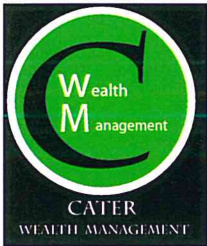

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Greg Cater Sr. and Greg Cater Jr.
Is The Fed Tightening Too Much?
8/15/18

Prior to the Great Financial Crisis (GFC) of 2008 the Federal Reserve (Fed) would tighten financial conditions when they believed the economy was running too hot. It would accomplish this by draining Reserves. Reserves are deposits commercial banks must keep at the Fed to support their lending. Contrary to what most think, banks don't lend existing deposits. This idea, called the Loanable Funds Model, was taught to all Econ majors, including myself, for a generation. It's too bad it's wrong. When a bank makes a loan, it creates a deposit in the account of the borrower (out of thin air). To be able to create this deposit, the bank must first have adequate capital, and then must have the required Reserves to support the loan (usually 10% of the loan balance) on deposit at the Fed.

Prior to the GFC banks did not keep excess Reserves deposited at the Fed. This would not have made financial sense. At that time the Fed did not pay Interest on Excess Reserves (IOER) like it does now. If a bank wanted to make a loan and didn't have the required Reserves it would borrow them from another bank. For well capitalized banks the Reserves would always be available. It was the Federal Reserve's job to make sure the required Reserves were in the system.

If the Fed believed the economy was running too hot they would make reserves scarce through open market operations (buying and selling treasury securities). If Reserves became scarce banks would have to pay more to borrow them. If the banks had to pay more to acquire the Reserves needed to support their lending, borrowers would have to pay more to borrow. This would tend to reduce borrowing and slow the economy.

The Fed now believes the economy is in danger of running too hot and has been increasing its target interest rate since December of 2015[1]. Since then they have raised the rate 7 times, it now stands at 1.75% to 2.0%. It started out a 0%. Since WW II the Fed has attempted to cool down an overheating economy (soft landing) 12 times[2]. Eleven of those times resulted in a recession. What are the odds they get it right this time? In addition we see tightening in at least 3 other areas. I have outlined them below.

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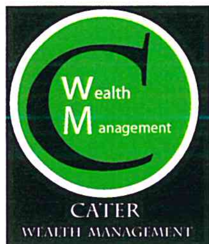

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1) **Reducing the Fed's balance sheet.**
   According to noted economist, Lacy Hunt, the Fed's current plan to reduce its balance sheet is, in effect, tightening more than the Fed Funds rate hikes. We don't know for sure (neither do they) because they have never done this before. The Balance Sheet reached a peak of $4.5 trillion and since the reduction started it has been reduced to $4.25 trillion[3]. Not much of a drop but the unintended consequences have some, including me, expecting a reversal soon. Every time the Fed reduces the assets on its balance sheet it has to reduce its liabilities by the same amount. The liabilities reduced are Reserves. I believe the tightening effects of the Balance Sheet reduction will force the Fed to abandon this idea before the end of this year.

2) **Increased issuance of US Treasury Debt.**
   Trump's tax cuts and other economic stimulus have led to a dramatic increase in the amount of Treasury bills, notes and bonds being issued. The net increase in US Treasury debt in 2017 was $519 billion[4]. J P Morgan Chase estimates it will hit $1.44 trillion this year[5]. Most people think more debt is inflationary. Not so. When the government issues debt it is paid for with cash, draining Reserves. If the private sector has less cash the cost to borrow goes up, which will slow economic activity.

3) **Trump's attempt to reduce the Trade Deficit.**
   President Trump believes the US Trade deficit is a bad thing. I believe a US trade deficit is necessary. The US dollar is the world's reserve currency. Over 80% of world trade is conducted in US dollars[6]. Trade between countries who have their own currency are often priced and settled in US dollars. The question becomes how does the rest of the world get their hands on the US dollars they demand? When we buy goods and services from foreigners we pay in dollars. We get the stuff we want and they get the Dollars they need. A reduction in the US trade deficit will lead to fewer dollars in foreign central banks which will cause dollar denominated trade to become expensive for foreign countries and is therefore another type of monetary tightening.

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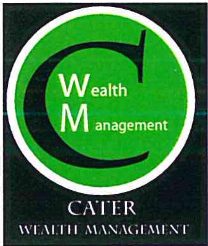

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