

Update on the Need to Return to a Monetary Framework

John B. Taylor¹
February 5, 2009

This is a brief update of the material I presented in a paper on January 3, 2009 in San Francisco at the National Association of Business Economics Panel. The purpose of that paper was to explain and raise questions about actions the Fed had taken to increase reserve balances by 100 fold in the prior three months. In this update I use the same figure and table numbers as in the original paper, which can be found on my web site www.JohnBTaylor.com.

My January 3 presentation reported on developments through Wednesday December 31, 2008, the latest data then available. The figures below go to Wednesday February 4, 2009.

A Turning Point

As shown in Figures 2 and 4, December 31, 2008 now represents a turning point in the amount of money creation by the Fed as reserve balances have declined steadily since then. Reserve balances, which had increased 100 fold from \$8 billion to \$848 billion in last three months of 2008, were down to \$662 billion for the week ended February 4, 2009. In each of the five weeks since December 31 reserves at the end of the week have declined. While still enormously elevated compared with last September, this is a 22 percent decline in just over a month. The size of the decline in January 2009 is nearly the same as the size of the increase in December 2008.

Reasons for the Change

The reduction in reserve balances may represent a welcome effort to exert control over the money supply and return to a monetary framework, but the change seems to have been driven by changing financing requirements as the Fed purchases securities and makes loans to certain

¹ I am grateful to Johannes Stroebel for excellent research assistance.

sectors and firms, as in the last three months of 2008. The reduction in reserves appears to be mainly due to the reduced portfolio of asset backed commercial paper (Figure 8) and loans to foreign central banks. In the meantime purchases of mortgage backed securities have started (part of securities in Figure 6) and are expected to rise to \$500 billion in the next few months. Purchases of securities backed by consumer credit and student loans of another \$200 billion will soon follow.

Regarding money demand versus money supply issues, observe that the overnight federal funds rate has moved up slightly as reserve balances have declined (Figure 11) and that currency and demand deposits at banks (Figure 12) as well as the M1 money supply (Figure 13) have also declined.

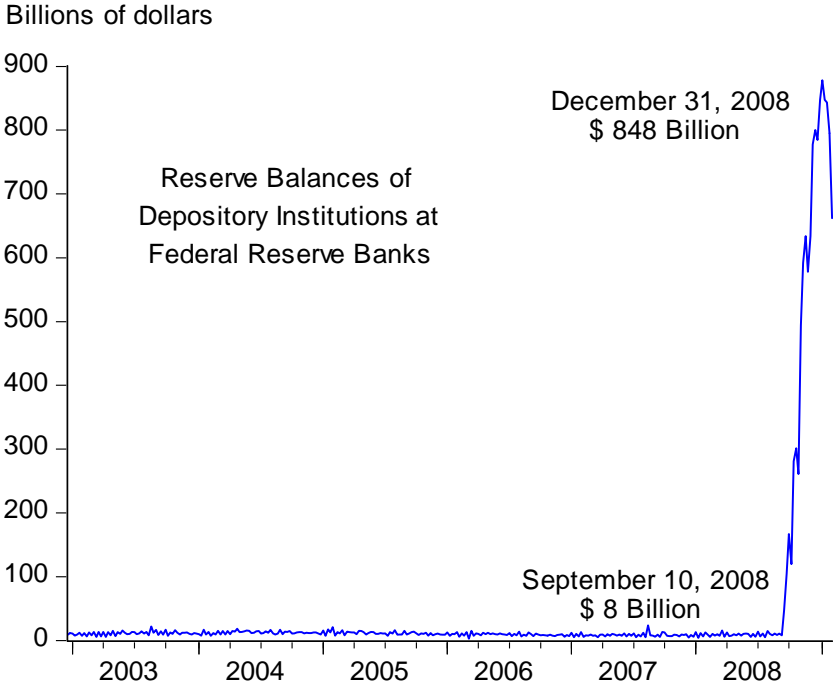


Figure 2. Reserve Balances 2003-2009

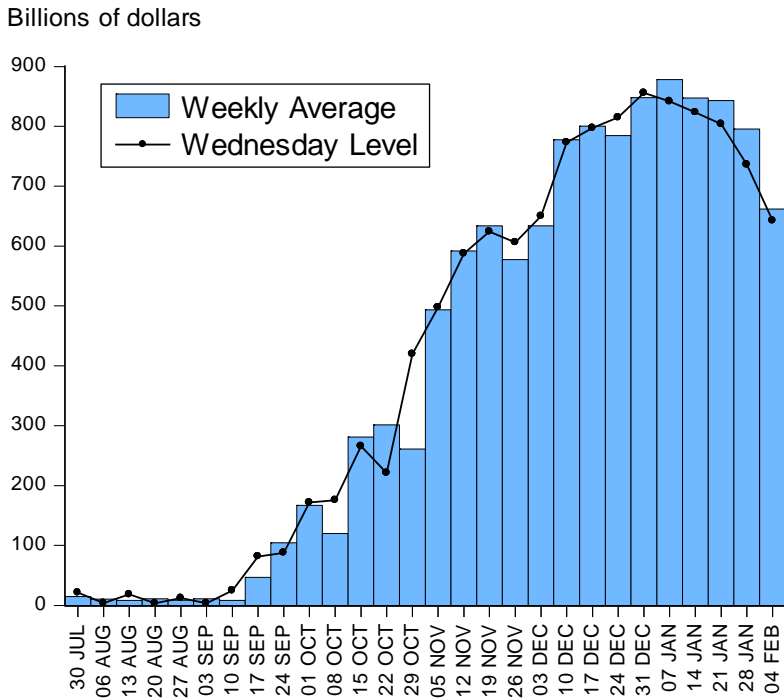


Figure 4. Reserve Balances, Weekly Average, Wednesday Levels,

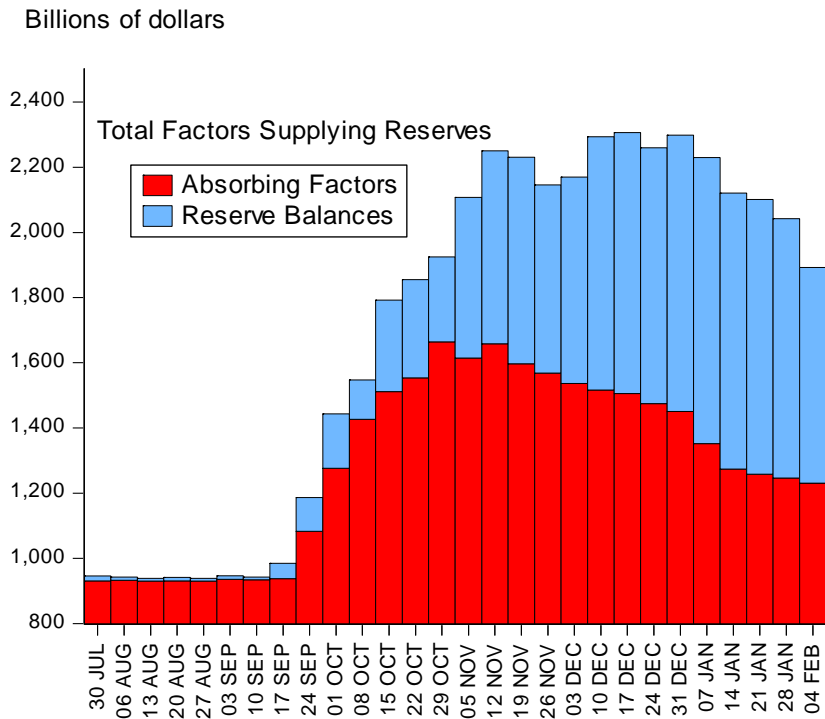


Figure 5. Reserve Balances: Equal to Supplying Factors less Absorbing Factors

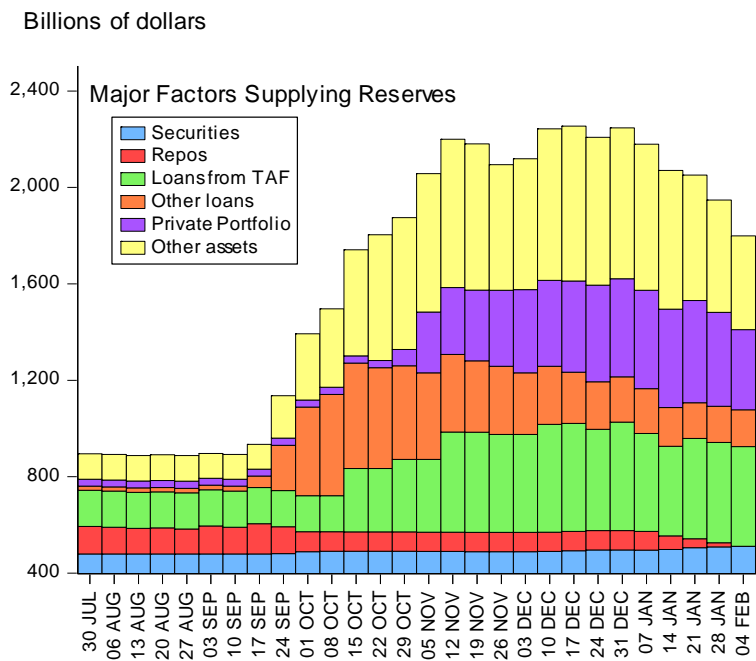


Figure 6. Developments Over Time in Major Factors Supplying Reserves

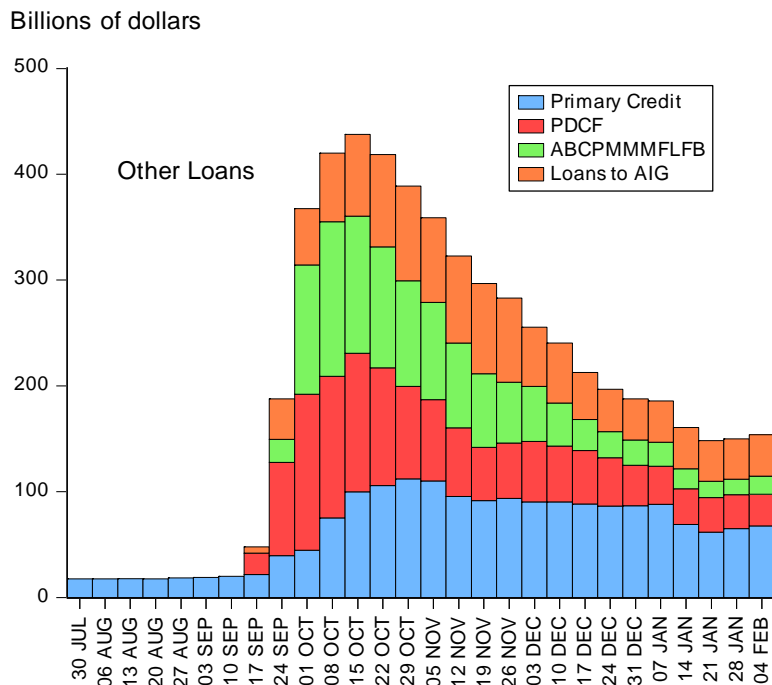


Figure 7. Components of the Other Loan Category on the Fed's Balance Sheet

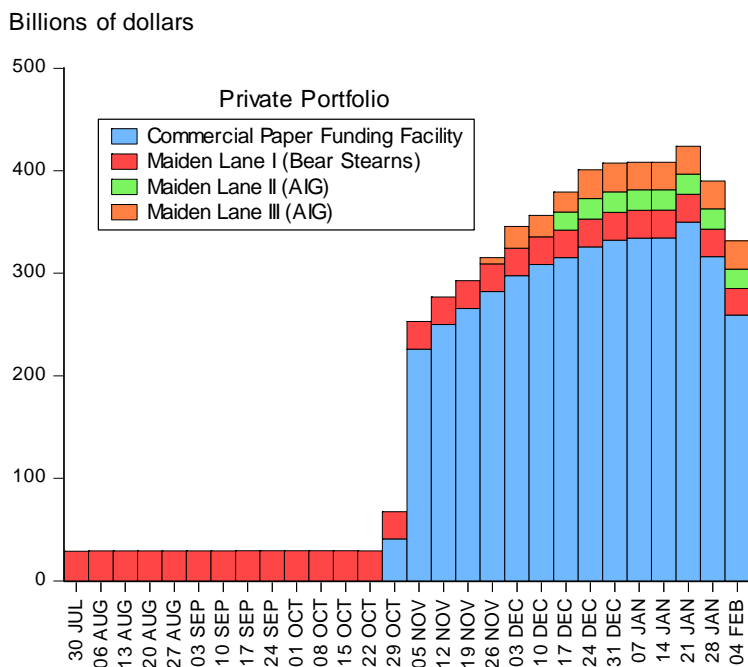


Figure 8. Components of the Private Portfolio on the Fed's Balance Sheet

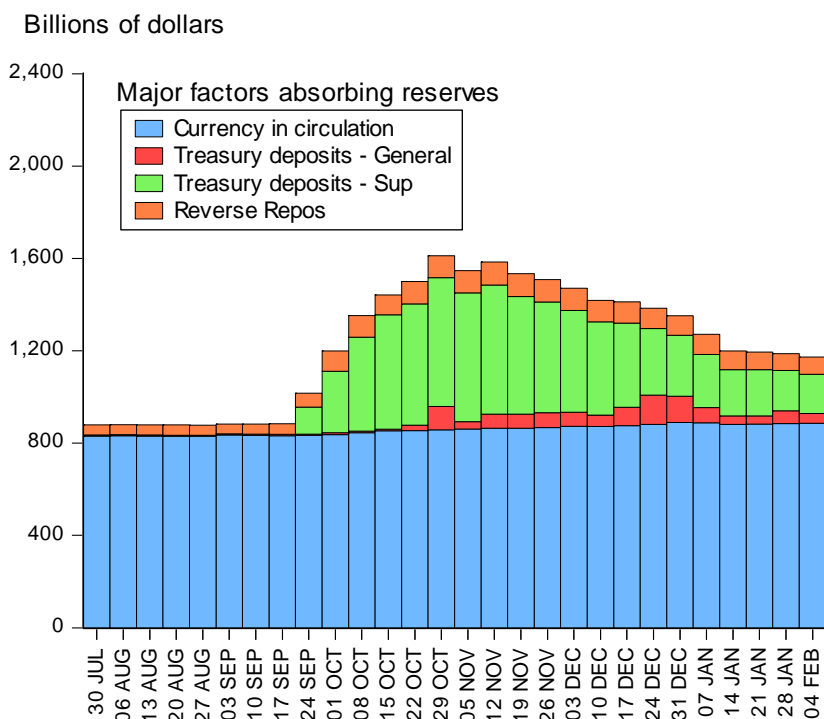


Figure 9. Changes Over Time in the Factors Absorbing Reserves

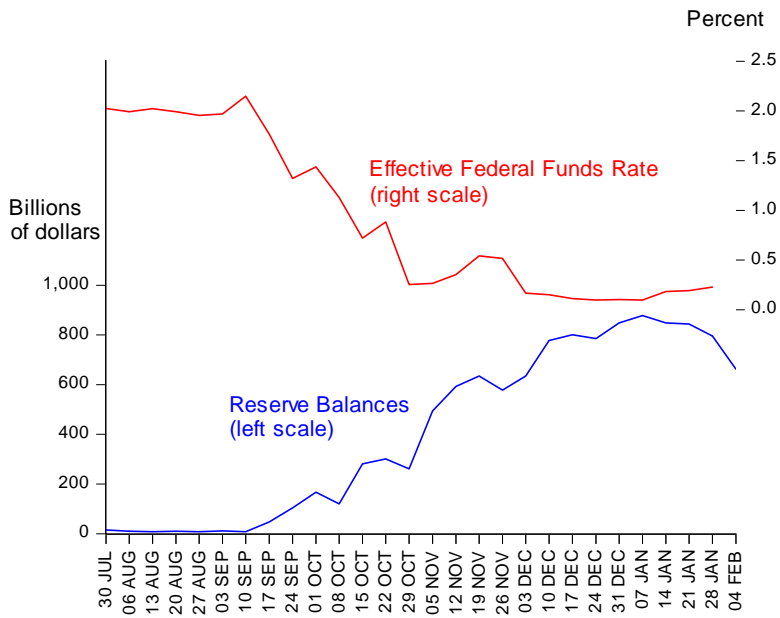


Figure 11. The Federal Funds Rate and Reserve Balances

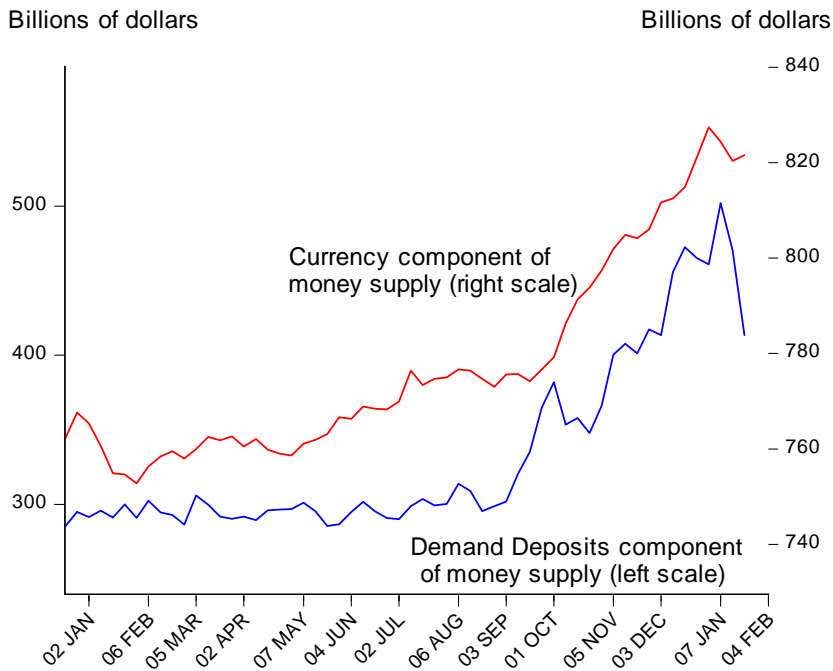


Figure 12. Growth of Currency and Demand Deposits since 2008

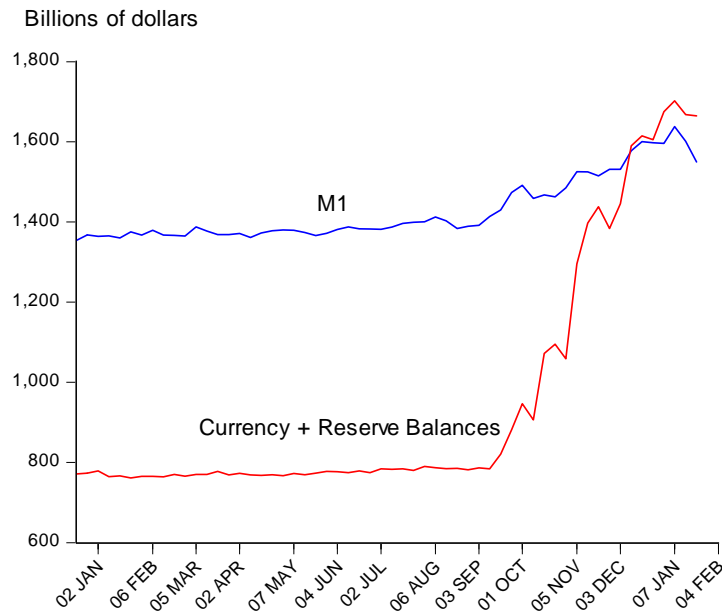


Figure 13. M1 and Currency plus Reserve Balances

Table 1 The Major Factors Supplying Reserves

Securities (Treasury and Agency) held outright

Repos

Loans from the TAF

Other Loans

o Primary Credit Facility (discount window)

o Primary Dealer Credit Facility

o Asset Back Commercial Paper Money Market Mutual Fund Liquidity Facility

o Loans to AIG

o Term Asset-Backed Securities Loan Facility (credit card, student, auto)

Private Portfolio holdings

o Commercial Paper Funding Facility

o Maiden Lane I (Bear Stearns)

o Maiden Lane II (AIG)

o Maiden Lane III (AIG)

o Money Market Investor Funding Facility

o Mortgage Backed Securities Purchase Program

Other Federal Reserve Assets (*very large loans to foreign central banks*)