Too Big to Fail?

The Federal Reserve is an independent entity structured specifically to promote the country's macroeconomic stability over time through maximum employment, stable prices and moderate long-term interest rates.

Unlike government agencies, the Fed does not rely on appropriations from Congress. Instead, it self-funds primarily through interest from the securities acquired via open-market operations, which are held in the Federal Reserve System Open Market Account (SOMA).

The income generated from SOMA typically far exceeds the Fed's expenses, which include both operating expenses and the interest paid on the reserve deposits of banks and on reverse repo agreements. The resulting "earnings" are by law remitted to the Treasury, which uses it as revenue to offset the federal deficit and debt. While historically modest in size, these remittances ballooned with the adoption of quantitative easing and bigger central bank balance sheets, as shown in Exhibit 1. The Fed sent the Treasury an average of $87 billion annually from 2012 to 2021 as a result of the interest earned off its expanding securities portfolio, and this figure topped $100 billion in 2021. But with the Fed raising the federal funds rate and paying more on its liabilities through interest on reserves than it is earning on its securities holdings, the funding party may be over. As shown in Exhibit 2, the Fed's remittances due to the Treasury turned negative earlier in 2022. Central banks worldwide are facing similar concerns.

Exhibit 1. Fed Remittances to the Treasury Have Been Significant...

Federal Reserve Remittances Paid to US Treasury Annually in Billions of Dollars, January 2008 through December 2021

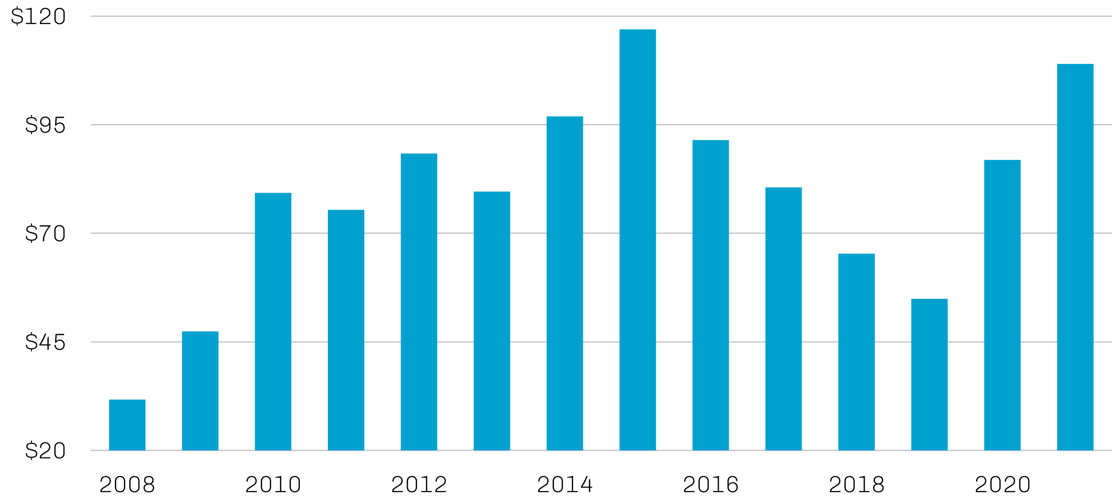
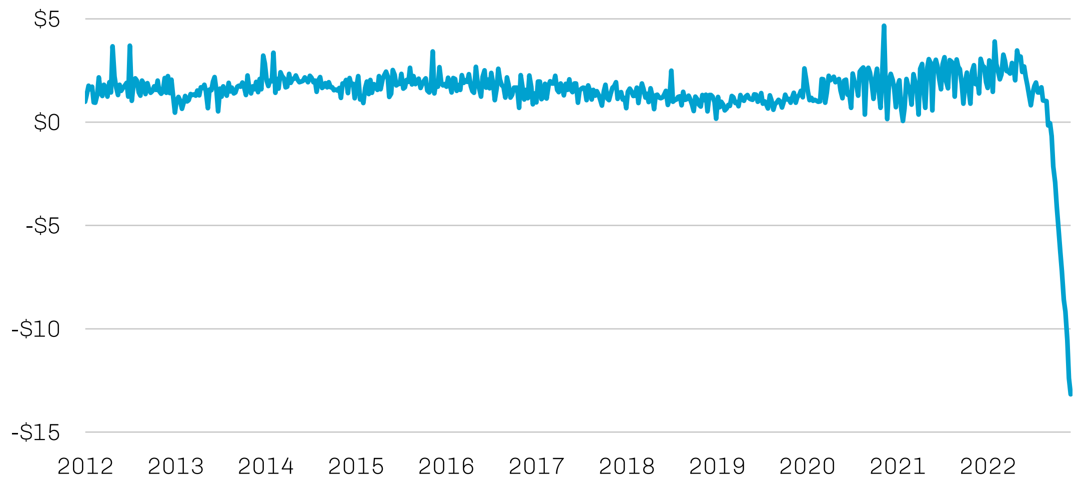


Exhibit 2. ...But May Be Coming to an End

Federal Reserve Remittances Due to US Treasury Weekly in Billions of Dollars, January 2012 through December 2022



Source: Haver/Federal Reserve Board, First Eagle Investments; data as of December 31, 2022.

Given its ability to print money to cover its expenses, the Fed cannot default. While its overhang of interest-bearing liabilities theoretically may become so great as to interfere with its ability to conduct monetary policy effectively, that would be an extreme circumstance. Less extreme, however, is the possibility that outside influences may shape policy.

Though independent from the other branches of government, the Fed remains accountable to Congress—and, by extension, to the representatives and senators that comprise it and the American public that elected them. The tension between long-term prudence (the Fed) and near-term desires (elected officials and the populace) has been an ongoing complication in the central bank's history. Paul Volcker's hard stance against inflation when he took over as Fed chair in 1979 paid obvious dividends for the country over the long run, for example, but this achievement likely was small consolation to the citizens who bore the near-term economic costs of very high interest rates and to the elected officials who lost their jobs as a result.

In addition to promoting higher income streams to the Treasury, very low interest rates have kept net interest outlays of the federal government manageable even as the federal debt ballooned. Though the federal debt held by the public has tripled as a share of GDP since 2000, historically low rates have kept interest expenses relatively constant over this period (2.2% of GDP in 2000 versus 1.9% of GDP in 2022).[1] With interest rates rising and economic growth slowing, we believe this figure is very likely to rise, presenting a conundrum for policy makers who must choose among accepting even higher debt levels, reducing spending or generating more revenue through taxes. With little political appetite for spending cuts or tax hikes, it's not hard to see how the Fed's independence may come under fire due to the Treasury's ongoing need for low interest rates.

> With rising interest rates and slowing economic growth, policy makers will need to choose between accepting higher debt levels, reducing spending or generating more revenue through taxes.

1. Source: FactSet; data as of November 30, 2022.

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Federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.

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