The Federal Reserve's Balance Sheet

FEDERAL RESERVE BANK *of* KANSAS CITY

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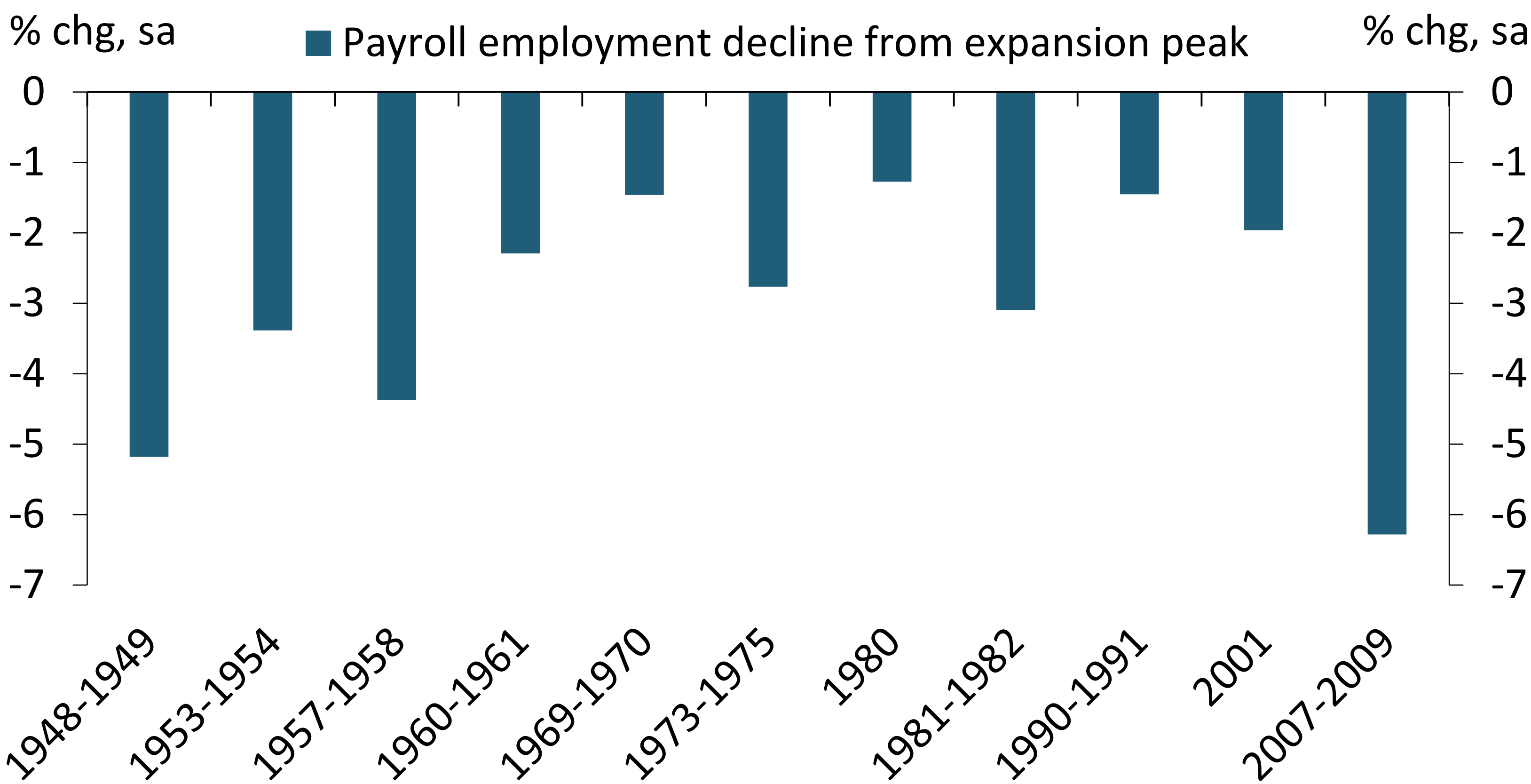
Overview

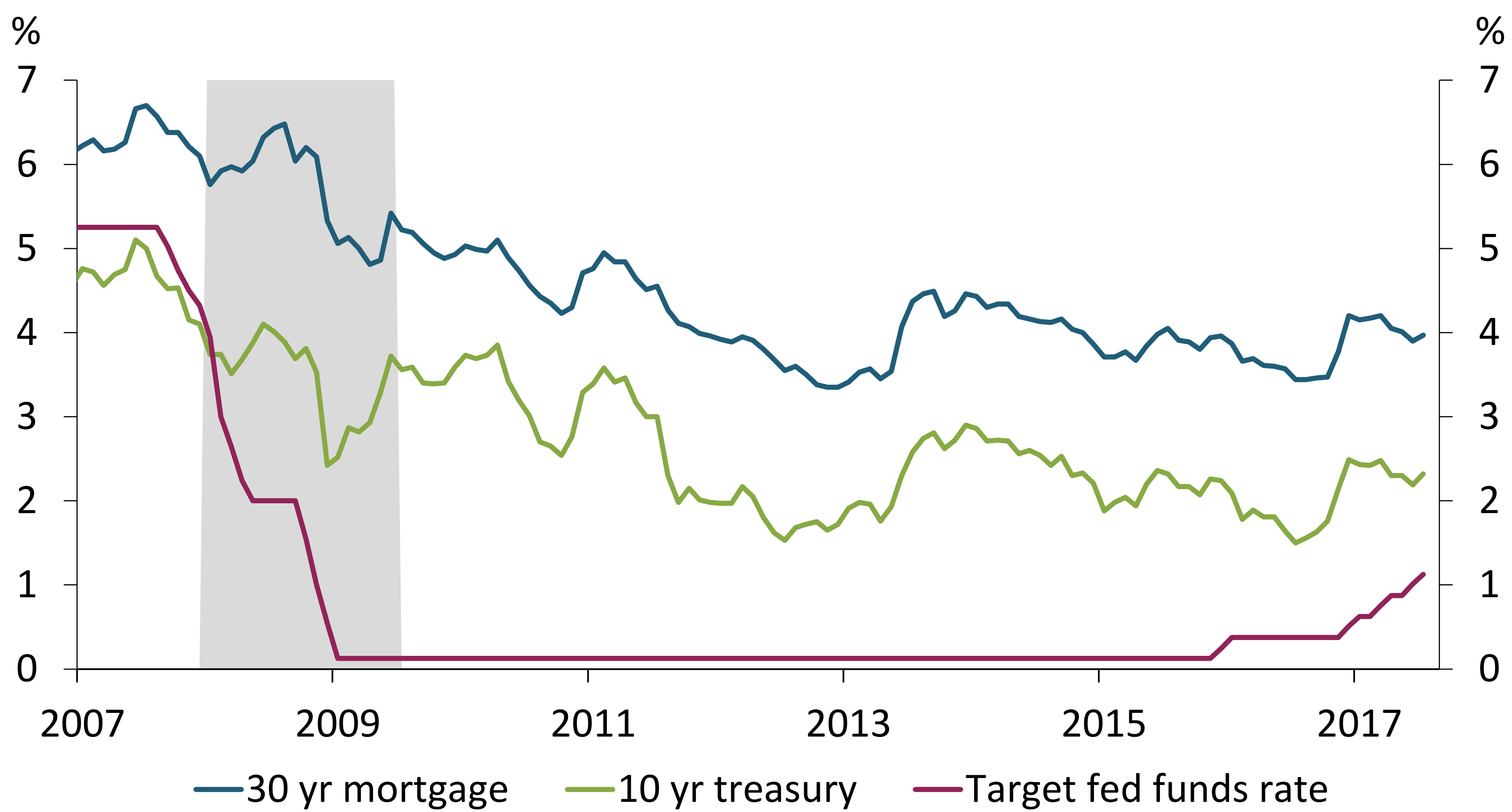
- The size of the Fed's balance sheet, like many other central banks, has increased drastically over the past decade
- With a larger balance sheet, the Federal Reserve has changed the way it conducts even "conventional" monetary policy and attracted political attention
- The Federal Open Market Committee (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



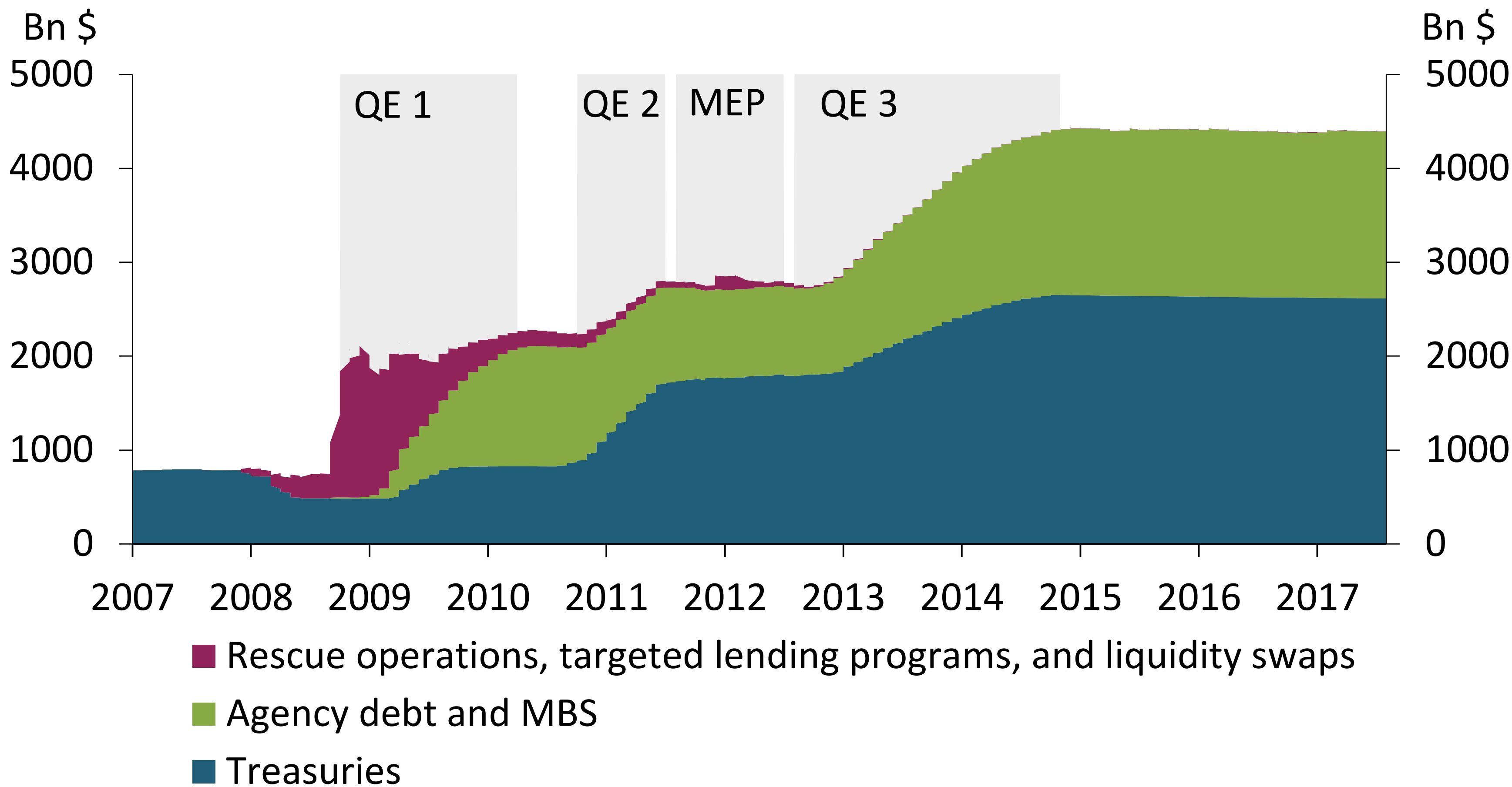
Sources: Bureau of Labor Statistics, NBER, Haver Analytics

“Conventional” monetary policy was exhausted by 2008, but long-term interest rates remained well above zero



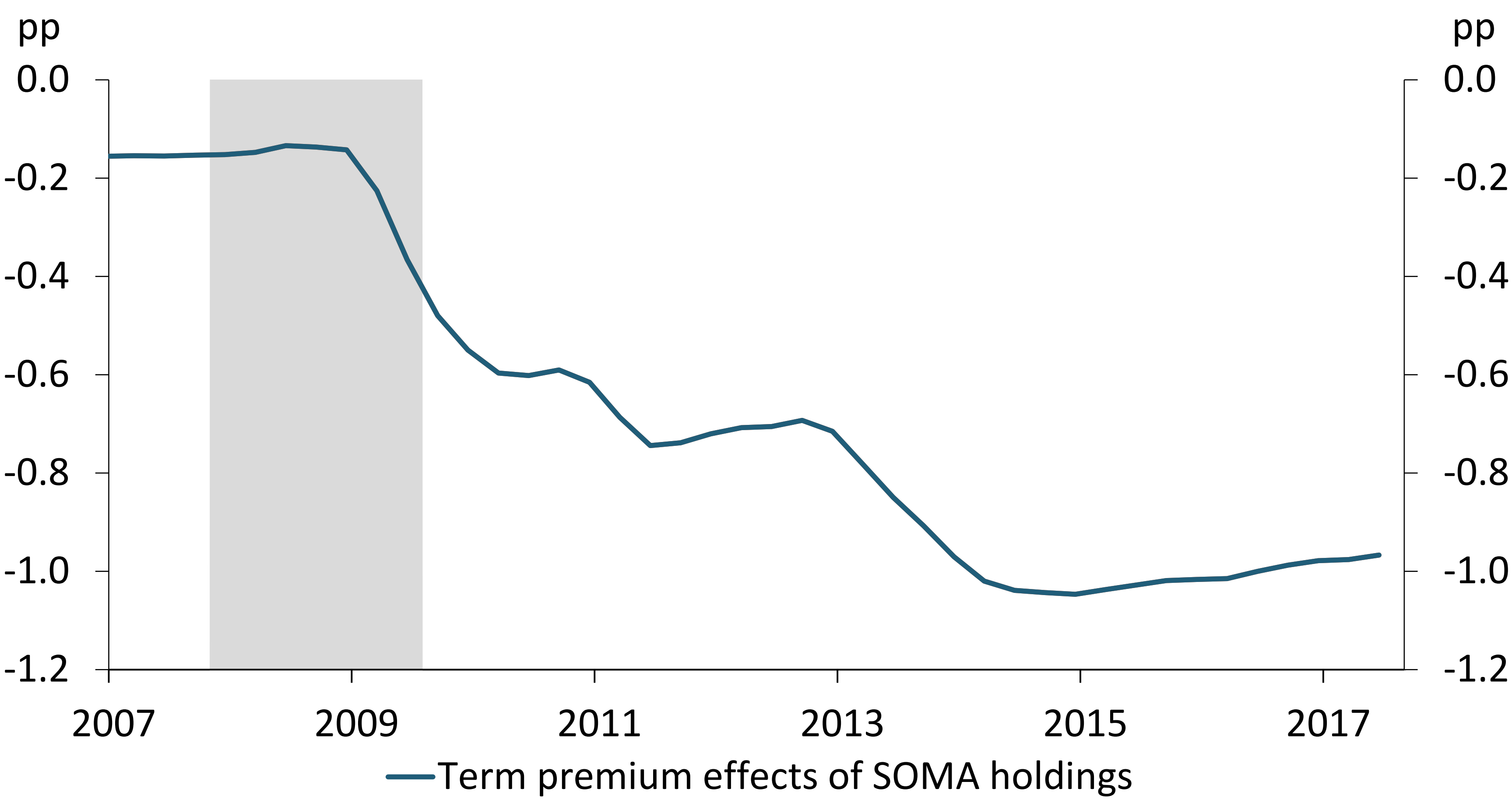
Sources: Federal Reserve Board, NBER, Haver Analytics

The FOMC used "unconventional" balance sheet policy to put downward pressure on long-term interest rates



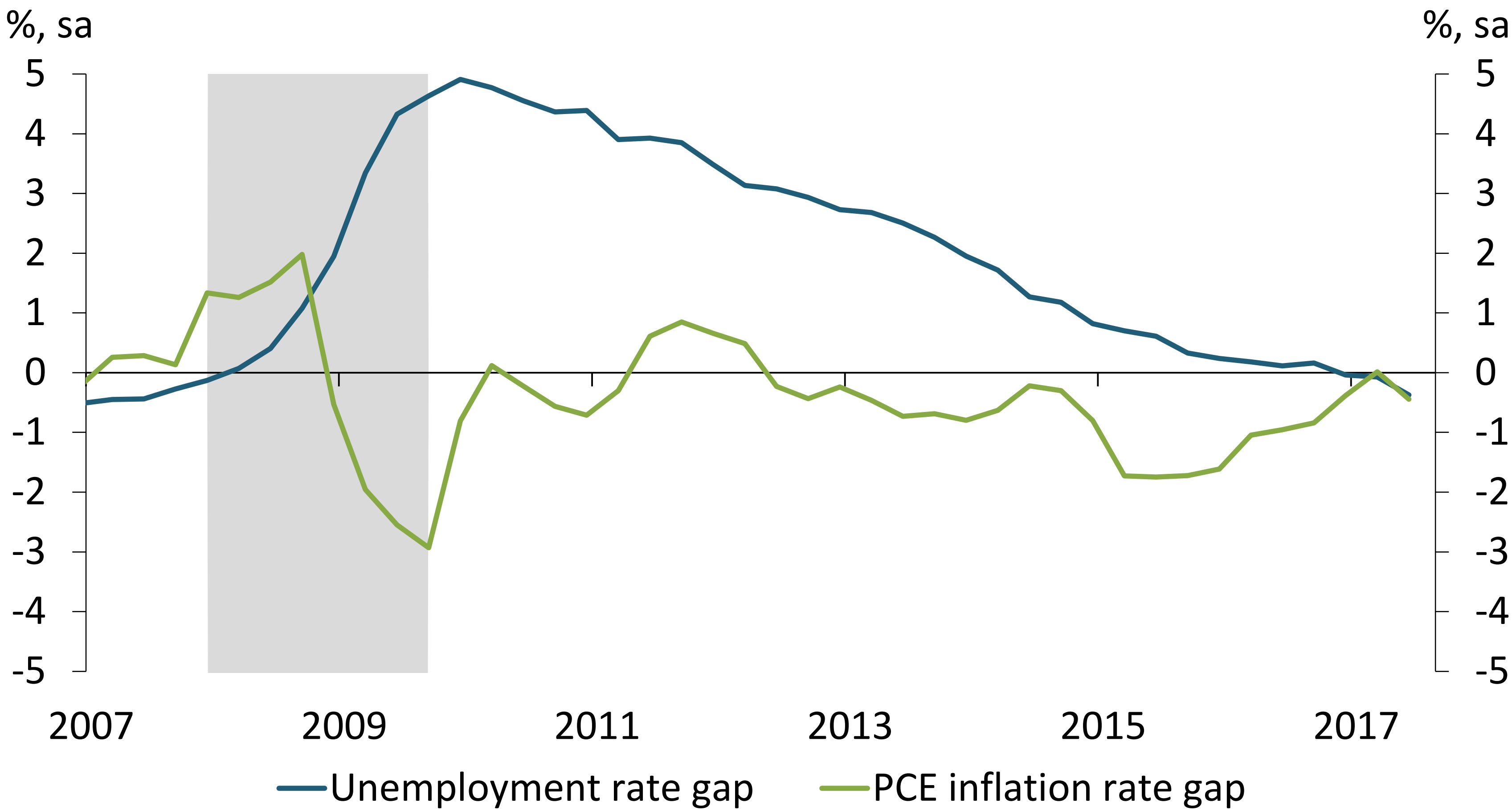
Sources: Bureau of Labor Statistics, NBER, Haver Analytics

Research suggests these policies depressed long-term rates



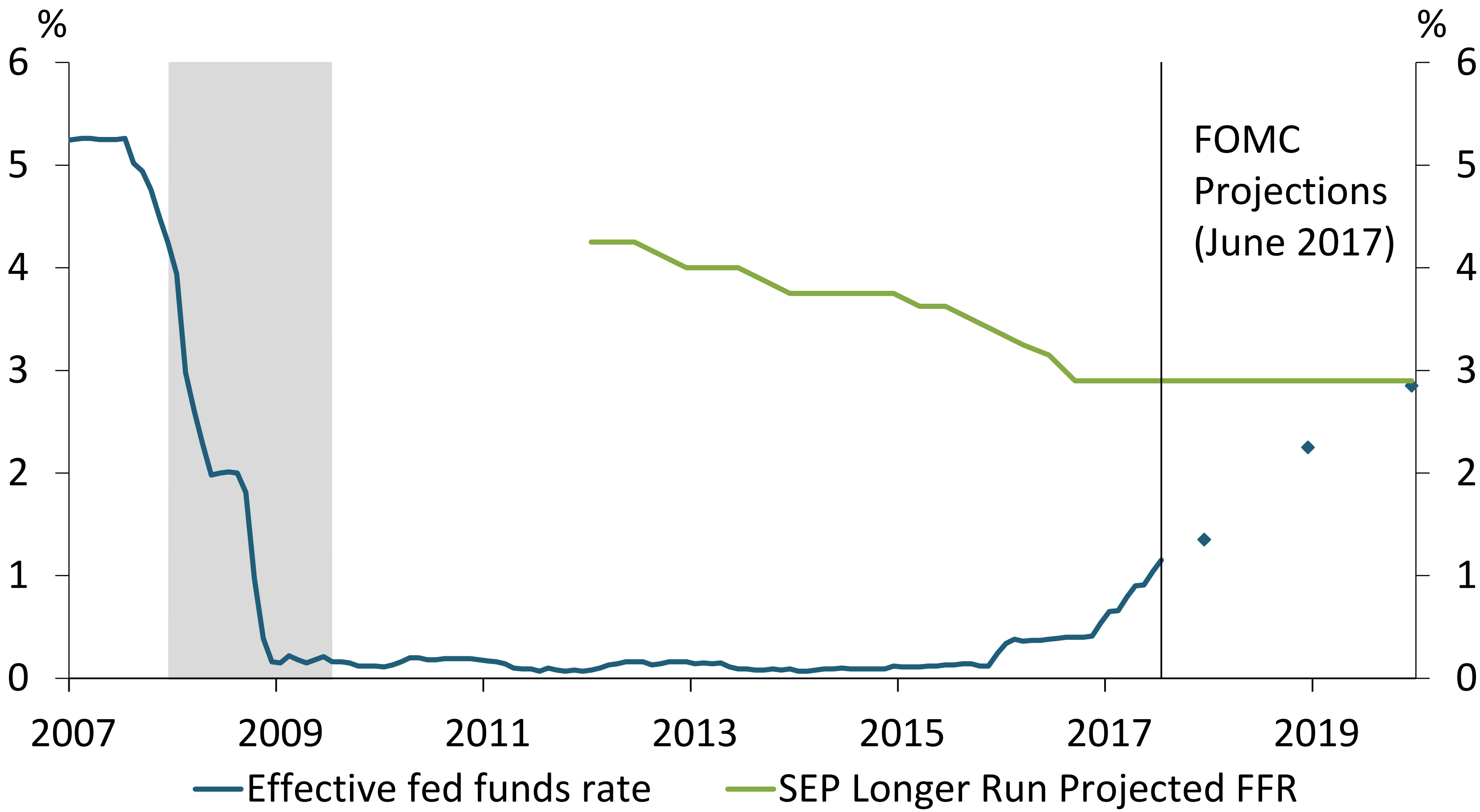
Sources: Bureau of Economic Analysis, Federal Reserve Bank of New York,
NBER, Haver Analytics, and author’s calculations

Economic conditions have since moved closer to the Fed's targets



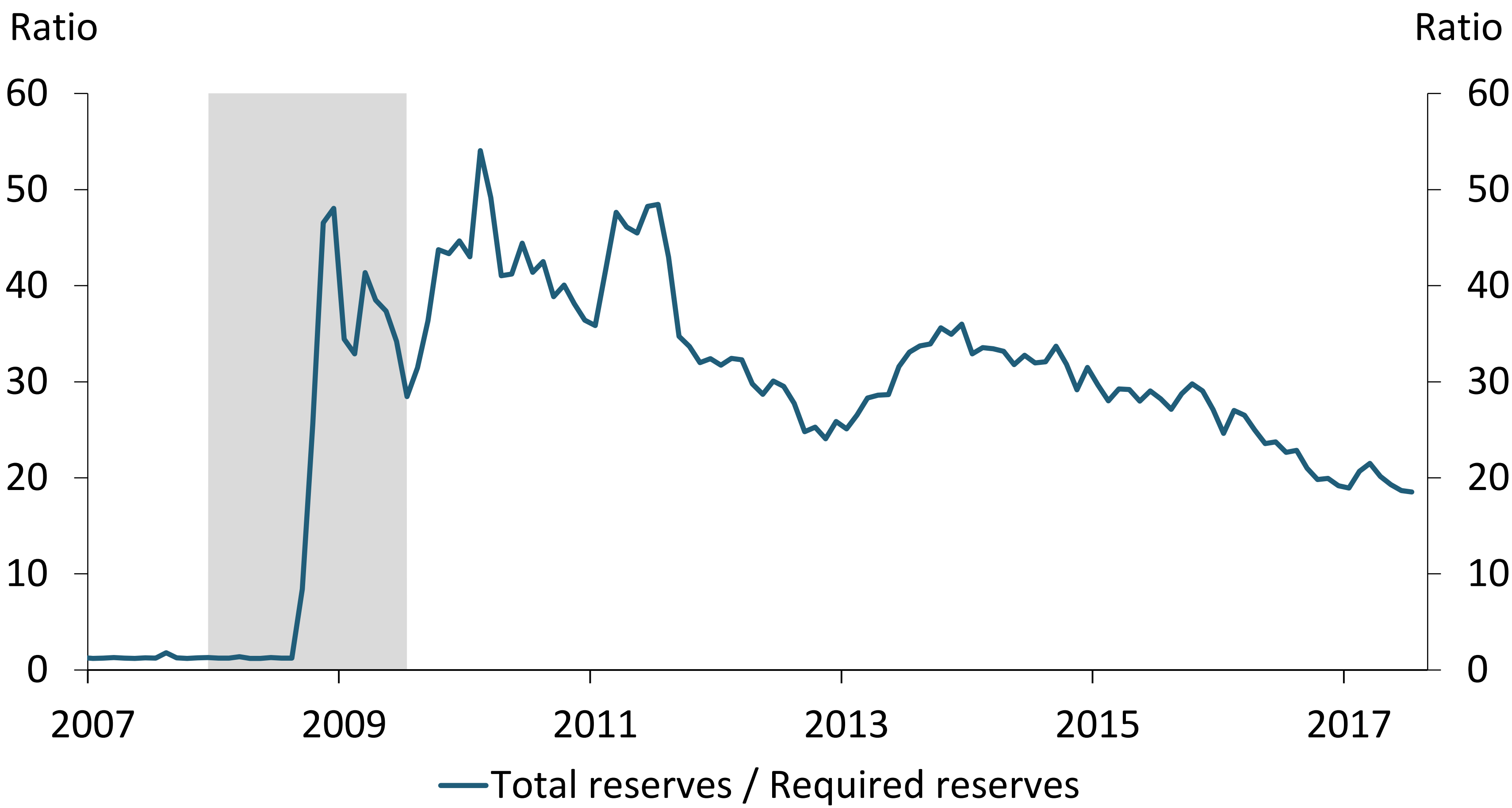
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Congressional Budget Office, NBER, Haver Analytics, and author's calculations

Monetary policy normalization was initiated with the funds rate



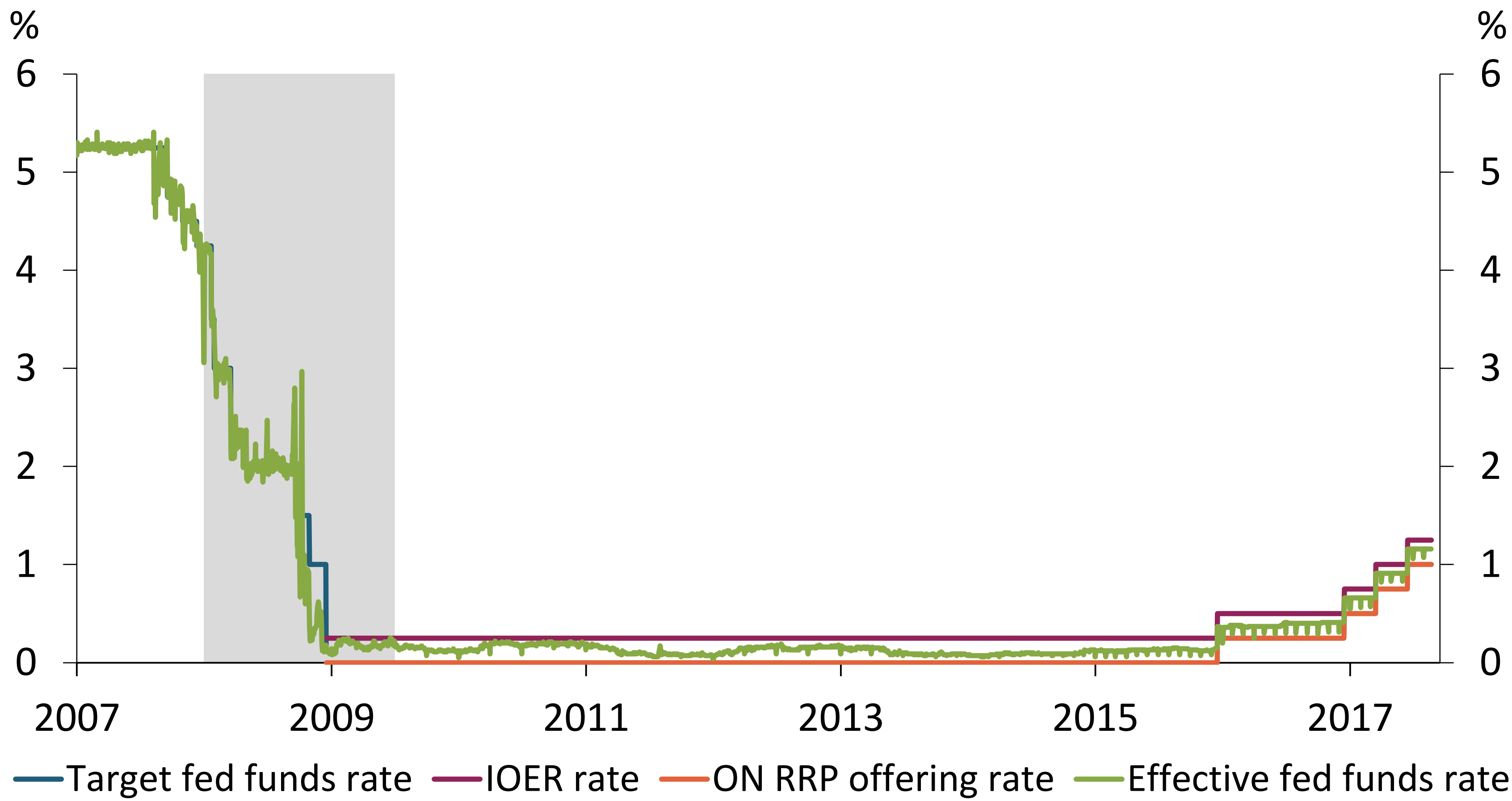
Sources: Federal Reserve Board, Summary of Economic Projections, NBER, Haver Analytics

Expanding the balance sheet saturated banks with reserves



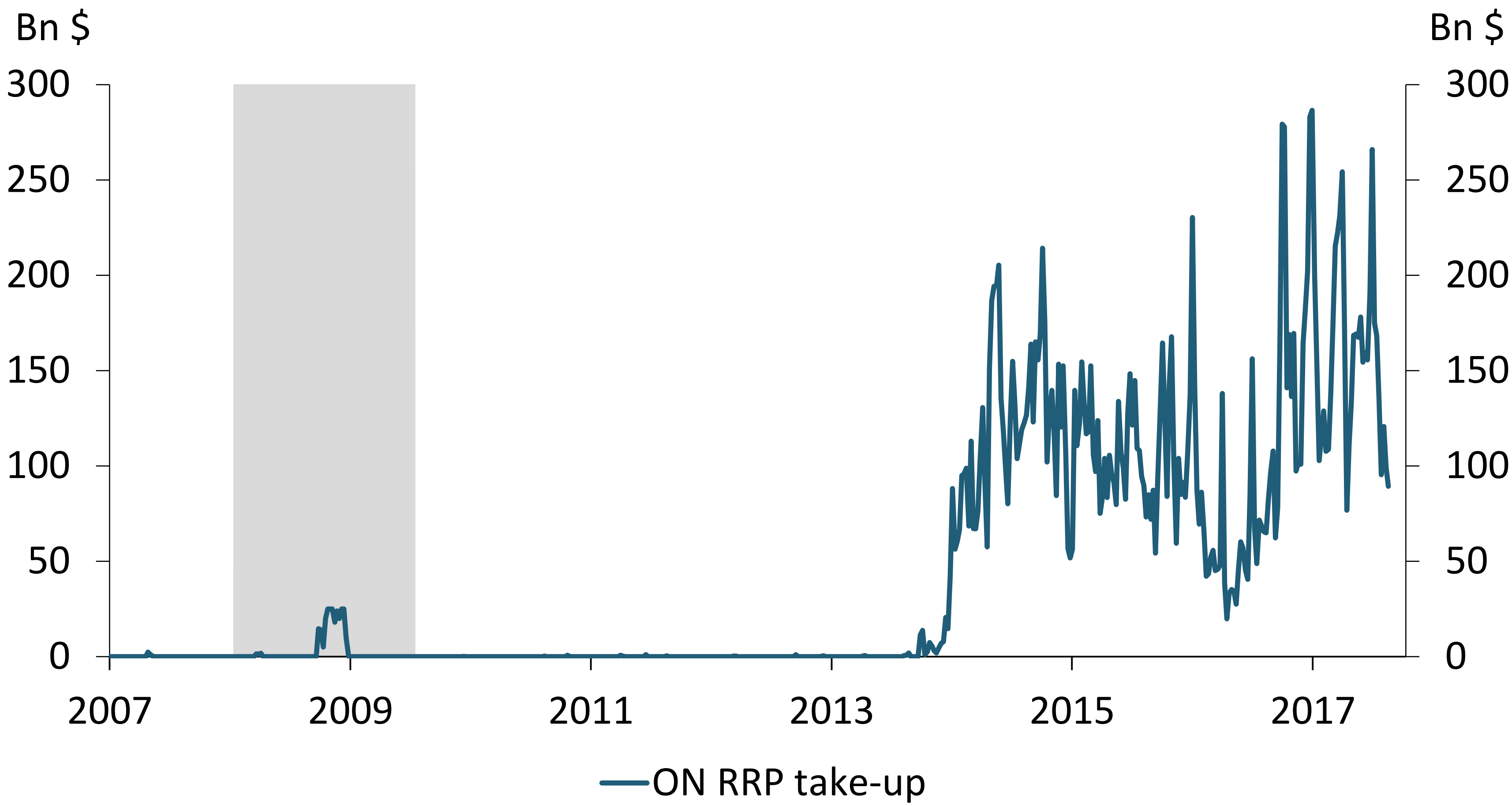
Sources: Federal Reserve Board, NBER, Haver Analytics, and author's calculations

In an environment with abundant reserves, interest rate changes have to be implemented in new ways



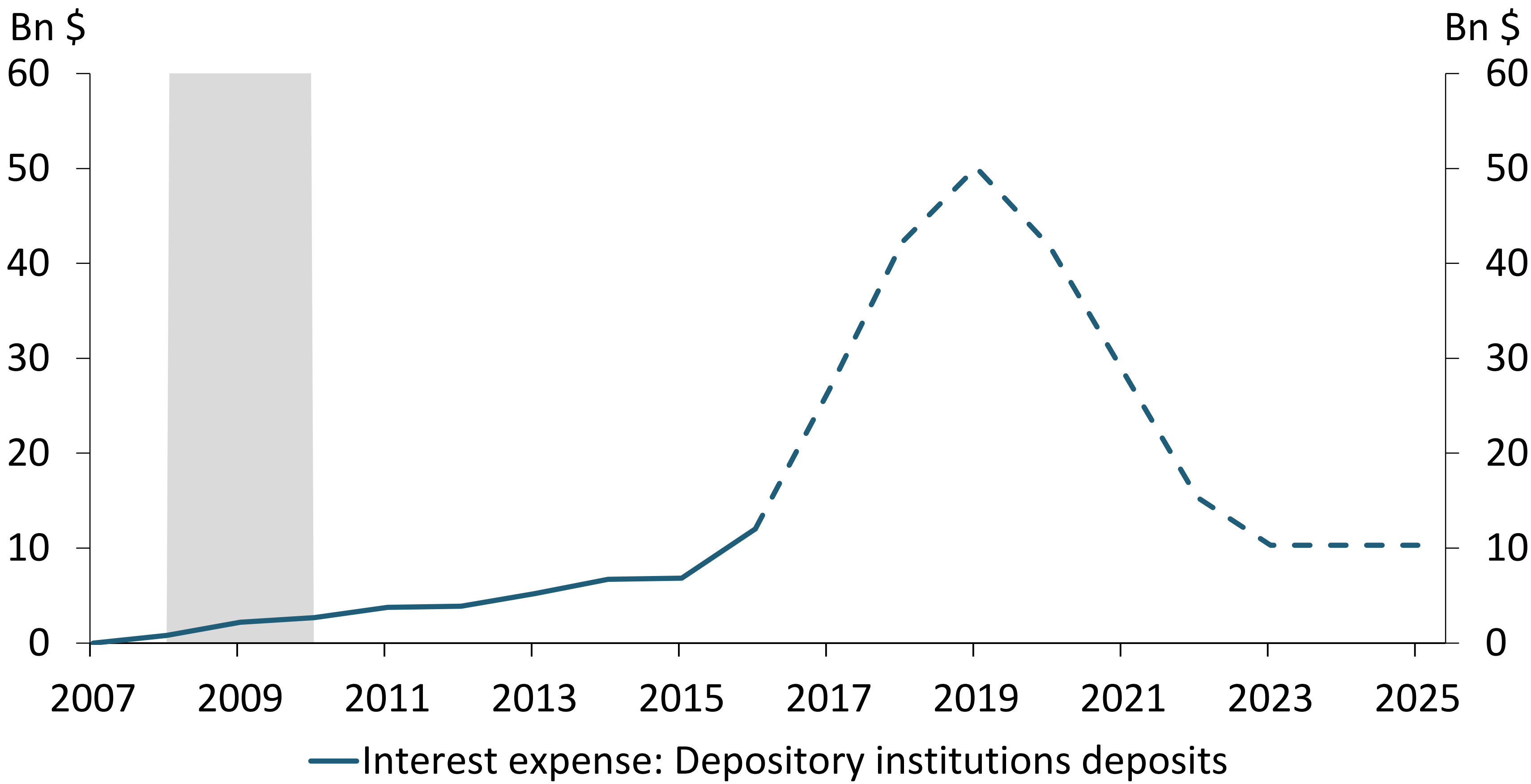
Sources: Federal Reserve Bank of New York, Federal Reserve Board, NBER, Haver Analytics

New tools are needed to control the fed funds rate



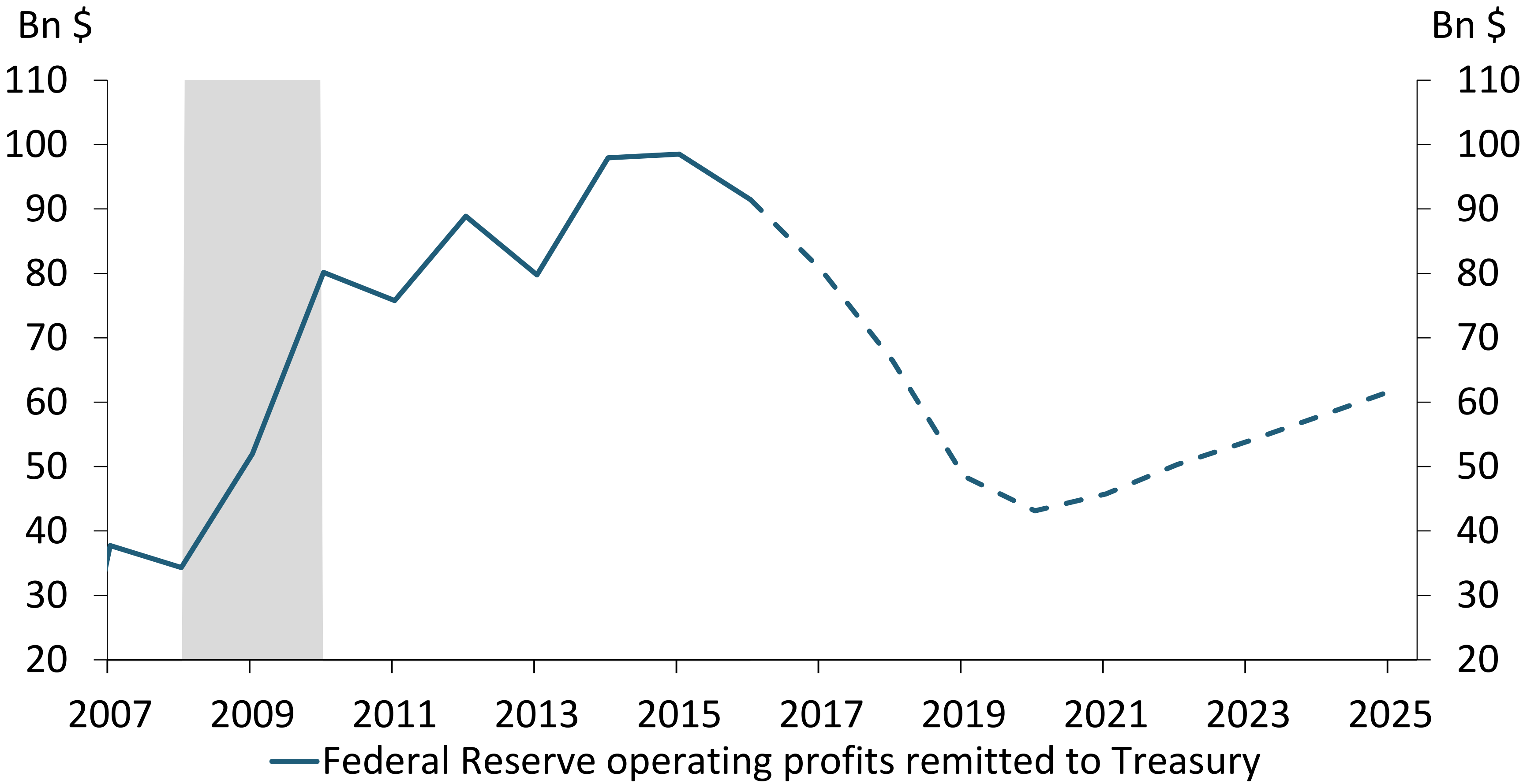
Sources: Federal Reserve Bank of New York, NBER, Haver Analytics

Some of these new tools bring political attention to the Fed



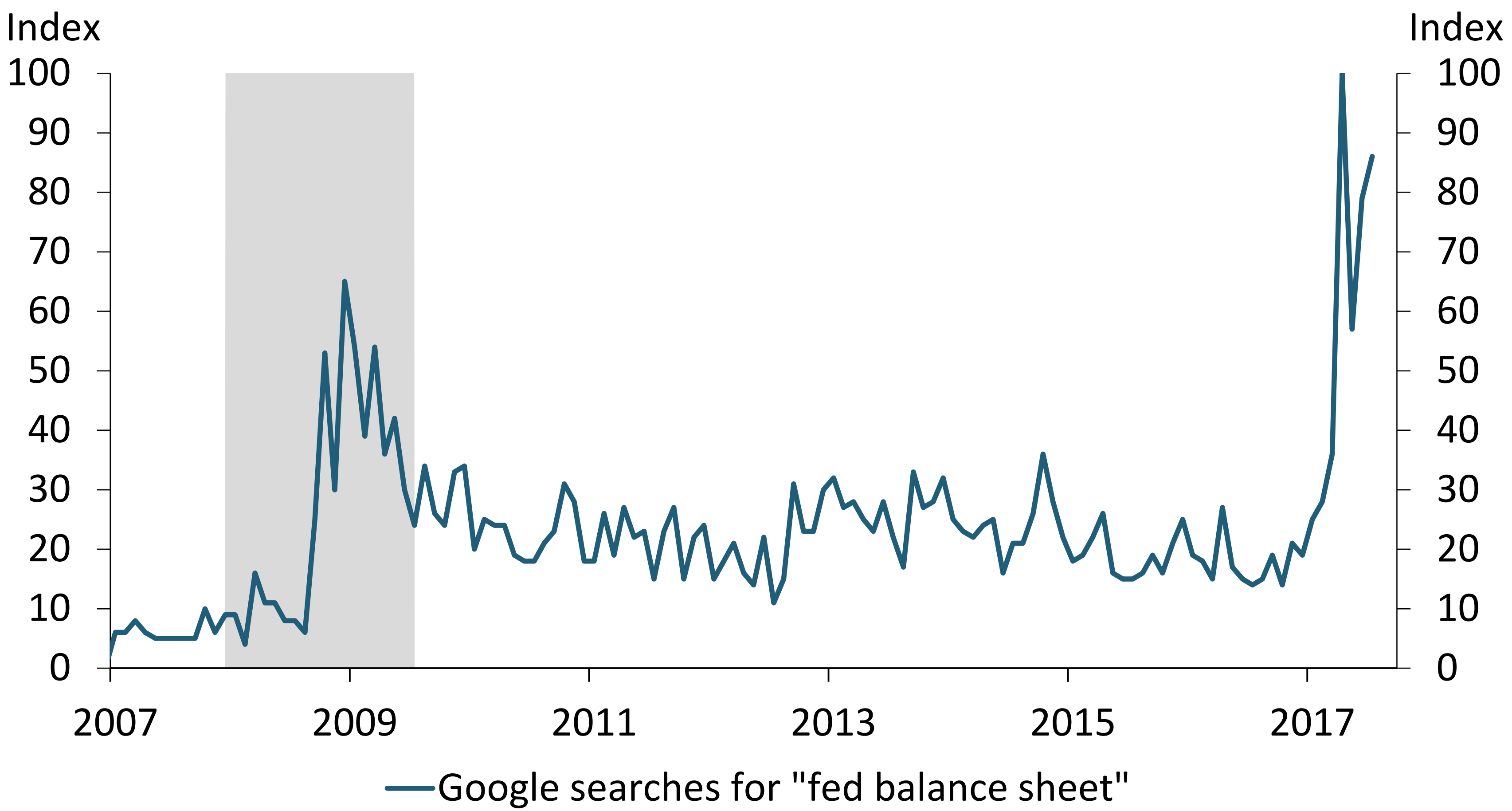
Sources: Federal Reserve Board, NBER, Haver Analytics

Maintaining a large balance sheet adds to the Fed's political risks



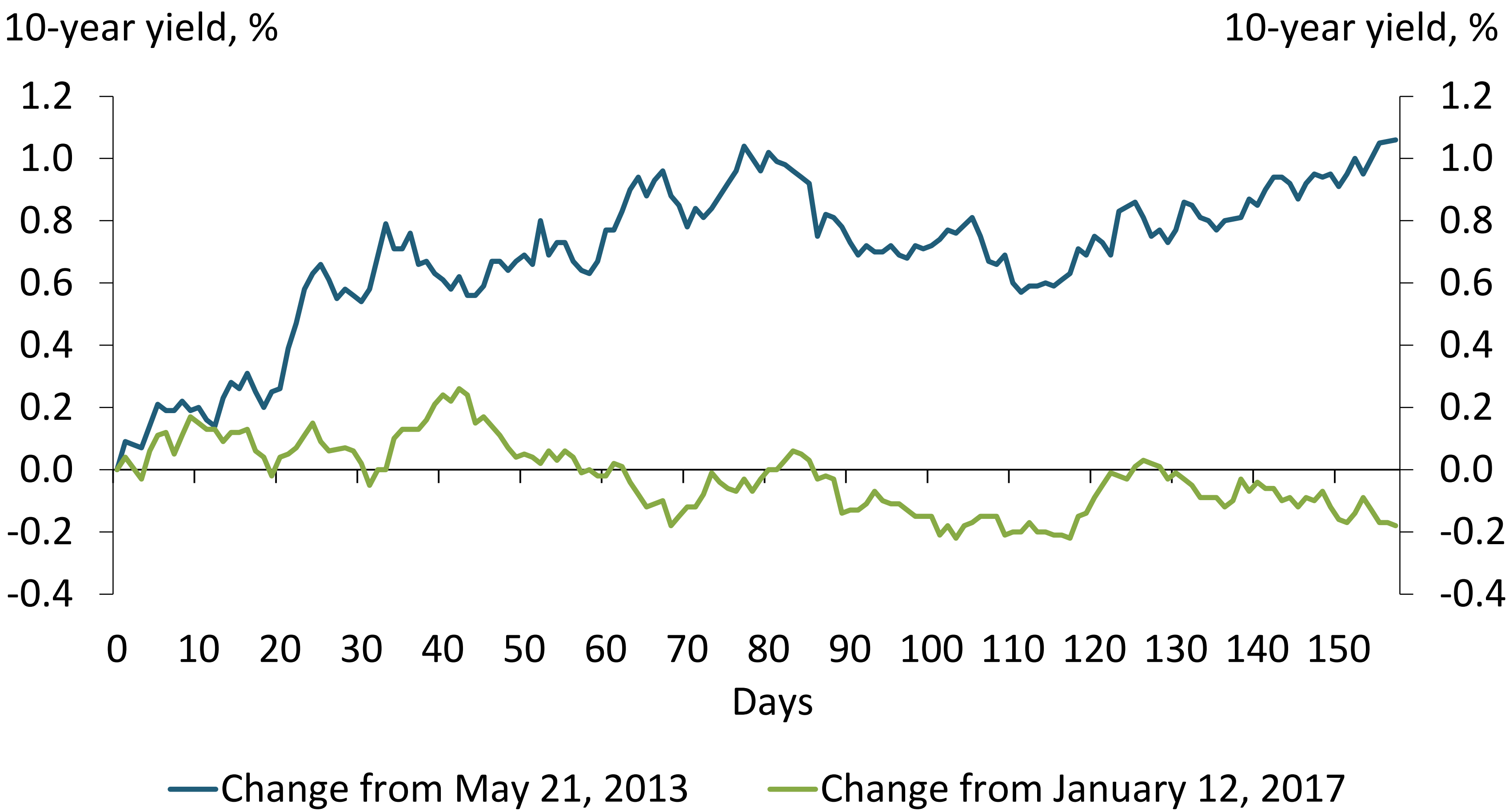
Sources: Federal Reserve Board, NBER, Haver Analytics

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

September 2014 “Policy Normalization Principles and Plans”

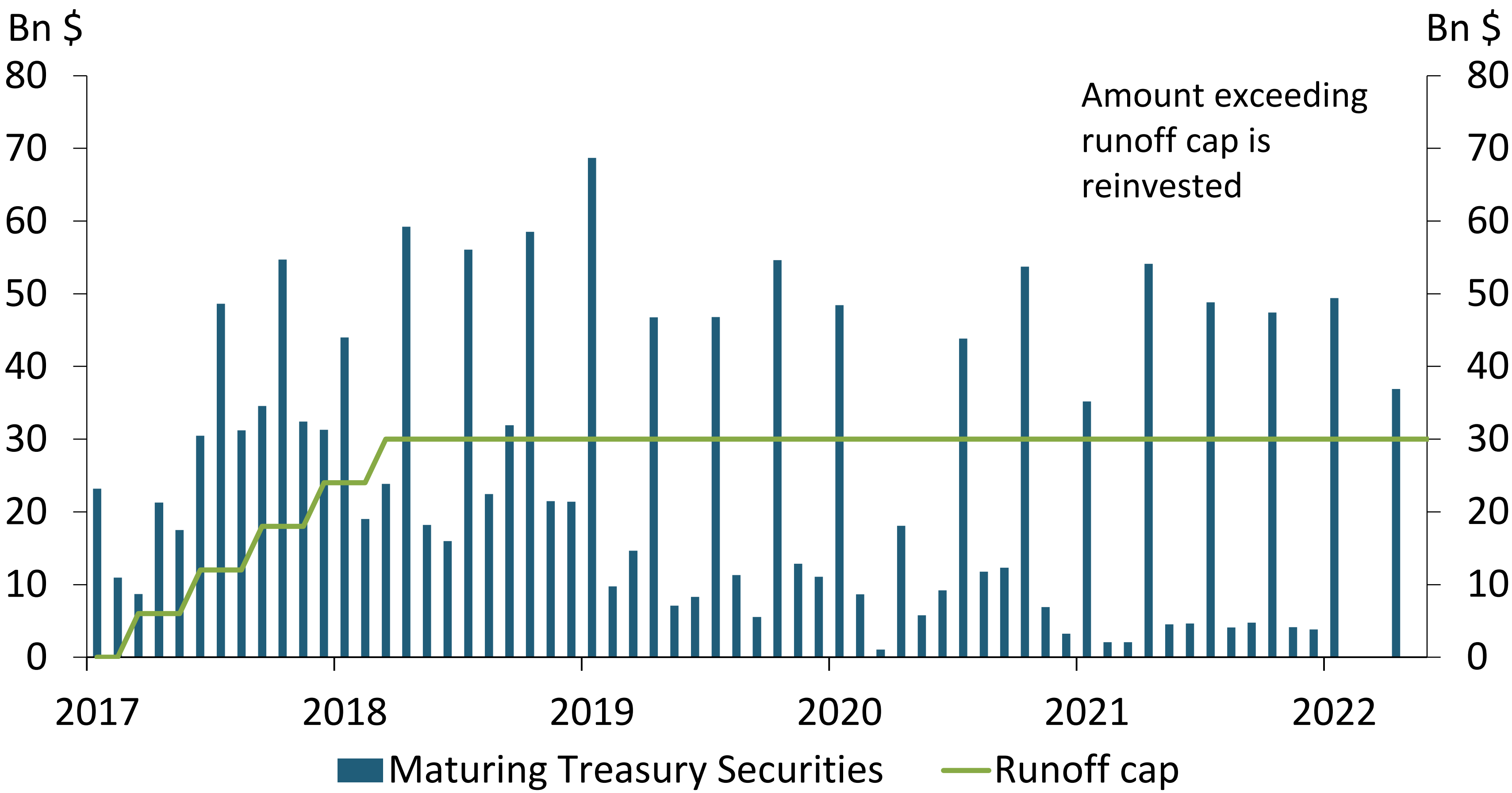
After increasing the target range for the federal funds rate …

- 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.

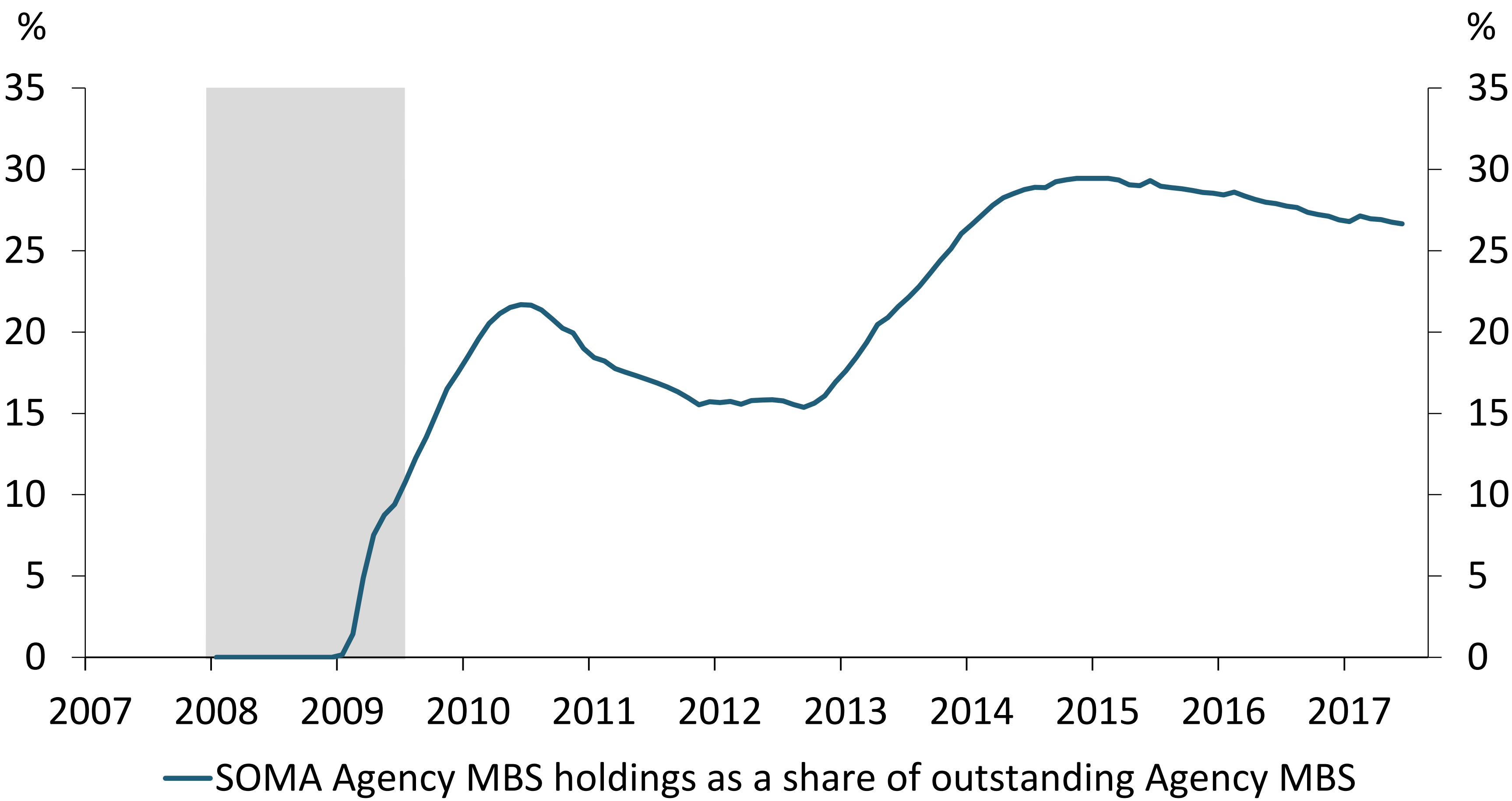
- In the longer run, the balance sheet will be:
  - Composed primarily of Treasury securities and
  - No larger than necessary to implement monetary policy.

A cap on the runoff of treasury securities ensures that the balance sheet will shrink at an even pace



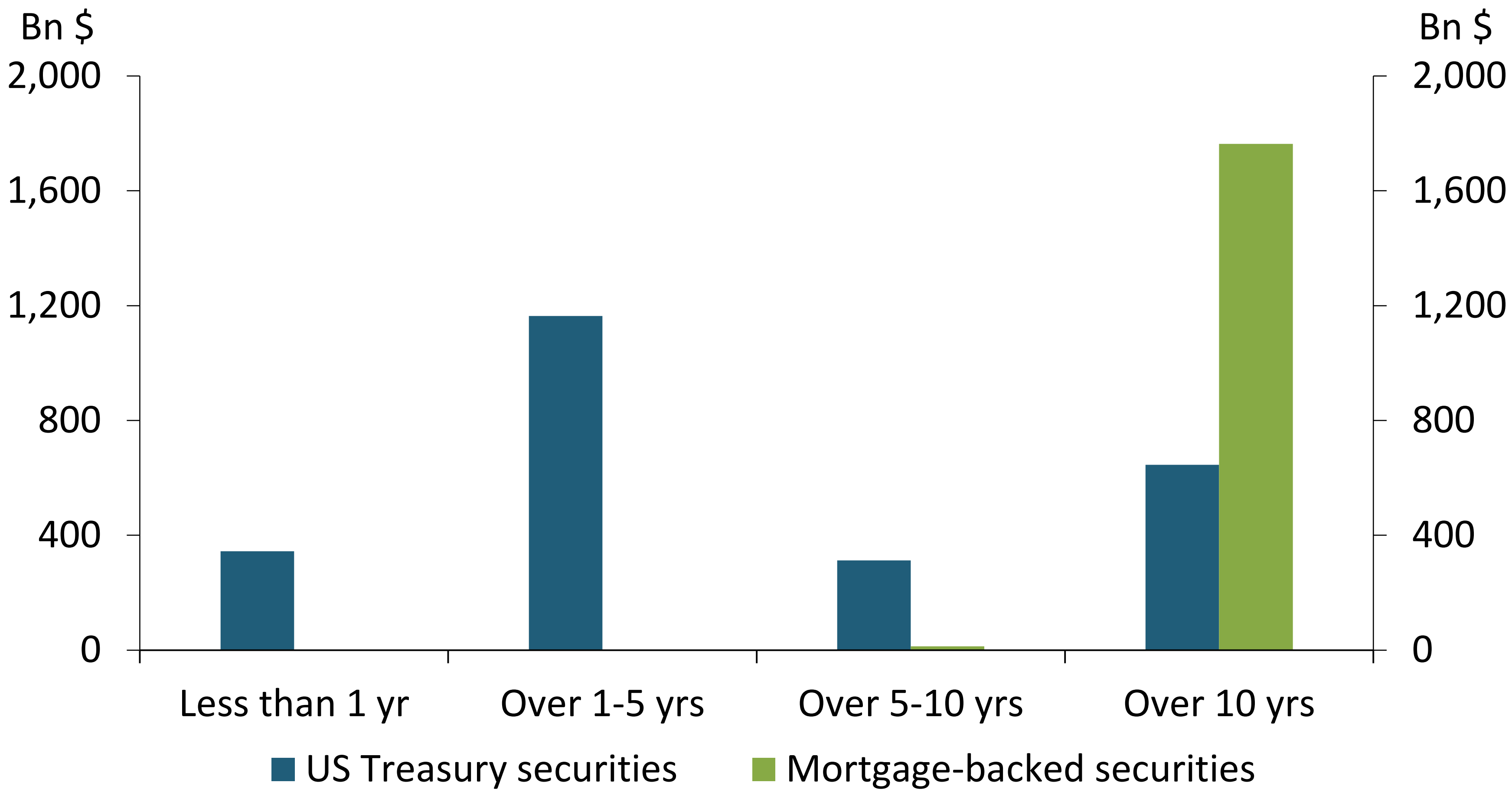
Sources: Federal Reserve Bank of New York, Federal Reserve

The Fed continues to own a sizeable share of the MBS market



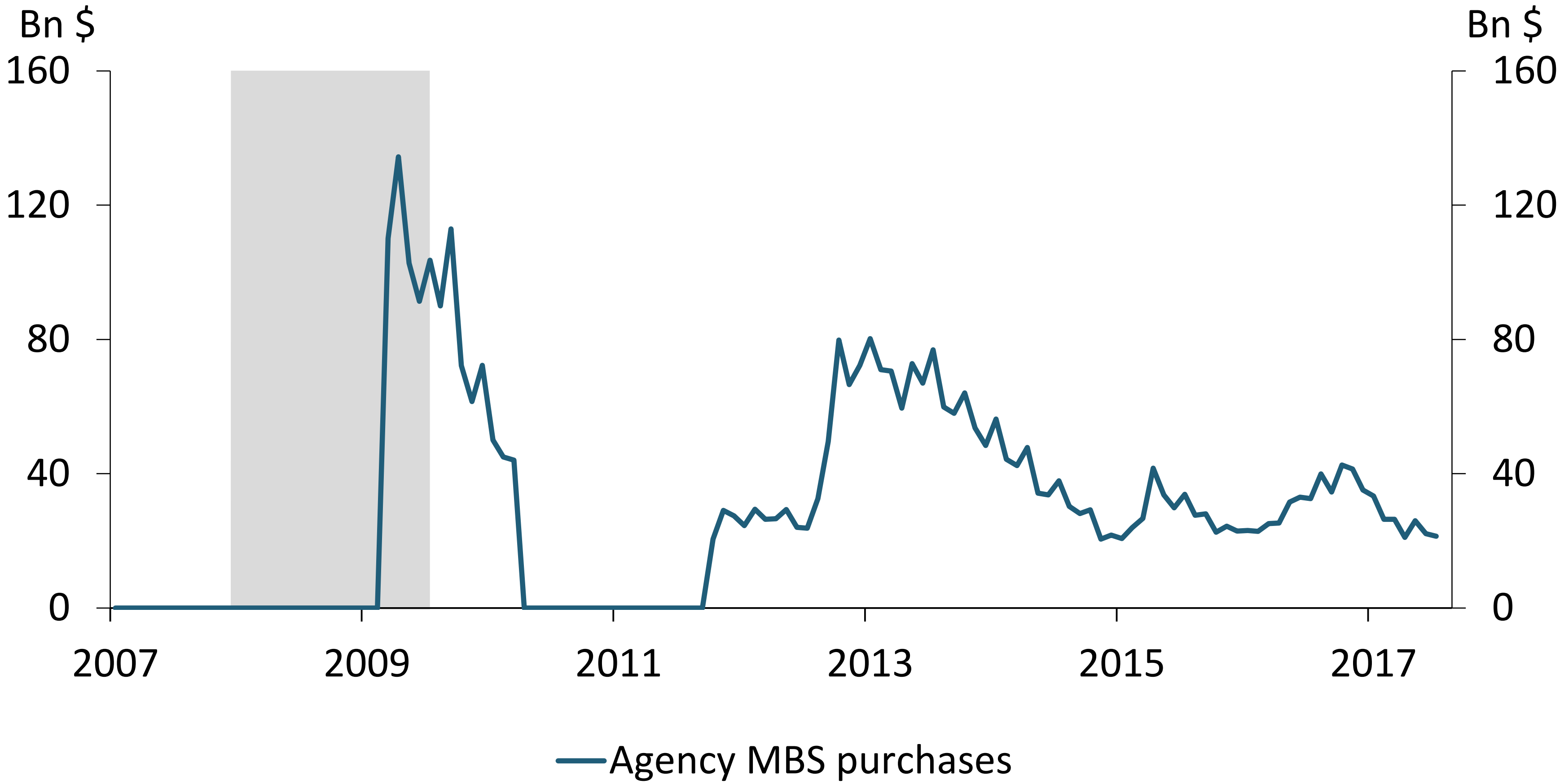
Sources: Federal Reserve Bank of New York, Fannie Mae, Freddie Mac, Ginnie Mae, NBER, Haver Analytics, and author's calculations

MBS holdings could remain large even after reinvestments cease



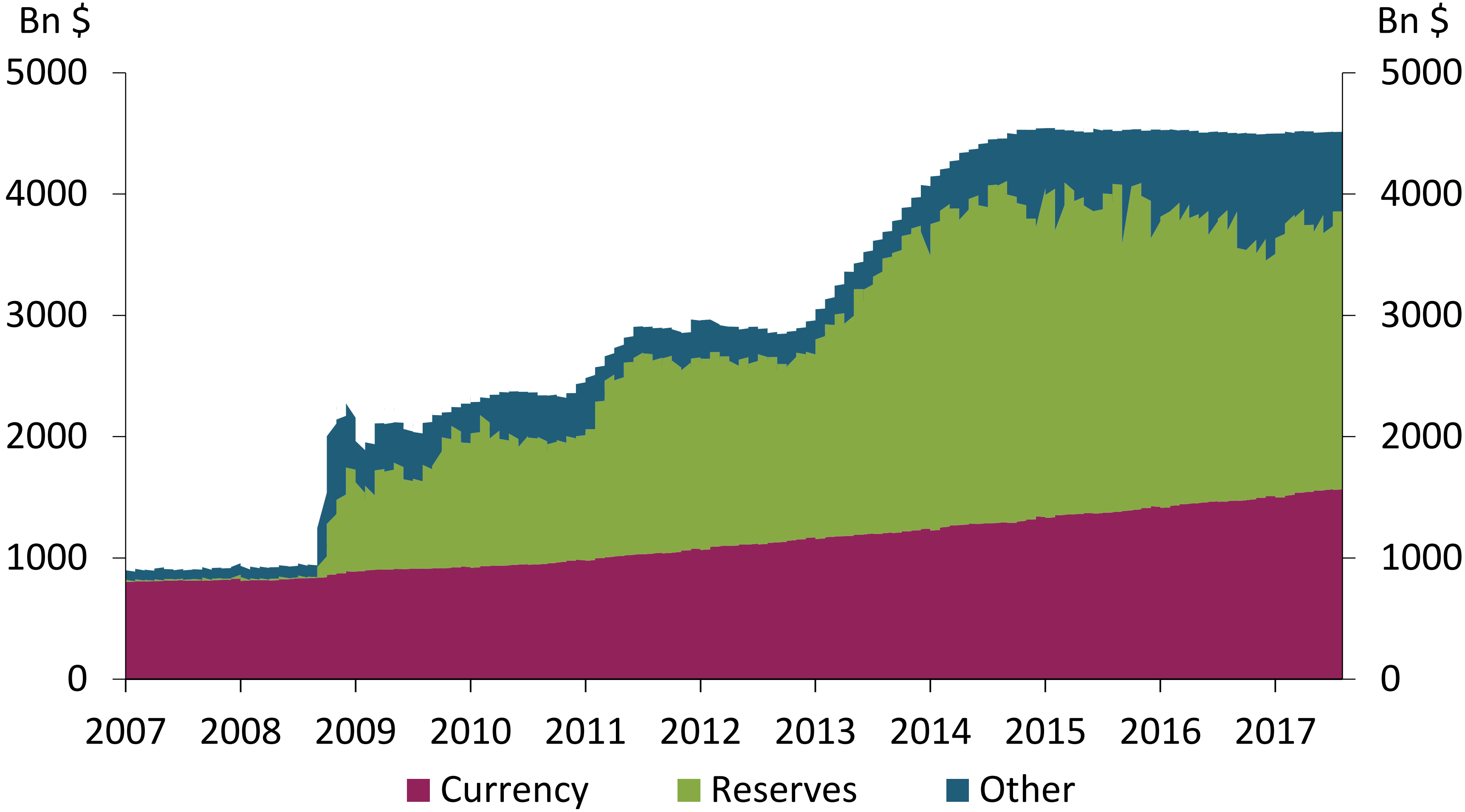
Sources: Federal Reserve Board, Haver Analytics

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