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RESEARCH SUMMARY

The Federal Reserve's Switch to the Floor System in 2008: Its Effect on the Great Recession and Economic Recovery

In October 2008, the Federal Reserve (Fed) changed from a "corridor" operating system for setting interest rates to a "floor" system. This poorly timed transition exacerbated the Great Recession and slowed economic recovery for years thereafter. So argues David Beckworth in "The Great Divorce: The Fed's Move to a Floor System and the Implications for Bank Portfolios."

CORRIDOR SYSTEM VERSUS FLOOR SYSTEM

- Under the corridor system, there was an upper and lower bound within which the Fed's target interest rate could move. The upper bound was the rate at which banks could borrow from the Fed (the discount rate), and the lower bound was zero percent. The Fed bought and sold securities through open-market operations to adjust its interest rate target within this corridor. The quantity of reserves and the stance of monetary policy were linked in this operating system.
- Under its current floor system, the Fed pays interest on excess reserves (IOER)—reserves beyond what banks are required to hold by law. The IOER is set equal to or above comparable short-term interest rates to encourage banks to hold all reserves that come their way. In addition, the IOER sets a floor for short-term interest rates because banks would not lend for less and lose the chance for a higher return. The floor system allows the Fed to set its target interest rate and adjust the amount of reserves in the banking system independently of each other. The Fed, in other words, can separately adjust the stance of monetary policy and the amount of liquidity in the banking system under the floor system. The stock of money is now "divorced" from monetary policy.

The Fed abandoned the corridor system and instituted the floor system in late 2008 as it made massive emergency loans to troubled banks. They wanted to prevent these loans from creating inflationary pressures, and the floor system ensured that outcome. Later, the floor system proved useful to the Fed as it engaged in large-scale asset purchases (LSAPs). The IOER meant that the large increase in bank reserves from the LSAPs would not lead to runaway inflation.

REDUCING LOANS, SLOWING GROWTH

- When the Federal Reserve implemented IOER in October 2008, it set the rate higher than comparable short-term market rates, which were declining as the economy contracted. This high rate increased banks' incentives to hold their money at the Fed rather than lend it out to market participants. Less lending meant less capital investment and less economic activity. An already-severe Great Recession became even worse.

- As Beckworth shows, the effects of the Fed's IOER system continue to be felt. Compared with the pre-crisis period, banks have moved a larger share of overall assets into reserves rather than into loans. Beckworth argues that this has adverse effects on economic growth.

KEY TAKEAWAY

- The Federal Reserve's floor system can be a drag on economic growth because, if set above market rates, it will discourage lending and investment and stifle economic activity.
- To avoid repeating its 2008 mistake, the Fed does not necessarily need to abandon its use of IOER, but it should not set the IOER rate equal to its short-term target rate. Rather, it should return to the corridor system with IOER as the lower bound and set the short-term rate comfortably above the IOER.