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The Monetary Wheels Go Round and Round

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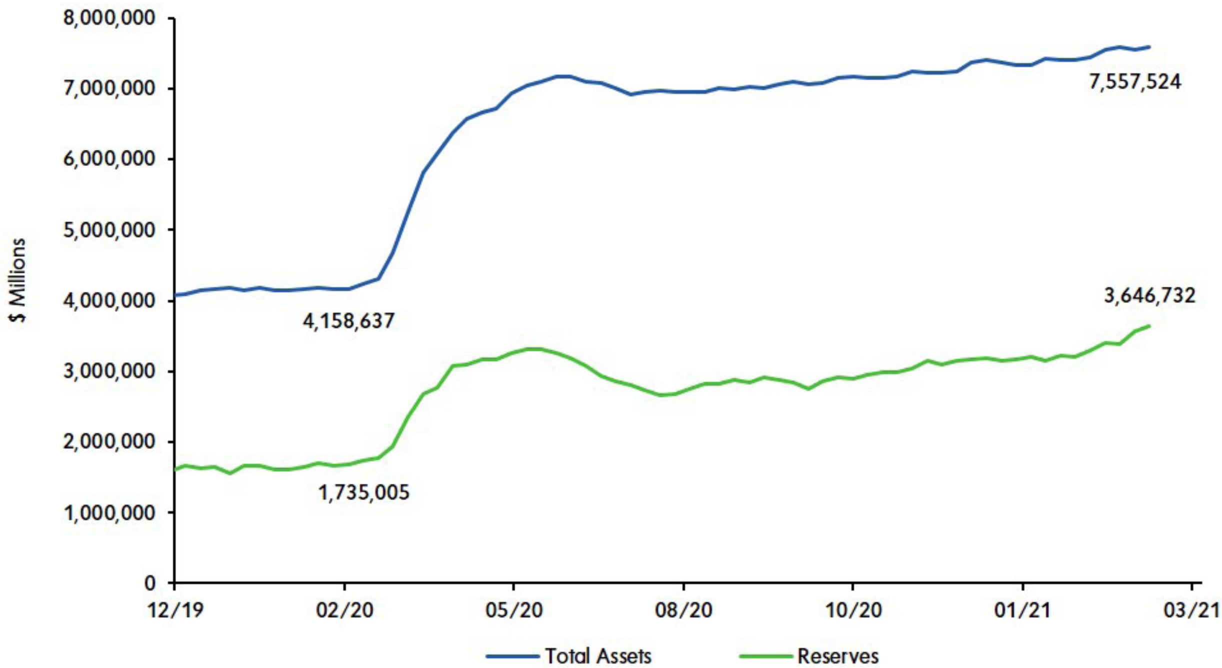
One year into the pandemic's crisis response, the Federal Reserve (Fed) has boosted the assets on its balance sheet by $3.4 trillion, from $4.2 trillion to $7.6 trillion, the latter representing 35 percent of nominal GDP. Reserves held by depository institutions have nowhere near followed up, increasing "only" $1.9 trillion in the past year. For the readers of most money and banking textbooks, and not a few current advocates of the costless monetizing of federal debt issuance, this poses a challenge to their usual logical chain:

- Reserves are held within the closed system of commercial banks.
- The Fed pays for the purchase of securities with reserves.
- Therefore, Fed assets and reserves move one for one.

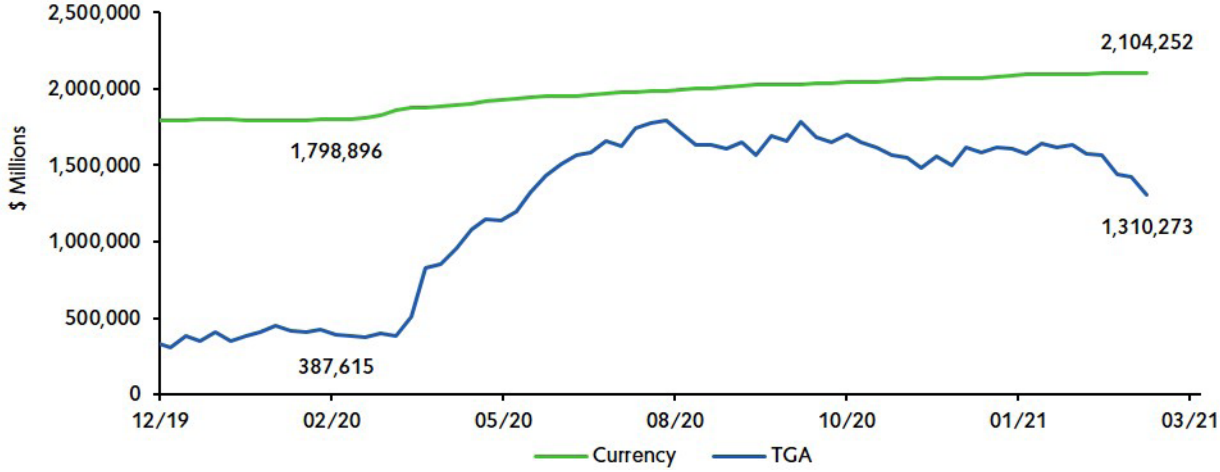
Total Federal Reserve Assets



Source: Federal Reserve accessed via FRED, as of 3/10/21.

No, the Fed has not violated accounting standards (notwithstanding that the Fed's Regulatory Accounting Principles have considerable craziness in their crevices). The left- and right-hand side of the Fed's balance sheet still have identical totals. In fact, the Fed has more liabilities than just reserves. Currency in circulation—Fed bank notes—rose $0.3 trillion. Meanwhile, the US Treasury decided to step up its deposits at the Fed to over $1 ½ trillion at its peak and still $1 trillion above its year-ago level. That is, the Treasury sold more debt over the past year than was necessary to fund the government's considerable excess of outlays over receipts. The settlement of those securities removed funds in payment from bank balance sheets, transforming deposits of the Fed, which are reserves, into Treasury deposits at the Fed (in the Treasury General Account, or TGA), which are just deposits. (This, by the way, is a common mistake when explaining Modern Monetary Theory—asserting that only the Treasury can permanently increase reserves by issuing debt. More accurately, the Treasury must use the proceeds of the issuance for them to become reserves.)

Total Federal Reserve Assets



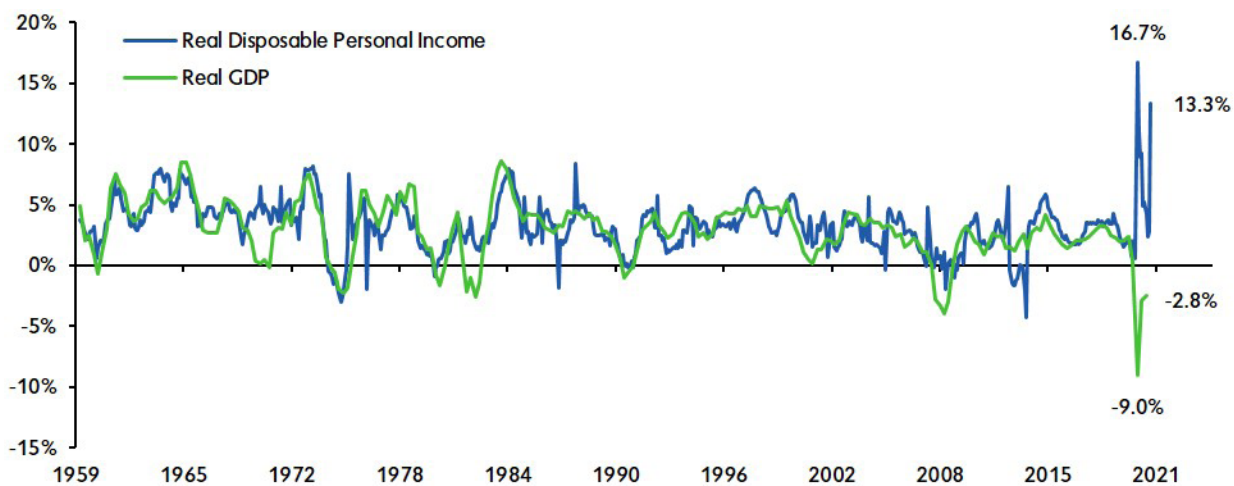
Source: Federal Reserve accessed via FRED, as of 3/10/21.

That is the arithmetic: increases in other governmental obligations booked through the Fed's balance sheet—the issuance of currency by the Fed and securities by the Treasury to raise funds that were not disbursed—also pay for asset purchases. But who acquired those obligations? As for the former, people anomalously fled to the high-touch store of value—currency—at a time of elevated concerns about virus transmission, suggesting that off-the-books activity filled at least some of the lockdown void.

As for the latter, the best place to begin the search is the enormous wedge between what the US produced over the past year and what its citizens received as income. As seen in the chart below, through the twelve months ending in January, real disposable income gained about 13 percent. Through the four quarters ending last year, output fell almost 3 percent.

Real GDP and Real Disposable Personal Income

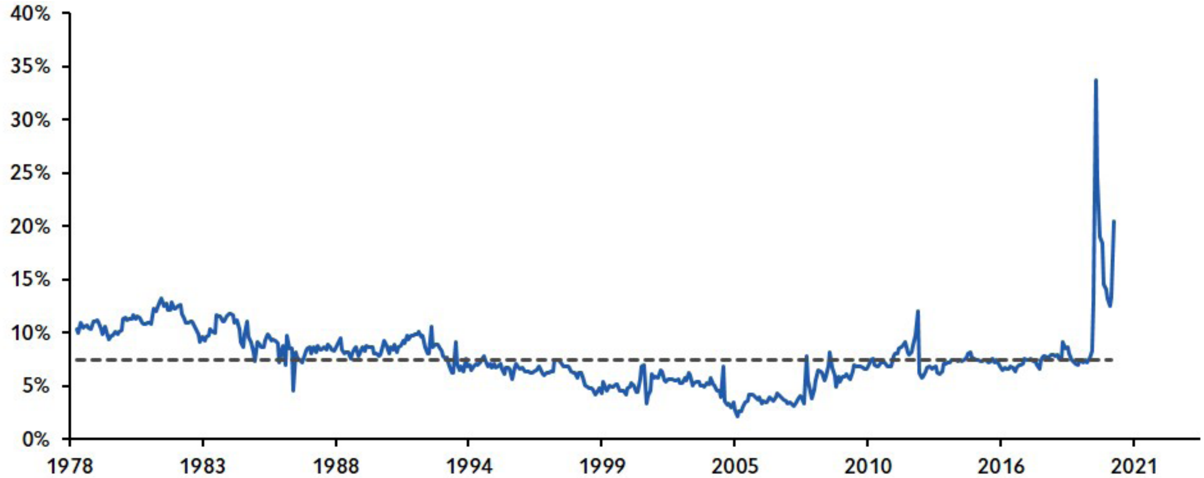
Growth from One Year Earlier



Source: Bureau of Economic Analysis (via FRED on 2/26/21) and Mellon calculations.

Personal Savings Rate

As Share of Disposable Income



Source: Bureau of Economic Analysis (via FRED on 2/26/21) and Mellon calculations.

	Disposable Income	Savings Rate	"Excess Saving"	
	$ Billions	%	Monthly $ Billions	Cumulative $ Billions
Jan-20	16,714.40	7.6		
Feb-20	16,831.30	8.3	11.2	11.22
Mar-20	16,550.10	12.9	74.5	85.7
Apr-20	19,035.90	33.7	415.6	501.3
May-20	18,147.10	24.7	260.1	761.4
Jun-20	17,899.50	19.0	171.5	933.0
Jul-20	18,008.60	18.4	163.6	1,096.5
Aug-20	17,430.40	14.6	103.1	1,199.7
Sep-20	17,546.80	14.1	96.5	1,296.2
Oct-20	17,398.90	13.2	82.6	1,378.8
Nov-20	17,151.40	12.5	71.5	1,450.3
Dec-20	17,254.50	13.4	84.8	1,535.1
Jan-21	19,217.70	20.5	208.2	1,743.3

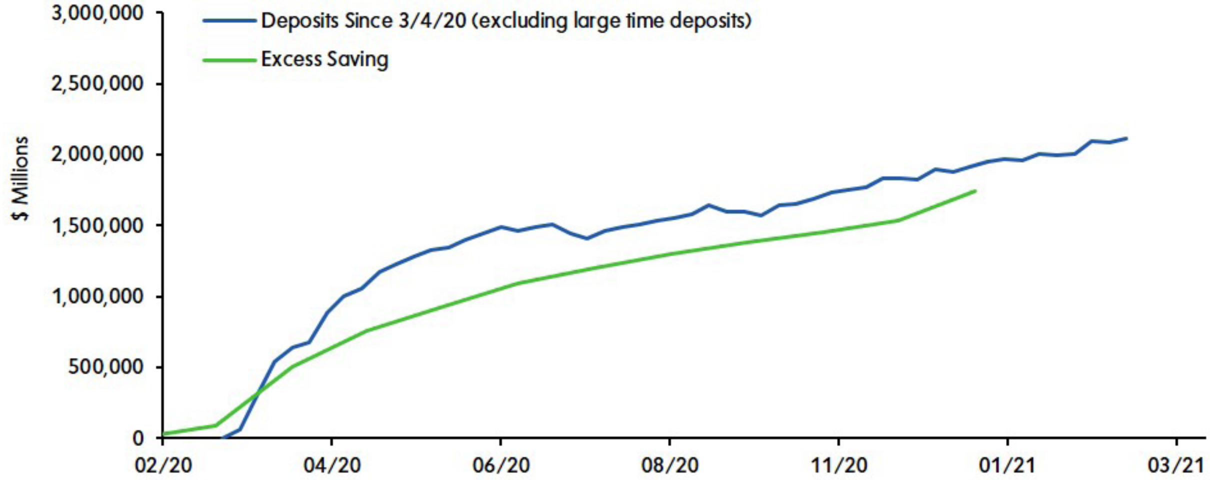
Source: Bureau of Economic Analysis (via FRED on 2/26/21) and Mellon calculations.

Aside from the scale of US fiscal stimulus, these data highlight the extent to which income was saved. As in the above chart and table, the savings rate blew out to double digits. The last two columns of the table work through a counterfactual baseline: How much more did Americans save relative to the prevailing norm of 7 percent of disposable income? The answer cumulates $1 ¾ trillion by January.

Apparently, as suggested in the chart on the following page, it may have turned up as deposits on the books of large commercial banks, as both lines eerily track a trajectory toward a $2 trillion increase. First the "T-accounts." When a commercial bank accepts a stimulus payment as a deposit, the Fed shifts a claim on it from the Treasury to that bank. Both are liabilities of the Fed, but the former is a deposit (going down) and the latter are reserves (going up).

Other Deposits at Large Commercial Banks and Excess Savings

Since 3/4/20

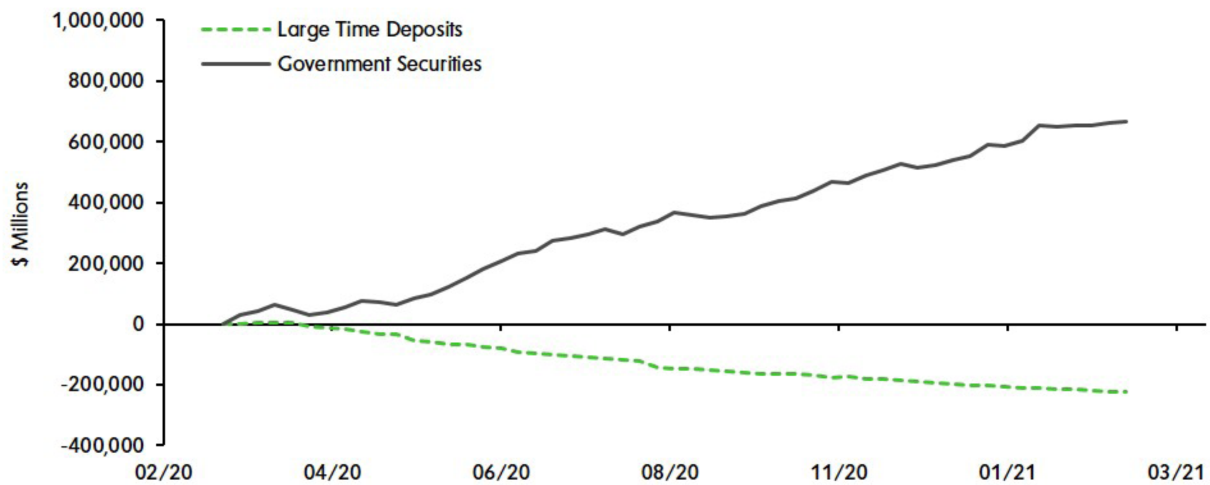


Source: Federal Reserve accessed via FRED, as of 3/10/21.

What did big banks do with this windfall of reserves and deposits that came when households squirreled away stimulus payments? As in the chart below, they bought some of the securities that the Treasury was issuing, exceeding the funding needs of the government, and let expensive funding from large time deposits run off.

Large Time Deposits and Government Securities Outstanding at Big Commercial Bank

Since 3/4/20



Source: Federal Reserve accessed via FRED, as of 3/10/21.

This informs a few of our forward-looking observations.

- The timeliest place to see how the latest round of stimulus payments are used is the Fed's weekly H.8 release of consolidated commercial bank balance sheets, published two weeks after the fact. If other deposits bulge and then do not run off sharply, estimates of excess saving will follow upward, implying estimates of the multiplier effect of fiscal impetus commensurately sag.

- Ultra-low rates at very short maturities may be witness to a bit of a supply shortage as banks, without the need, have not been ready issuers of safe assets. If the Treasury follows through on its plan to trim the TGA, the shortage of supply will persist as bill issuance does not ramp up with the swelling federal budget deficit.

- Meanwhile, the trimming of the TGA will convert $1 trillion of Fed liabilities from deposits to reserves that have to find their home on bank balance sheets. This comes as the counterpart to the Fed's $120 billion purchase of securities each month which adds that much to reserves.

- With so many reserves hitting their books, the view of big banks on their appropriate holdings of the other safe asset—government securities—depends on regulatory action, specifically the extension of the exemption of safe assets from the calculation of the supplementary leverage ratio (SLR), the binding constraint on their balance sheet. (The exemption on the SLR sunsets at the end of March 2021.)

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Vincent is Mellon's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Disclosure

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