Fed looks to extend debate on liquidity

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Published: April 29 2008 01:13 | Last updated: April 29 2008 01:13

Federal Reserve policymakers will discuss paying interest on bank reserves in a closed door meeting on Wednesday. Such a move could in theory allow the Fed to expand its liquidity support operations without limit.

The discussion will take place alongside the Fed's regular meeting on monetary policy, at which officials are expected to agree to cut rates another quarter point (25 basis points) to 2 per cent and hint at a possible pause in June.

Under a law passed in 2006, the US central bank will gain the authority to pay interest on reserves in 2011.

The meeting on Wednesday is based on that timeframe and will not be followed by any announcements.

However, the meeting could spark an internal debate as to whether the Fed should consider asking Congress to bring forward this authority to help it deal with the current credit crisis.

Many experts think that would be a good idea. Vincent Reinhart, former chief monetary economist at the Fed, said paying interest on reserves would allow the Fed to "expand their liabilities to support more asset purchases".

A number of other central banks already have the authority to pay interest on reserves, as well as the authority to lend banks money.

In normal times they can use these deposit and lending rates to put a corridor around the main policy rate, and prevent it from being buffeted too far away from the level they aim to set.

But at times of financial market stress, the ability to pay interest on reserves takes on added significance. Currently, the Fed cannot expand or contract its balance sheet without altering the overall supply of reserves and changing its main policy rate, the Fed funds rate.

All it can do is change the composition of its balance sheet – absorbing more duration risk, liquidity risk or credit risk from the private sector.

But if the Fed was able to pay interest on deposits, it could use that rate to put a floor under the Fed funds rate.

That would free the US central bank to conduct liquidity operations that were larger than the size of its current balance sheet – roughly $800bn.

“The point...would be to allow the Fed to expand its balance sheet without having to drive the fed funds rate to zero in the process,” said Goldman Sachs.