

## **Update 9.6 on the Need to Return to a Monetary Framework**

John B. Taylor<sup>1</sup>  
February 13, 2009

This is a brief update of a paper I gave at a National Association of Business Economics Panel in San Francisco on January 3, 2009. It incorporates Federal Reserve balance sheet data through February 11, the 6th weekly report of 2009. 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. I use the same figure and table numbers as in the original paper which is on my web site [www.JohnBTaylor.com](http://www.JohnBTaylor.com). In my January 3 presentation I reported on developments through Wednesday December 31, 2008, the latest data then available.

### ***From One Hundred Fold to Seventy Five Fold***

As shown in Figures 2 and 4, reserve balances continued to decrease from the peak reached on December 31, 2008, which is now clearly a turning point in the amount of money creation by the Fed. Reserve balances, which had increased 100 fold from \$8 billion to \$848 billion in last three months of 2008, were down to \$603 billion for the week ended February 1, 2009. In each of the six weeks since December 31 reserve balances at the end of the week have declined. While still enormously elevated compared with last September, this is a 29 percent decline from the end of 2008. Reserve balances are now around the level they reached in mid November 2008. Rather than a 100-fold increase since September 2008, this is a 75-fold increase.

---

<sup>1</sup> I am grateful to Johannes Stroebel for excellent research assistance.

### ***Reasons for the Change in the Past Week***

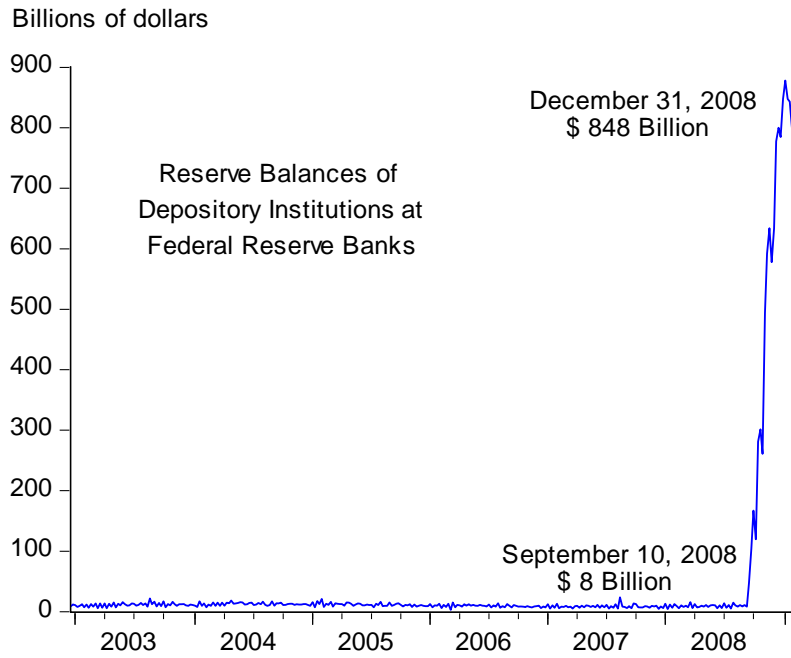
As shown in Figure 5, the size of Fed's balance sheet (measured by total factors supplying reserves in Figure 5) decreased by a relatively small amount (\$10 billion) in the past week, especially in comparison with the much larger (\$58 billion) decrease in reserve balances which are more important for determining the impact of Fed actions on the money supply. The reason for the big difference between the change in the balance sheet and the change in reserve balances is found in the increased factors *absorbing* reserves also shown in Figure 5.

### ***Increased Deposits by the Treasury in the Supplemental Account***

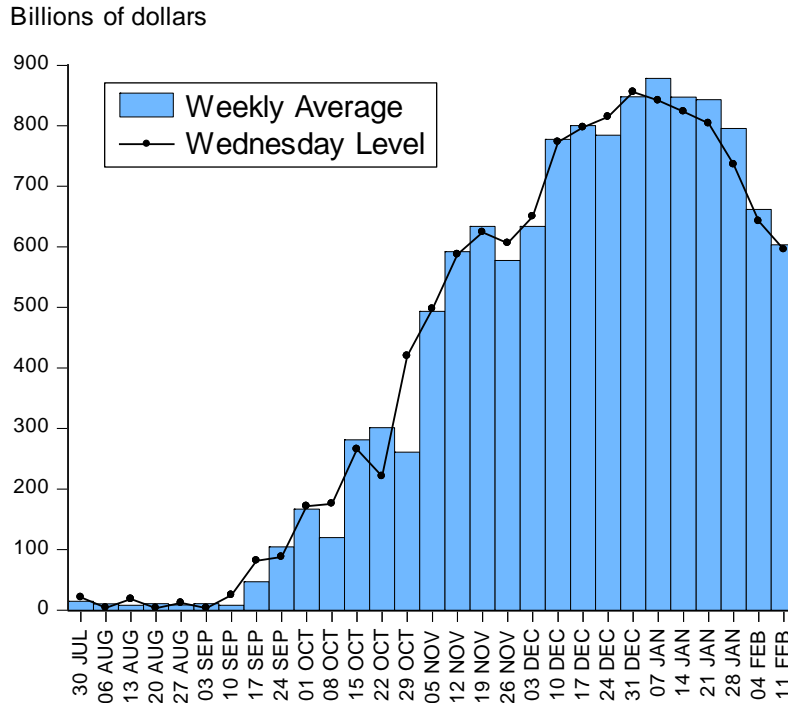
What caused that increase in absorption? Figure 9 examines the major factors. There appears to have been an unusually large increase in Treasury deposits at the Fed in the special supplemental account created last September. After several weeks of drawing down these deposits the Treasury increased them in the past week and the level is back to what it was one month ago. As I mentioned in my last update, the recent reduction in reserve balances may represent a welcome effort to exert control over the money supply and return to a monetary framework. In the past week, however, it appears that the decrease is not mainly driven by a reduction of Fed purchases of securities and loans, but rather to increased financing by the Treasury, which raises legal and political issues as I mentioned in my NABE paper. This may represent a change in Treasury policy under a new Treasury Secretary; it appears to be consistent with his February 10 speech <http://www.ustreas.gov/press/releases/tg18.htm>. Fed Purchases of mortgage backed securities, consumer credit securities, and student loans securities are expected to grow to \$700 billion in the next few months and could grow further under the new trillion dollar Consumer and Business Lending Initiative announced in the February 10 speech.

### ***Impact on Monetary Aggregates***

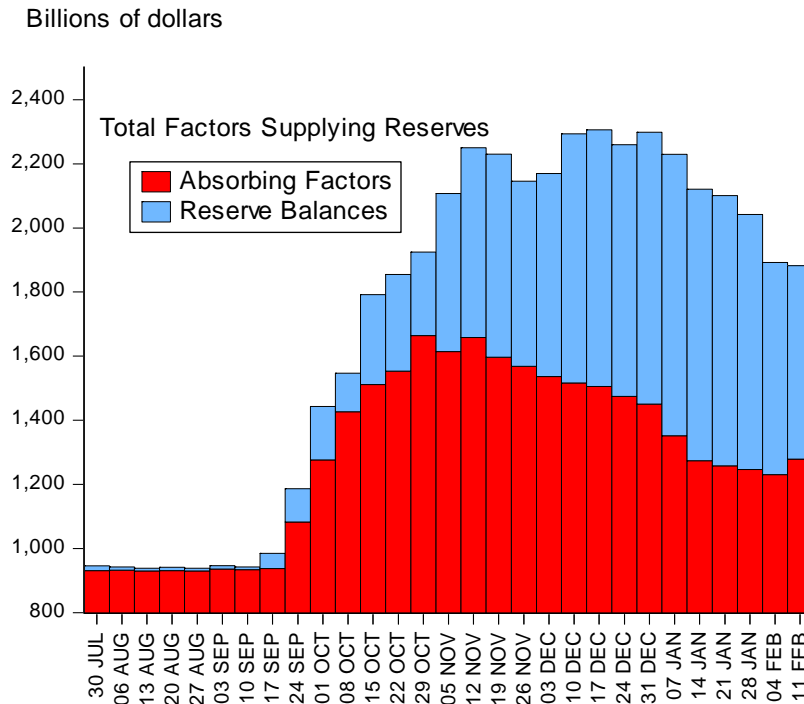
What has been the impact of the recent turnaround in reserves balances and the monetary base on the broader money supply? Demand deposits at banks have turned around sharply as shown in Figure 12, which of course impacts M1, M2 and other measures of the money supply. As shown in Figure 13 the movements in M1 are close in timing to the movements in the monetary base, even though the money multiplier has decreased substantially since last September.



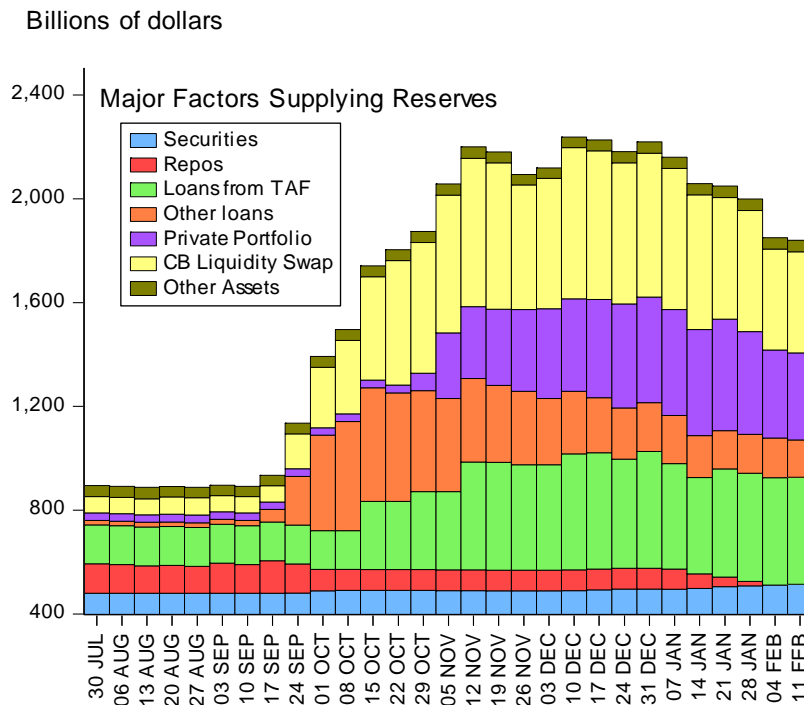
**Figure 2. Reserve Balances 2003-2009**



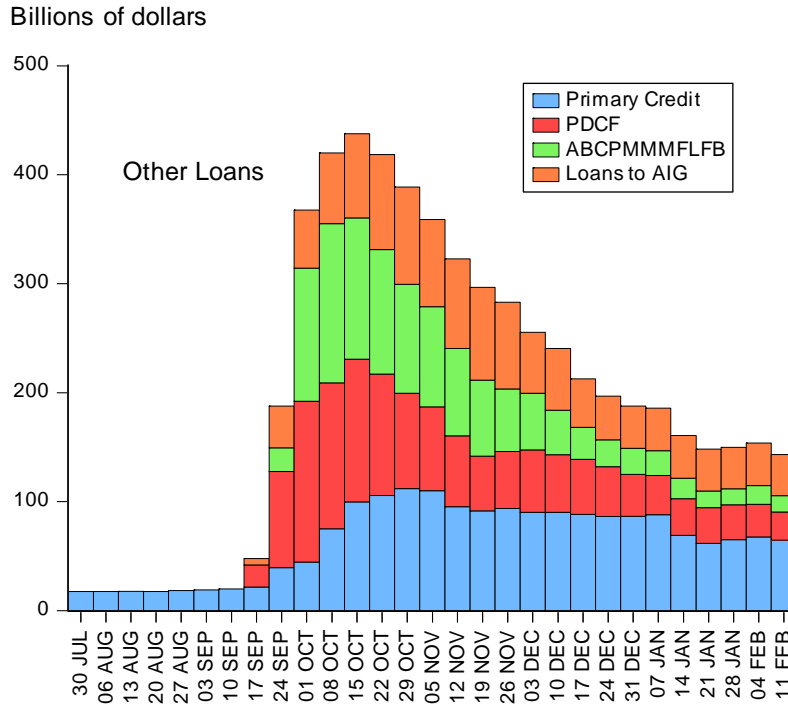
**Figure 4. Reserve Balances, Weekly Average, Wednesday Levels**



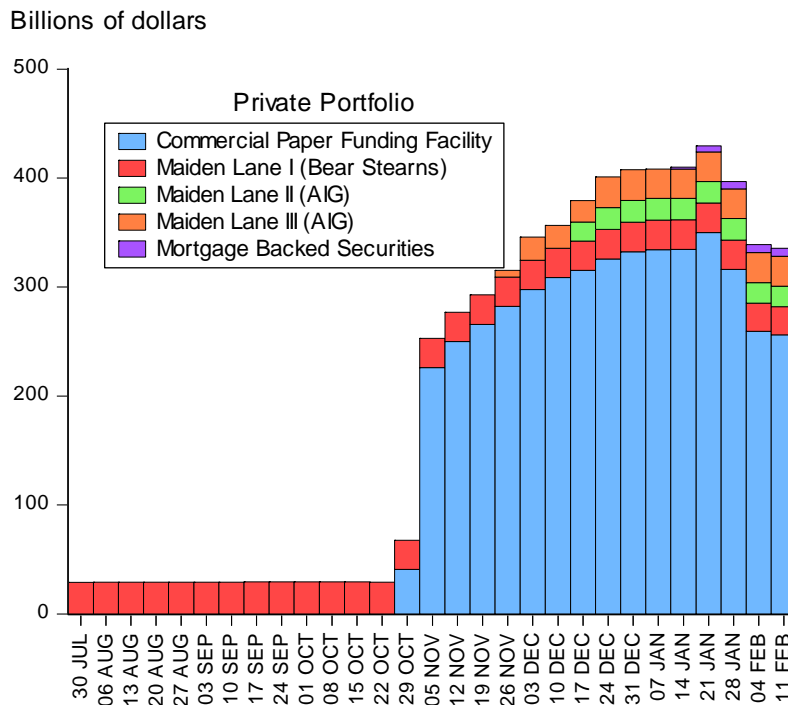
**Figure 5. Reserve Balances: Equal to Supplying Factors less Absorbing Factors**



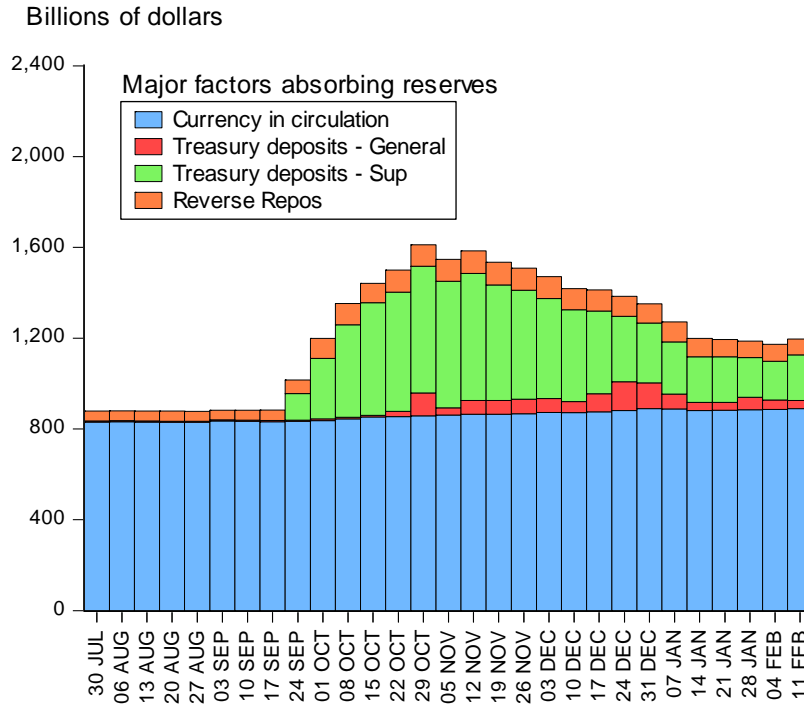
**Figure 6. Developments Over Time in Major Factors Supplying Reserves**



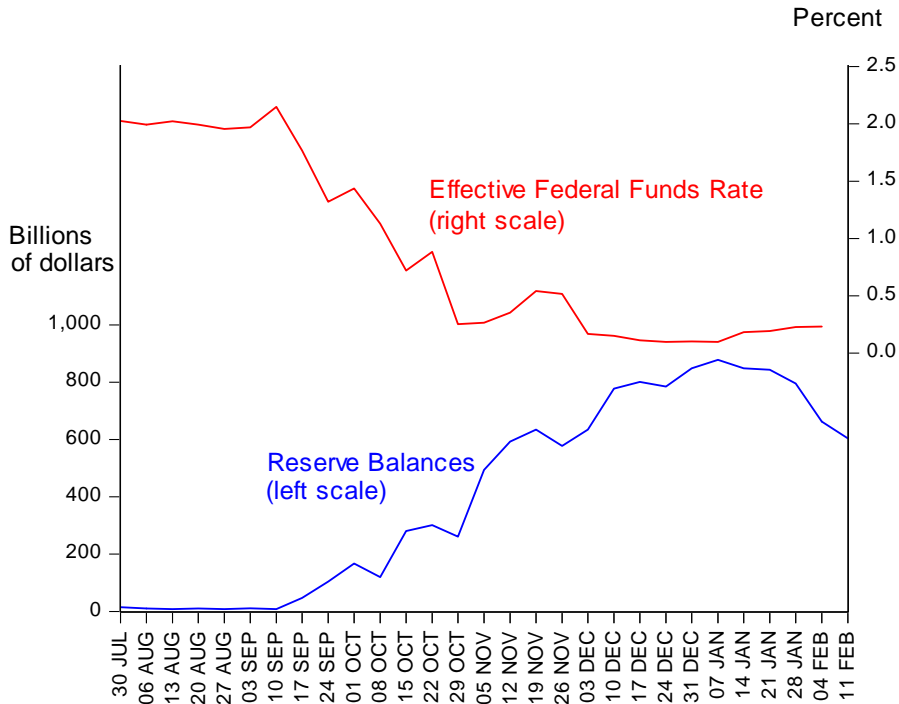
**Figure 7. Components of the Other Loan Category on the Fed's Balance Sheet**



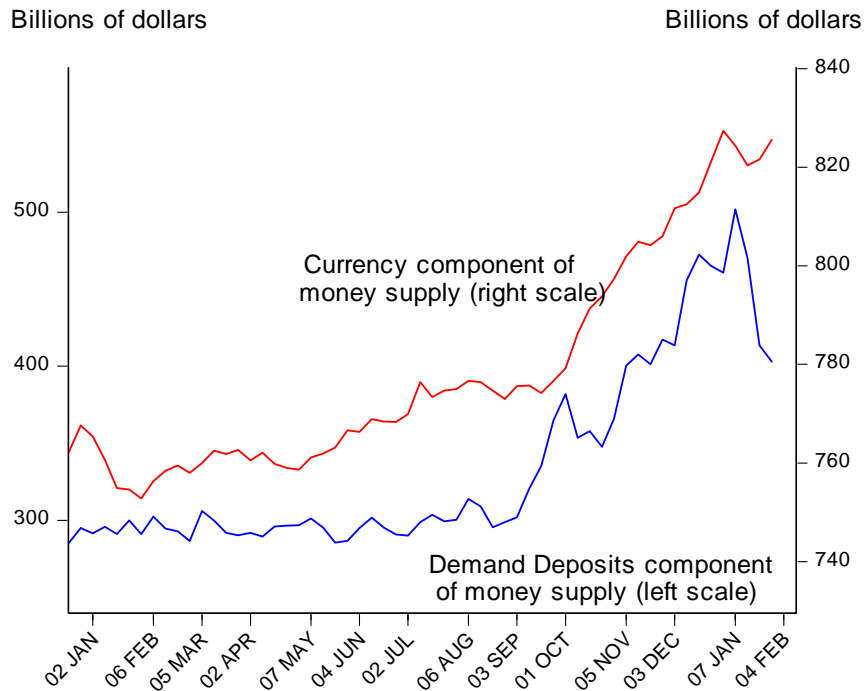
**Figure 8. Components of the Private Portfolio on the Fed's Balance Sheet**



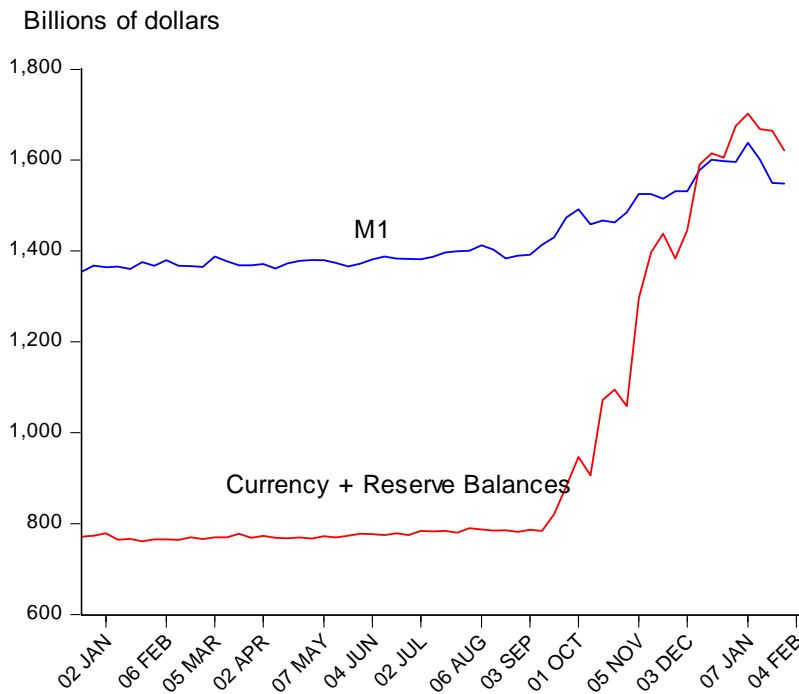
**Figure 9. Changes Over Time in the Factors Absorbing Reserves**



**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**