First Trust
Monday Morning OUTLOOK

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Are Abundant Reserves Paying for the CFPB?

Back in 2008, the Federal Reserve made important changes in the way it handles monetary policy. We've written about them several times, but few really understand. The press won't ask questions about it and few economists discuss them. They seem nuanced and arcane, and they are, but they are also massively important, and potentially dangerous.

With Quantitative Easing, the Fed shifted from a scarce reserve model to an abundant reserve model. The flood of new money grew the Fed's balance sheet from $870 billion in August 2008 to its current level of $7.4 trillion. That's a 747% increase. The Fed was just 5% of the size of the economy in 2008, today it exceeds 25%.

In order to contain the potential inflation from all this money the Fed has raised banks' capital requirements and increased liquidity demands. Despite being flush with reserves, banks are constrained in making loans, holding three to four times more reserves as a share of deposits than they did in 2007 before all these changes happened.

One result of this is that banks no longer trade federal funds. They don't need to because they all have excess reserves, the system as a whole is flooded with them.

When banks had scarce reserves, interest rates were a signal about the demand for money because banks borrowed and lent reserves every day. With reserves now piled everywhere, there is no market for federal funds and the Fed sets rates wherever it wants them…with or without regard to the demand for money.

Because the Fed is a creature of Washington DC, political pressure plays a role. And, when it comes to politics, low rates are better than high rates. Not for savers, but for car loans or mortgages and also for a government running large deficits.

As a result, the Fed has held interest rates below inflation 80% of the time since 2008, and at roughly 0% for nine out of the past fifteen years. This policy is now creating real problems. Everyone got used to low interest rates; banks acted like they would last forever and made loans or bought bonds at artificially low interest rates. But QE and an abundant reserve policy were playing with fire. With all that money in the system, an inflationary mistake was inevitable.

And with higher inflation comes higher interest rates. So, to put this in historical perspective, a policy (QE) that was implemented in order to counteract less than $400 billion in losses from subprime loans has created unrealized losses on bank balance sheets of more than $680 billion as of Q3 2023 (and the Fed itself has seen unrealized losses on their own balance sheet approach $1 trillion). When rates rise, the value of loans and bonds falls. It's why we are seeing bank failures these days.

The key difference is that in 2008, the US was enforcing mark-to-market accounting. This caused a relatively small problem to become a massive problem, a panic. Today, banks don't have to mark those losses to market and the system is much more stable. But please don't ignore the fact that we have nearly double the losses on bank books today than we did in 2008.

Another problem with this new policy is that the Fed bought the same bonds the banks did during the low-rate environment. And because the Fed decided to pay banks to hold reserves, it is now paying more in interest to banks than it is earning on the bonds in its portfolio.

We have asked many times before: if the Fed is losing $100 billion dollars a year, how does it pay its staff? Apparently, the answer is: by borrowing from the Treasury with a promise to repay when it makes profits in the future. In other words, the taxpayer is now footing the bill for this new method of managing monetary policy.

And that brings us to our final point. The Supreme Court ruled last week that the Consumer Finance Protection Bureau (CFPB), by a vote of 7-2, could remain an independent agency even though it wasn't funded by Congress like other agencies, but instead by the Fed.

The problem with the Court's logic is that the Federal Reserve is now losing money every day. The only way it can pay for the CFPB is to use taxpayer money by borrowing directly from the Treasury. So, the CFPB is deemed "independent" because it doesn't rely directly on Congress for funding, but in reality it is spending taxpayer funds when the Fed runs losses.

But even if the Fed were making a profit, (as it was when it was paying banks 0% on reserves while earning money on its portfolio of bonds) and remitting that money to the Treasury, it would be holding back funds in order to pay for the CFPB. In other words, no matter how you cut it, the Fed ultimately gets all its resources from the taxpayer…either through the cost of inflation, by remitting less to the Treasury, or by borrowing from the Treasury when it is not running a profit.

If the Supreme Court understood the complications of monetary policy, especially after the changes implemented in 2008, we would have expected a different ruling.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-22 / 9:00 am	Existing Home Sales – Apr	4.220 Mil	**4.220 Mil**		4.190 Mil
5-23 / 7:30 am	Initial Claims – May 18	220K	**220K**		222K
9:00 am	New Home Sales – Apr	0.679 Mil	**0.693 Mil**		0.693 Mil
5-24 / 7:30 am	Durable Goods – Apr	-0.8%	**-0.6%**		+0.9%
7:30 am	Durable Goods (Ex-Trans) – Apr	+0.1%	**+0.2%**		+0.2%

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.