

Update 9.7 on the Need to Return to a Monetary Framework

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This summary of recent trends in reserve balances and the monetary base is an update of a presentation I gave in January which is posted at www.JohnBTaylor.com. The update incorporates Federal Reserve balance sheet data through Wednesday February 18, 2009. It uses the same figures (and figure numbers) as in the original paper which reported on developments through Wednesday December 31, 2008.

Reserve Balances Increase by \$86 billion Reversing Recent Trend

As shown in Figure 2, reserve balances increased by \$86 billion in the week ended February 18. This is the first increase in six weeks, and can be seen more clearly in the shorter time frame of Figure 4. The increase brings reserve balances up to \$689 billion, below the \$848 peak reached on December 31, 2008 though still enormously elevated compared with \$8 billion of this past September.

Reasons for the Change in the Past Week

The major reason for the increase in reserve balances this week was that it was used to finance the purchase of \$58 billion of mortgage backed securities by the Fed. You can see this most clearly in Figure 8 where we classify the increased purchases as part of the “private portfolio” of the Fed’s balance sheet along with the commercial paper funding facility and the Maiden Lane portfolios. In Figure 6 you can see how the increase in the size of the “private

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

portfolio” adds to the factors supplying reserves. Fed purchases of mortgage backed securities are expected to continue during the next few months, eventually totaling \$500 billion.

Another factor supplying reserves that increased significantly in the past week was the amount of term auction loans to commercial banks through the term auction facility.

Unlike in the previous week the U.S. Treasury did not increase the amount of reserves absorbed by increasing its deposits in the supplemental account at the Fed.

Impact on Monetary Aggregates

What been the impact of this week’s change in reserves balances on the broader money supply? Though excess reserves remain very high, the increase in reserve balances was associated with an increase in demand deposits component of the money supply as shown in Figure 12.

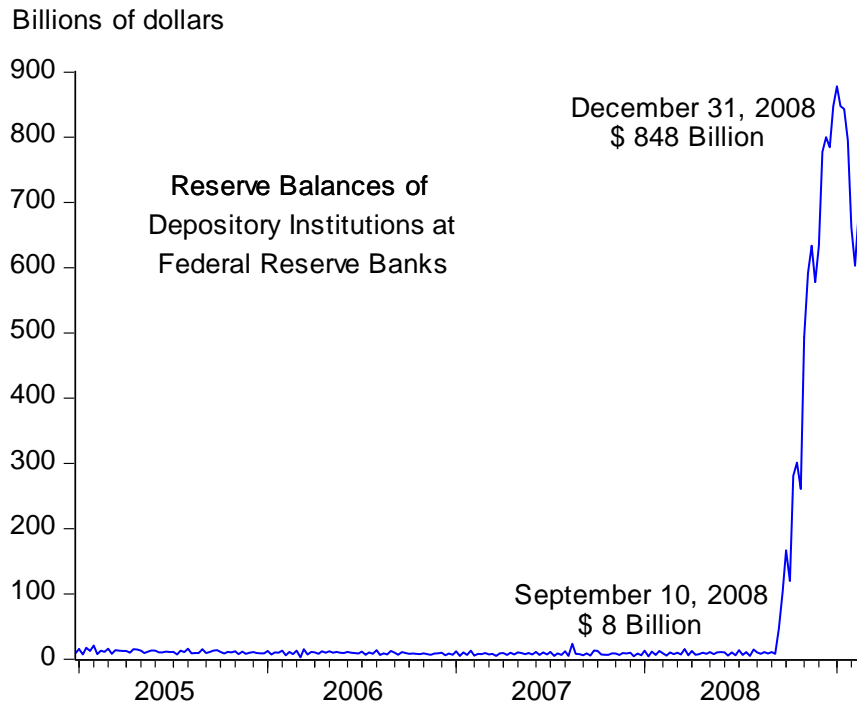


Figure 2. Reserve Balances 2005-2009

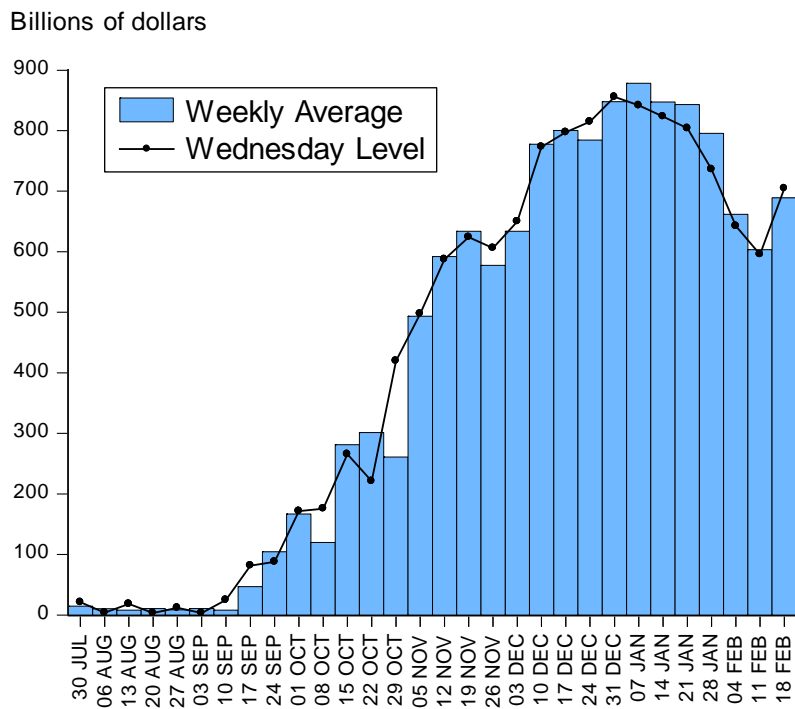


Figure 4. Reserve Balances, Weekly Average, Wednesday Levels

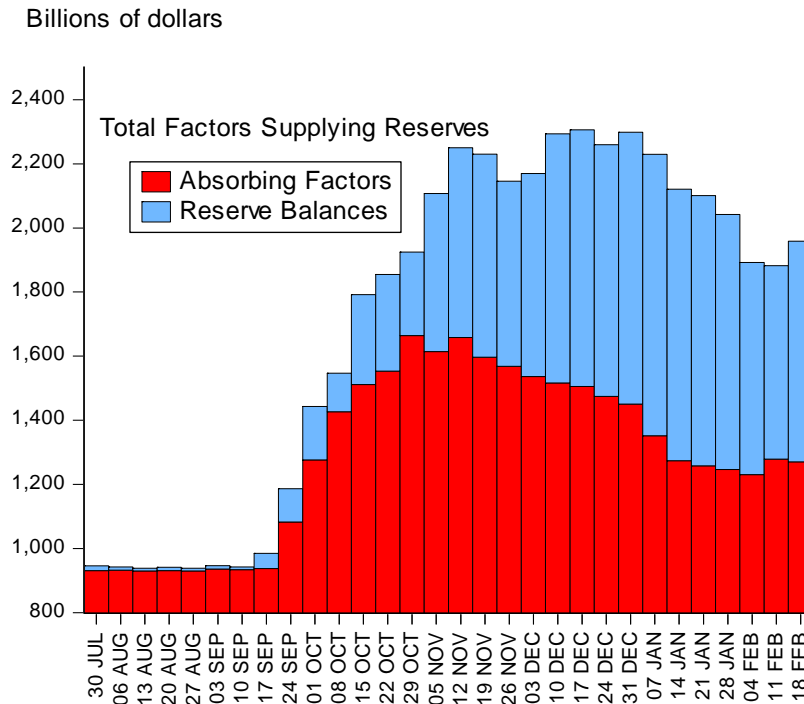


Figure 5. Reserve Balances: Equal to Supplying Factors less Absorbing Factors

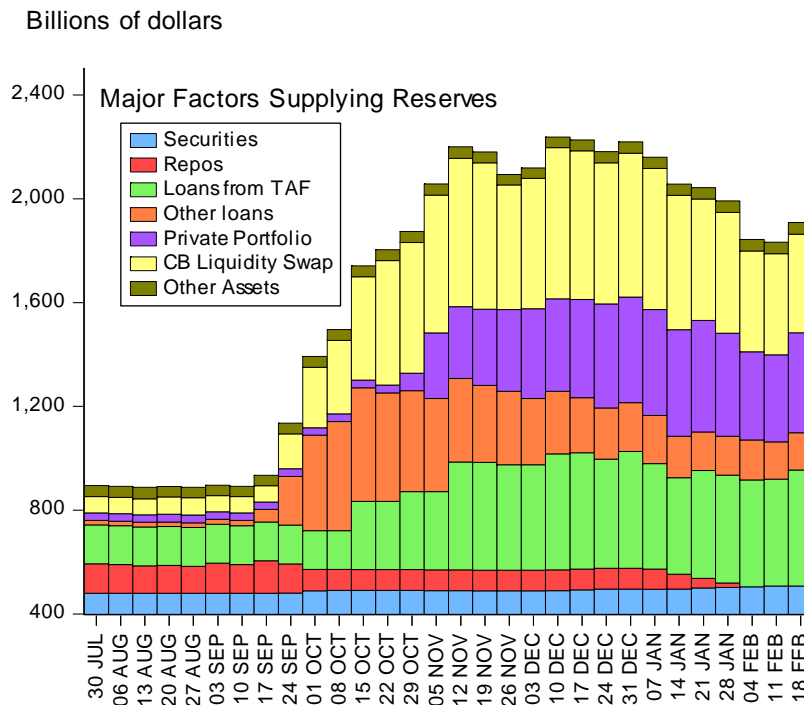


Figure 6. Developments Over Time in Major Factors Supplying Reserves

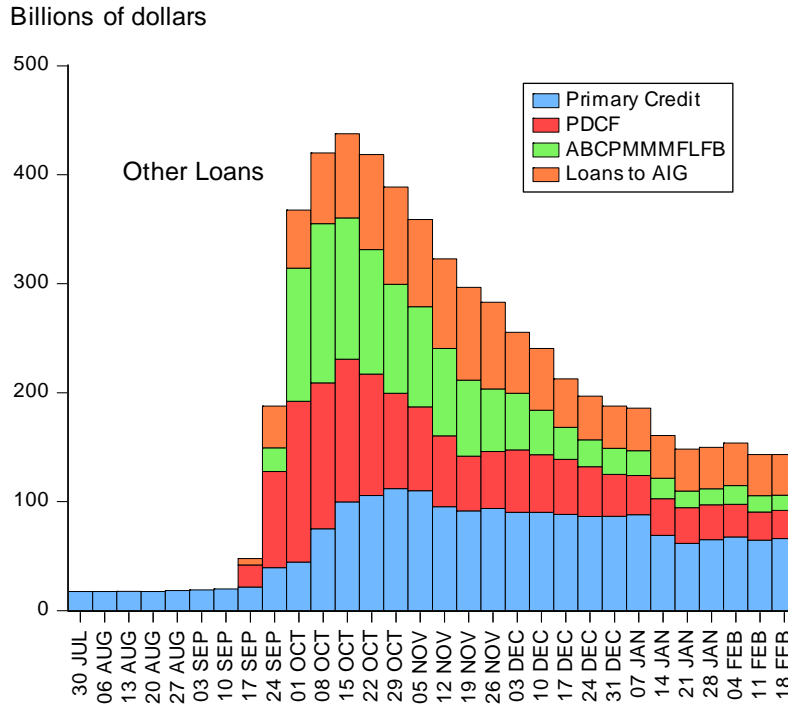


Figure 7. Components of the Other Loan Category on the Fed's Balance Sheet

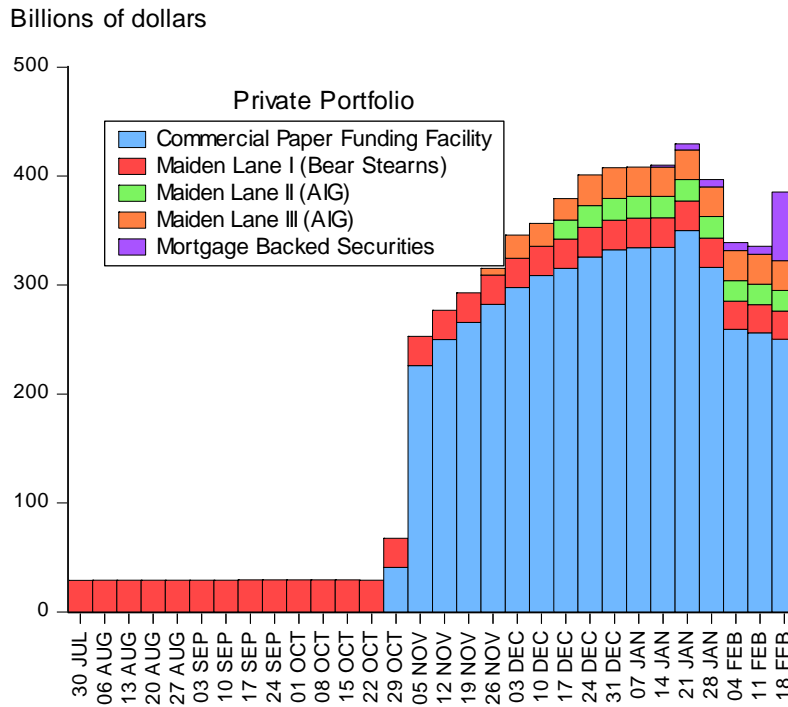


Figure 8. Components of the Private Portfolio on the Fed's Balance Sheet

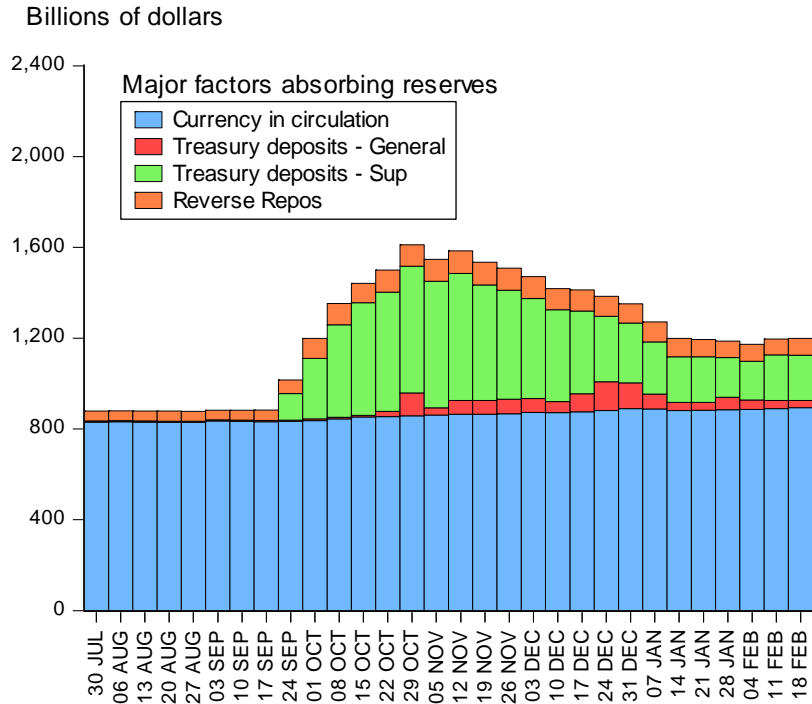


Figure 9. Changes Over Time in the Factors Absorbing Reserves

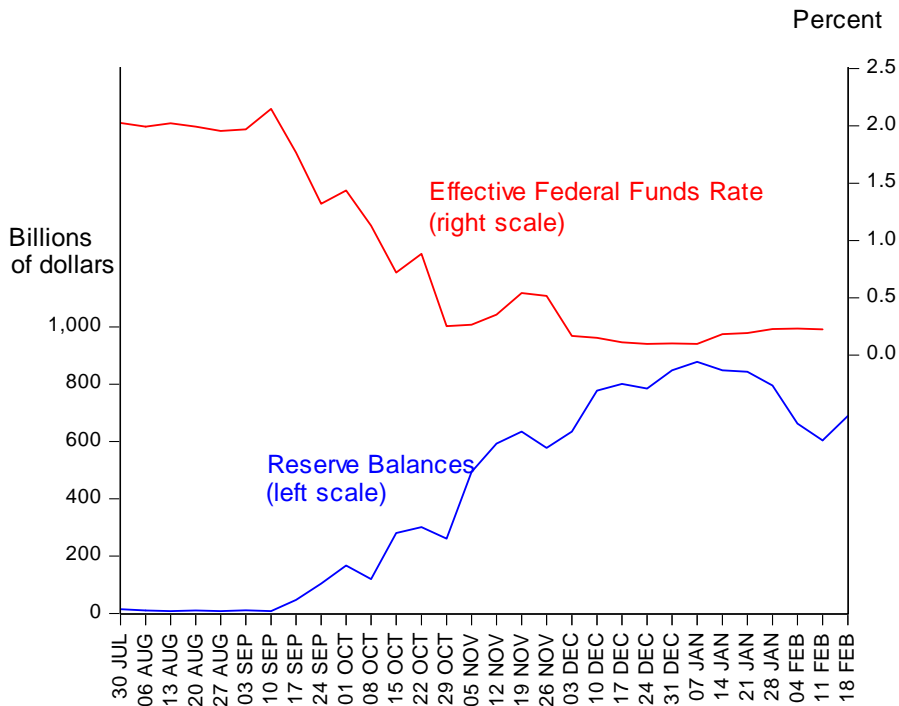


Figure 11. The Federal Funds Rate and Reserve Balances

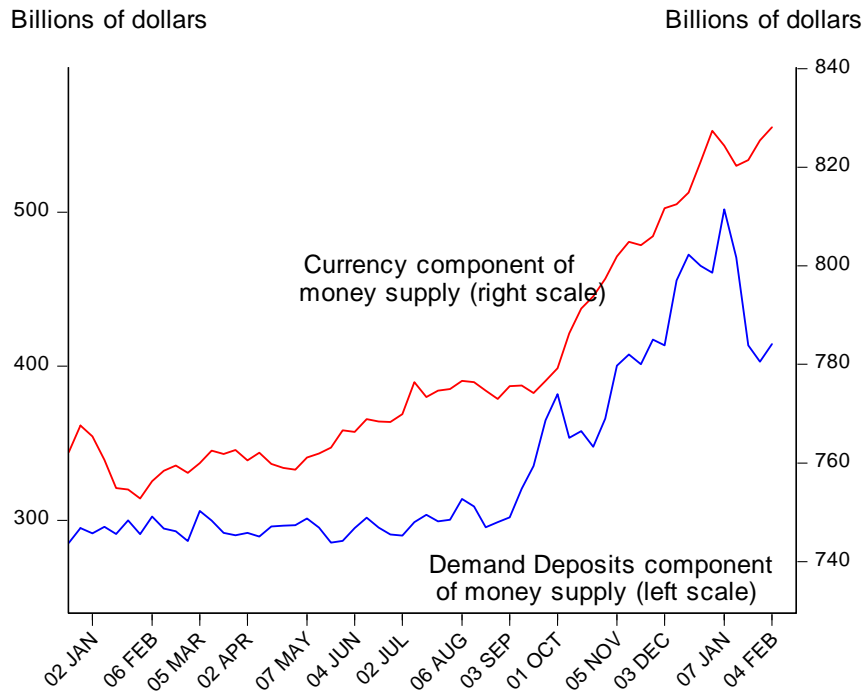


Figure 12. Growth of Currency and Demand Deposits since 2008

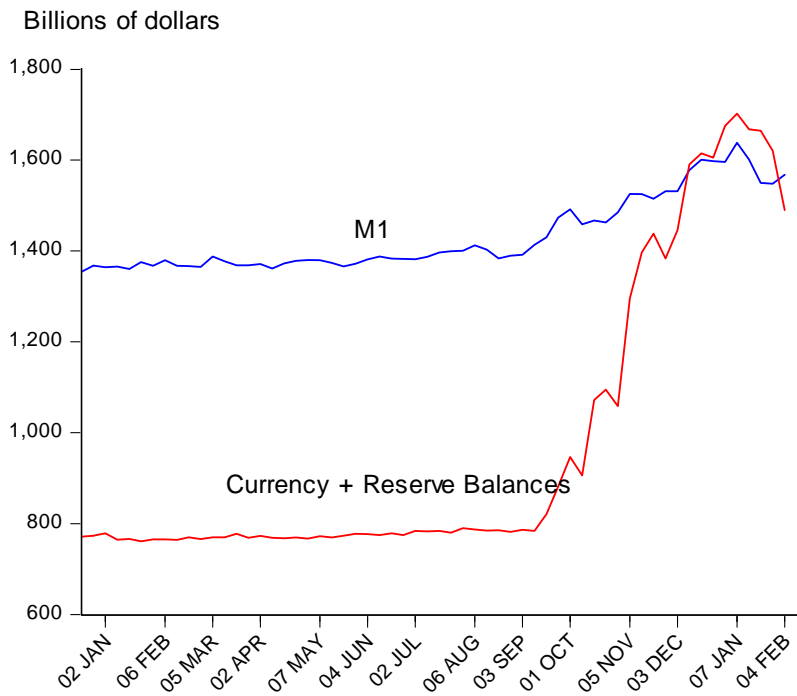


Figure 13. M1 and Currency plus Reserve Balances