The Federal Reserve’s Balance Sheet

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Overview

• The size of the Fed’s balance sheet, like many other central banks, has increased drastically over the past decade

• With a larger balance sheet, the Federal Reserve has changed the way it conducts even “conventional” monetary policy and attracted political attention

• The Federal Open Market Committee (FOMC) recently announced that it will begin the process of balance sheet normalization next month

• The Fed’s normalized balance sheet will likely look different compared to its pre-crisis form, but much uncertainty surrounds its future size and composition
The 2008 recession was the most severe post-war recession.

Sources: Bureau of Labor Statistics, NBER, Haver Analytics
“Conventional” monetary policy was exhausted by 2008, but long-term interest rates remained well above zero.
The FOMC used “unconventional” balance sheet policy to put downward pressure on long-term interest rates.
Research suggests these policies depressed long-term rates

Sources: Bureau of Economic Analysis, Federal Reserve Bank of New York, NBER, Haver Analytics, and author’s calculations
Economic conditions have since moved closer to the Fed’s targets

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Congressional Budget Office, NBER, Haver Analytics, and author’s calculations
Monetary policy normalization was initiated with the funds rate.
Expanding the balance sheet saturated banks with reserves

Sources: Federal Reserve Board, NBER, Haver Analytics, and author’s calculations
In an environment with abundant reserves, interest rate changes have to be implemented in new ways.
New tools are needed to control the fed funds rate

Sources: Federal Reserve Bank of New York, NBER, Haver Analytics
Some of these new tools bring political attention to the Fed

Sources: Federal Reserve Board, NBER, Haver Analytics
Maintaining a large balance sheet adds to the Fed’s political risks.
Public focus is now shifting back to the balance sheet

Sources: Google Trends, NBER, Haver Analytics
Changes to the balance sheet have been announced, but financial market reaction has been fairly muted.

Sources: Federal Reserve Board, Haver Analytics, author’s calculations.
After increasing the target range for the federal funds rate ...

• Asset holdings will be reduced in a gradual and predictable manner primarily by ceasing reinvestments

• Sales of MBS are not anticipated, although limited sales might be warranted in the longer run to reduce or eliminate residual holdings.

• In the longer run, the balance sheet will be:
  • Composed primarily of Treasury securities and
  • No larger than necessary to implement monetary policy.
A cap on the runoff of treasury securities ensures that the balance sheet will shrink at an even pace.

Sources: Federal Reserve Bank of New York, Federal Reserve.

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Maturing Treasury Securities

Runoff cap

Amount exceeding runoff cap is reinvested

Sources: Federal Reserve Bank of New York, Federal Reserve
The Fed continues to own a sizeable share of the MBS market

SOMA Agency MBS holdings as a share of outstanding Agency MBS

Sources: Federal Reserve Bank of New York, Fannie Mae, Freddie Mac, Ginnie Mae, NBER, Haver Analytics, and author’s calculations
MBS holdings could remain large even after reinvestments cease

Sources: Federal Reserve Board, Haver Analytics

Sources: Federal Reserve Board, Haver Analytics
MBS prepayments are difficult to predict, but are expected to slow as rates move higher.

Sources: Haver Analytics
The normalized balance sheet will be larger than it was prior to the Great Recession.

Sources: Federal Reserve Board, Haver Analytics
Summary

• Monetary policy normalization was initiated with an increase in the target federal funds rate in December 2015

• Balance sheet normalization will be initiated next month

• A framework for balance sheet normalization is in place, but some details remain to be determined

• The Fed’s balance sheet will likely remain in public focus as it is expected to be a part of the FOMC’s monetary policy toolkit going forward