For drivers across the United States who fret over growing congestion and aging roads and bridges, some welcome news arrived when President Obama signed a sweeping five-year transportation bill into law in December. The $305 billion measure boosted funding across the board, including an $8 billion increase for highways over current levels, along with an additional $2 billion for mass transit, just to name two examples.

The unusual twist is that roughly $36 billion of the law’s funding comes from the Federal Reserve. When lawmakers couldn’t agree on how to boost financing via traditional means — including raising the gas tax — they found their source within the Fed instead. Although senior Fed officials objected that using a central bank to fund specific fiscal needs would set a worrisome precedent, the strong political momentum to complete the long-stalled bill persuaded large majorities in both parties to throw their support behind the underlying legislation.

The transportation legislation taps into two Fed sources: $19.3 billion as an immediate transfer from the Fed’s capital surplus account — a pool of funds the Fed has routinely set aside since its early years — followed by another $14 billion over the next five years; and a further $2.8 billion diverted from the Fed’s dividend payments to member banks, also over five years. Although it isn’t the first time Congress ordered Fed surplus-account funds to be channeled to the Treasury, this case represents the largest such transfer ever, both in nominal and in percentage terms.

Previous transfers from the Fed’s surplus account were relatively small and rare, and they generally went toward general deficit reduction. In this case, however, Congress ordered the money to be channeled to the Treasury for a specific fiscal need unrelated to monetary policy: surface transportation. It also required that the surplus account, which was $29.3 billion at the end of December 2015, be capped at $10 billion — the first permanent limit ever imposed — and that any surplus funds in excess of that cap go back to the Treasury. The cut in dividend payments was also a first. Altogether, these provisions allowed lawmakers to close a financing gap in the legislation that had grown over the years due to broad political reluctance to hike the long-frozen gas tax, the primary source of revenue for highway funding. Without the Fed money, financing the measure would have been a far heavier lift, according to lawmakers.

“There is plenty of profit sloshing around there that would come back to the Treasury anyway,” was how Sen. Dan Coats (R-Ind.) described the prevailing sentiment to Roll Call. Most lawmakers viewed the surplus account as “easy money,” he added.

This may have indeed seemed like easy money to some, but the move prompted concerns from economists and Fed policymakers about the underlying principle of central bank independence. They also noted that the funding fix didn’t represent a long-term budget solution on the fiscal side.

Fed’s Rainy Day Fund or Congress’ Piggy Bank?

There is often confusion between the Fed’s “surplus account” and the Fed’s (far larger) “operating surplus,” which is
income left over after expenses and sent to the Treasury on a weekly basis. There is also a common perception that the surplus account has been traditionally used as a “rainy day fund” in Fed operations, even though that isn’t exactly the case, either. The Fed doesn’t need such a surplus the way a bank needs capital as a buffer, because it has the power to expand or contract the amount of money in the economy. And while many other central banks have similar accounts, not all do. Nor has the surplus account played a major role when the Fed has responded to emergencies, such as its various forms of lending during the 2007-2009 financial crisis.

Instead, a more accurate description of the surplus account is that it’s one piece of a larger package that dates back to the Fed’s beginnings, namely, the framework that set up the relationship between the Fed and member banks. This is because the surplus account — until the highway legislation — was tied directly to another component of the Fed-bank relationship: It had to equal the amount of stock that member banks hold in the regional Reserve Banks as paid-in capital. After several revisions in the Fed’s early decades, the Federal Reserve Board of Governors set this ratio in 1964 so there wouldn’t be ambiguity about the surplus account’s required size. Due to this peg, the surplus account grew along with the paid-in capital account as more banks joined the System and as their assets grew over the years. In 2001, for example, the surplus account totaled $7.3 billion; by 2015, it had expanded to $29 billion (see chart).

Most of the Fed’s gross earnings come from the interest the Fed earns from the Treasuries and other securities on its $4.4 trillion balance sheet. Out of that income, the Fed must pay out its operational expenses, the interest it pays banks on the reserves they hold, and dividend payments to member banks. Once those costs are covered, the Fed sends to the Treasury any excess earnings. Those remittances have amounted to almost $600 billion since the financial crisis, when the Fed vastly expanded its holdings of securities during the 2007-2009 financial crisis.

Early Warnings
If the Reserve Banks tap into the surplus account only on rare occasions, and if the account hasn’t played a meaningful role in Fed operations or in emergencies, why did senior Fed officials oppose its funding the highway bill? One underlying concern, raised by Fed Chair Janet Yellen and others, is that such a transfer represents an infringement of Fed independence by breaking down the wall between fiscal policy — the exclusive domain of Congress — and monetary policy — the exclusive domain of the Fed since the 1913 Federal Reserve Act. Generally speaking, if central banks are forced to subordinate monetary policy to fiscal or political needs, politicians could compel them to print money, which in turn could spur inflation. In this particular case, warnings from Fed officials focused on the concern that Congress could turn to the Fed in future budget battles rather than making fiscal trade-offs (cutting spending or raising taxes) on its own. This was the gist of the warning issued by Fed Vice Chairman Stanley Fischer last November, when he said that the legislation has “manifold implications for central bank independence as well as for the quality of fiscal policy decisions.”

“Financing federal fiscal spending by tapping the resources of the Federal Reserve sets a bad precedent and impinges on the independence of the central bank,” agreed Yellen in congressional testimony in December. In addition, she said, “it weakens fiscal discipline.”

Former Fed Chairman Ben Bernanke, writing on his blog last December, detailed another critique on the budget side, one that other senior Fed officials have also noted. Because the surplus account holds U.S. government bonds, he wrote, the Treasury would see a drop in remittances if the Fed sold those securities to the public so that the proceeds could be transferred as cash to the Treasury. In effect, the outcome would be the same if the Treasury issued new debt to sell to the public and then paid interest on that debt to bondholders: There would be no net infusion of revenue to the government. So while its congressional backers may have presented the highway bill as fully funded, what actually occurred was, in Bernanke’s words, “budgetary sleight of hand.”

The Century-Old Framework
The debate over the Fed’s role in funding the highway legislation is unlikely to end soon, but one thing is clear: The move represents a change from organizational principles dating from the Fed’s early days that relate to both the surplus account and the relationship between the Fed and member banks.

When the 1913 Federal Reserve Act chartered the Reserve Banks, it required that they be financed by member banks rather than congressional appropriations, in an attempt to make the Fed seem less risky to taxpayers and therefore politically more popular. Under these guidelines, if a bank wanted to join the Fed system, it had to purchase Fed stock in an amount equal to 3 percent of the capital and surplus listed on the bank’s most recent Call Report (namely, the accounting categories that represent the sum of owners’ permanent
Fed put into the banking system through its unconventional monetary policy. This infusion dates back to late 2008, after the Fed had lowered the federal funds rate to a range of zero to 0.25 percent — effectively to the “zero lower bound” — and sought new tools for stimulus. It turned to making unprecedented amounts of bond purchases as a way to inject more reserves into the banking system and pressure longer-term interest rates (including mortgage rates) lower. Cumulatively, those bond purchases expanded the Fed’s balance sheet from $800 billion in summer 2008 to $4.4 trillion today, more than a fivefold increase, while reserves held by banks ballooned from $25 billion to $3 trillion. (When the Fed acquires assets, it buys them with newly issued money, namely, bank reserves. So the bigger the Fed’s balance sheet, the greater the amount of reserves.)

Now that there are substantial excess reserves in the banking system, rather than changing the federal funds rate through buying or selling bonds on the open market — as was traditionally done — the Fed is using adjustments to its interest payments on reserves to implement policy changes. In a July 2009 report to Congress, the Fed called this particular authority the most important tool the Fed can use in raising interest rates without shrinking its balance sheet — that is, selling the bonds it currently holds.

By extension, a diminished surplus account could complicate the Fed’s plans to continue lifting rates by giving it less room for adjustment: If interest rates rise in coming years, as the Fed projects, it may choose to pay out more in interest payments on reserves held by banks to prevent the banking system from using excess reserves to rapidly expand lending, which could create inflationary pressures. Accordingly, if interest rates go up quickly or suddenly — say, if inflation spikes — the spread could narrow more than expected between what the Fed takes in as interest earnings (on the securities it bought when yields were low) and the amount it has to pay out as interest on reserves (which will increase as rates rise).

The Fed’s expected path toward “normalization” also implies that the Fed’s interest earnings will diminish in the years to come, assuming it will start shrinking its balance sheet as it has pledged to eventually do. To do this, rather than re-invest the securities it holds, as it has done since 2008, the Fed has stated that it plans to start letting bonds “roll off” the balance sheet upon reaching maturity. This means the Fed’s interest income will decline.

A note of general caution came from Bernanke himself in September 2009, when the FOMC gathered for its policy meeting, as members discussed how the Fed would absorb possible losses during a period of rising interest rates. “We’ll be returning to the Treasury very high levels of seigniorage over the next few years,” he said, noting he had been in talks with Treasury officials. “I think there would be some basis for withholding some of those earnings to augment our capital, so that if we do have losses, we’d be able to absorb them.”

For now, the Fed still plans to re-invest its securities. But taking these factors together, some economists conclude that the Fed may need an extra cushion in the years ahead,
even "unhinge" inflation expectations.

Other economists see this scenario as unlikely: They argue that the difference between the Fed’s remittances to the Treasury and its interest payments on reserves is so great that the Fed is unlikely to face a net loss even if interest earnings fall and interest payments increase. For example, the Fed paid banks $6.9 billion in interest on reserves in 2015, while its total interest income was $113.6 billion. Moreover, the interest rate on reserves has thus far been well below the average yield paid on Treasuries held by the Fed, many of which have longer-term maturities. For securities averaging 10 or more years in maturity on the Fed’s balance sheet, the average yield is 2.5 percent.

To see what the near and mid-term risks could look like, three economists at the San Francisco Fed, Jens Christensen, Jose Lopez, and Glenn Rudebusch, have modeled alternative interest rate scenarios against baseline forecasts, and in a 2013 working paper they concluded that “the risk of a long or substantial cessation of remittances to the Treasury is remote.” In fact, in almost 90 percent of their simulations, they projected no shortfalls at all through 2020.

Even under scenarios of continuing remittances, however, many economists expect they will drop. A recent analysis by five researchers at the Fed’s Board of Governors estimating the Fed’s projected remittances to the Treasury through 2020 (under baseline assumptions) forecast a drop in net remittances to $18 billion in 2018, $23 billion in 2019, and $31 billion in 2020. But if interest rates were to rise by 200 basis points (2 percentage points) higher than expected, remittances to the Treasury could fall to zero, according to this model. Noting that 2 percentage points are beyond the historical standard deviation of the 10-year Treasury yield (around 1.6 percent), the authors concluded that “this higher interest rate scenario should be seen as a somewhat unlikely scenario, but not an implausible one.”

For now, there remain two implications that go beyond technical questions of balance-sheet operations. First, it remains to be seen what the political fallout will be if the Fed’s remittances to the Treasury do decline sharply in coming years. The other question is psychological: namely, whether the Fed’s credibility will be weakened as a result of Congress having tapped into the surplus account. This risk to credibility could either take the form of Congress opting for future interventions that could directly affect the Fed’s conduct of monetary policy, or a scenario in which the Fed has to resort to printing money to cover losses that result from such an intervention. In both cases, the Fed’s ability to control inflation would come into question.

Speaking at the time of the last (and far less controversial) surplus-account transfer in 2000, then-Fed Gov. Lawrence Meyer raised the issues of perceptions and credibility. He noted that while the risks to the Fed’s balance sheet had receded over the years, there was still value in maintaining the surplus account, on grounds that it “may help support the perception of the central bank as a stable and independent institution by ensuring that its assets remain comfortably in excess of its liabilities.”

Yellen chose to emphasize this last point, as well, as she testified to Congress in December, “Almost all central banks do hold some capital in operating surplus,” said Yellen. “And holding such a surplus or capital is something that I believe enhances the credibility and confidence in the central bank. ... [W]e don’t have a lot of capital, but we have long had capital in surplus that, I think, creates confidence in our ability to manage monetary policy.”

Readings


