The Diminishing Marginal Utility of Excess Bank Reserves

By: Bob McTeer **June 26, 2012**

This is not an argument for more quantitative easing, or QE3, as it would inevitably be called. Instead, this is about the logic of the argument for more quantitative easing. It is intended as a response to the oft-heard argument that more quantitative easing wouldn't stimulate the economy because past quantitative easing hasn't produced the desired results.

The answer is a simple economics concept, the concept of diminishing marginal utility. Other things equal, the more you have of something the less additional satisfaction comes from more of it.

Given the financial crisis, recession, slow recovery, and the pounding the banking industry has taken from all fronts, the banks have had a large appetite for excess reserves as a contingency. They may be excess in a technical sense, but they are not excess to the bankers under current circumstances. Therefore, the huge amount of reserves created by the Fed's past open market purchases have largely ended up on banks' balance sheets as excess reserves rather than being fully utilized to make money-creating bank loans and investments. A similar phenomenon occurred during the depression.

If the Fed had not engaged in aggressive open market operations to create reserves, chances are the banks would have tried to add to their reserves by shrinking their balance sheets. At this point, additional reserve creation may lead to more reserve hoarding, but, given the diminishing marginal utility of those reserve, at some point what can be done with additional reserves will become more attractive to banks than accumulating more reserves.

If a medicine has been sufficient to keep a patient from worsening, but not sufficient to restore his health, the answer may be to increase the dosage rather than remove the medicine altogether.

Don't worry whether diminishing marginal utility is a Keynes or Hayek concept. It is neither. It is micro rather than macro.