

## How can the Federal Reserve keep all the money it's been “printing” from developing into runaway inflation?



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### How can the Federal Reserve keep all the money it's been “printing” from developing into runaway inflation?

The short answer is that the Federal Reserve is unwaveringly committed to price stability and has the tools to fight inflation at every turn. The slightly longer answer follows.

Let's start by revisiting the motivation for the Federal Reserve's “money printing,” which has resulted in a balance sheet that is more than 2½ times larger than it was before the financial crisis. The Federal Reserve's balance sheet now contains assets of almost \$3 trillion, a record high that amounts to about \$9,600 per U.S. resident. When people talk about all the money the Federal Reserve is printing, that's what they mean.

The increase in assets served two key purposes. One was to support market functioning. The other was to lower longer-term interest rates.

As the nation's lender of last resort, the Federal Reserve is responsible for providing backstop lending. When private credit markets panicked and dried up in the fall of 2008, the financial system likewise froze. The Federal Reserve accomplished its backstop role by expanding access to credit facilities for a broad array of financial institutions—including investment banks and money market mutual funds—and by purchasing an increasing array of assets, including mortgage-backed securities and commercial paper (figure 5). The increased lending served its purpose: it stabilized markets, restored credit flows, and supported the economic recovery.

Most assets associated with the emergency lending programs have now rolled off the balance sheet. The more persistent components were those intended to lower longer-term interest rates. This program began in November 2008 with an FOMC policy directive to make large-scale purchases of a range of

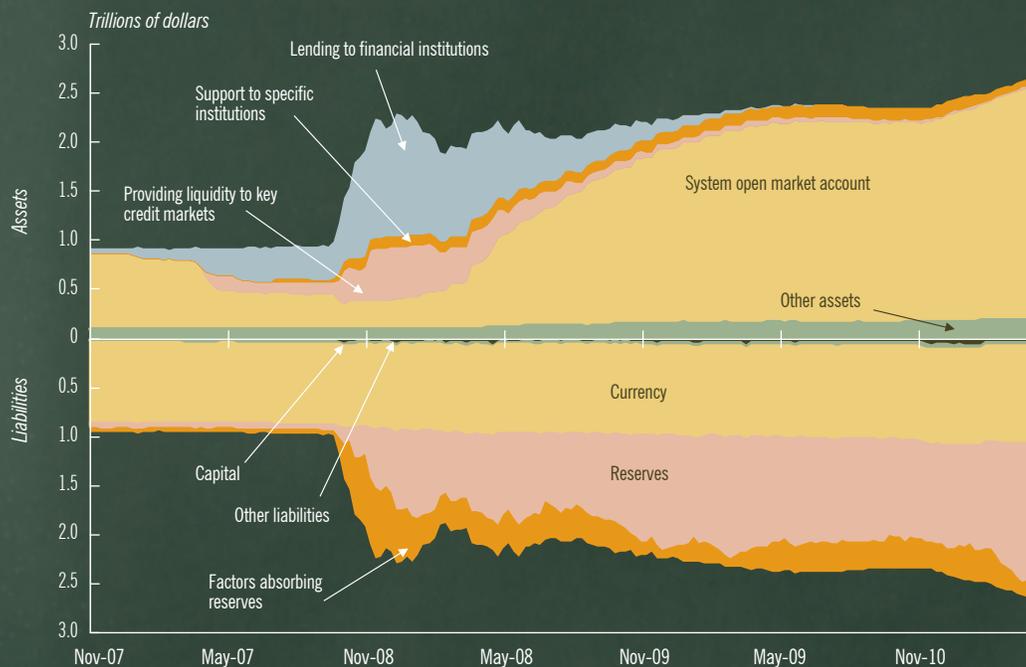
longer-term securities. The large-scale asset purchase program (LSAP) was expanded in March 2009 and continued after the economy began to grow in June 2009. Indeed, the FOMC ordered another round of purchases in November 2010 as economic indicators suggested a weaker-than-expected recovery and the potential for menacingly low inflation. This most recent effort is commonly called Quantitative Easing 2 (QE2) and has received no shortage of attention in the press.

LSAP was a departure from the conventional Federal Reserve policy tool of targeting the interest rates paid on overnight borrowings between banks—known as the federal funds rate. With the funds rate hitting the zero bound—when the FOMC lowered the federal funds rate target to between zero and ¼ percent in December 2008—there was no more room to go lower. But the goal of each tool, whether conventional or unconventional, is the same: to provide monetary stimulus for generating a sustainable expansion of economic activity.

In effect, the asset purchases have been funded by the creation of bank reserves. It is this large supply of bank reserves (composed almost entirely of excess reserves) that has some analysts worried about the potential for an increase in inflation.<sup>5</sup> Excess reserves, like currency, are immediate money, meaning they can be spent instantly. Thus, analysts who are concerned about inflationary pressures see the surge in excess reserves as a case of “printing money.”

Unlike Federal Reserve notes, which are actually printed and largely held by individuals, excess reserves remain idle and essentially exist only as entries on banks' balance sheets. Nevertheless, some fear that excess reserves could allow banks to expand credit dramatically, and that could lead to inflationary pressures. Understanding this dynamic, the Federal Reserve began developing an exit strategy well before LSAP was fully implemented.

Figure 5. Federal Reserve's Balance Sheet



Source: Federal Reserve Board.

As part of the exit strategy, Chairman Ben Bernanke has emphasized that the FOMC remains unwaveringly committed to low and stable inflation, and that it “has the tools to be able to smoothly and effectively exit from the current highly accommodative policy stance at the appropriate time.”<sup>6</sup>

Congress gave the Federal Reserve one of the most important exit strategy tools in 2008 with the authority to pay interest on reserve balances at Federal Reserve Banks. This authority allows the Federal Reserve to put upward pressure on short-term rates and thus to tighten monetary policy even if bank reserves remain high. Banks won't want to trade with one another at or below the rate by keeping their reserves on deposit at the Federal Reserve.

In addition, the Federal Reserve has developed other tools that will allow it to absorb reserves, immobilizing them as needed to allow a smooth withdrawal of policy accommodation when conditions warrant. Finally, the Federal Reserve could also tighten policy by redeeming or selling securities in the open market. ♦

<sup>5</sup> Excess reserves consist of reserves over and above the levels that banks are required to keep on deposit at the Federal Reserve.

<sup>6</sup> Testimony before the Committee on the Budget, U.S. House of Representatives, Washington, DC, February 9, 2011.