The Daily Dish

Deep Breaths, Everybody

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This is a big week for the Federal Reserve. Not because the Federal Open Market Committee meets on Tuesday and Wednesday to decide the future path of interest rates, inflation, and unemployment in the absence of any real-time data on those issues. No, the big action is this Thursday, when the Senate will hold a hearing on the adrenalin-saturated topic of paying interest on banks' reserve deposits at the Fed.

Eakinomics knew that would get your attention!

Banks hold deposits at the Fed, which count as part of banks' reserves to meet demand for deposits and cover loan losses. The Fed pays interest on what are essentially loans to the Fed. That interest rate is an important tool for controlling short-term interest rates because loans to the Fed are safe and no riskier loan will be made to a private-sector borrower at a lower rate.

Interestingly, the hearing is not being held by the Senate Committee on Banking and Urban Affairs, which is the natural venue for a discussion on reserve requirements and the tools of monetary policy. Instead, it is being held by the Committee on Homeland Security and Governmental Affairs, where paying interest is being characterized as a "big bank welfare program."

Certainly, stopping interest payments would reduce the perceived subsidy to large banks (who are the banks that have accounts at the Fed). And without the interest earnings, banks would have to lend to private borrowers and be subjected to more capital market discipline. It would also return the Fed to the pre-financial crisis world, when it did not pay such interest.

There would, however, be an incentive to hold fewer reserves and to lend to private borrowers; thus, banks would be exposed to greater risk. And the Fed would lose its most potent weapon for controlling short-term interest rates. While there may be superficial political appeal to attacking big banks, it should be noted that returning to the “good old days” means returning to a regime that proved to be less than perfectly stable.

Put differently, who cares what decisions get made on Tuesday and Wednesday if Thursday’s discussion means that those decisions may not be implemented effectively? There is no reason to make the Fed less stable, less useful, and less able to respond to stress. The right way to think about such a proposal is to look at the impact on the banking system and not any single bank.

It’s a big week for the Fed. Let’s focus on Tuesday and Wednesday.