

Only demand deposits are subject to a reserve requirement. Now any member bank holding more reserves than it wishes has two alternative; it can lend on the Federal Funds market or it can obtain interest on these reserves from the Fed. Consequently, the interest paid by the Fed on member bank reserves, 0.25 per cent, sets a floor on the interest rate in the Federal Funds market. Why would a member take less than 0.25 per cent on a loan to another member when it can get at least this much from the Fed?

By paying interest on member bank reserves, the Fed has a ready tool for raising the stock of high powered money. Nor is this all. The Fed has purchased enormous amounts of mortgages from Fannie Mae and Freddie Mac. To the extent that some of these funds become deposits at member banks, high powered money increases pari passu, as Lord Keynes would say. Whatever interest is paid on these mortgages to the Fed is turned over by the Fed into Treasury accounts and presumably becomes in one way or another high powered money.

These new tools enable the Fed to set minimum Federal Funds Rates and have a well oiled machine to increase the stock of high powered money. The lessons of the past are mixed. After the end of World War II when large stocks of money lay in savings accounts, the prominent Keynesian, Alvin Hansen, in his Harvard lectures in the Fall, 1951 wondered why there was no commensurate inflation. Huge increases in the money stock was associated with inflation during the 1970’s. What lies ahead now? Is the present situation closer to 1951 or to 1973?