

ECONOMIC VIEWPOINT



The Federal Reserve Should Soon Provide More Details on the Cuts to Its Balance Sheet

What Will That Change?

The Federal Reserve's (Fed) balance sheet has been shrinking slowly since the fall of 2017, and the markets are wondering how far the Fed will go. Until very recently, the Fed had been fairly quiet on the subject, suggesting it would stay on autopilot for quite some time. At January's monetary policy meeting, however, it said that it will be more flexible in managing its balance sheet, and intimated that more guidance would be forthcoming.¹

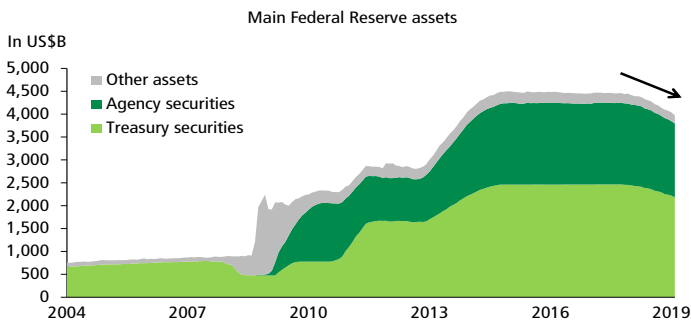
Greater clarity will probably help reassure the markets. However, caution is required in interpreting the new information that could be provided. The Fed does not want news of a change of pace or end date for its balance sheet normalization program to be construed as a more accommodative monetary policy. Maintaining surplus liquidity would primarily be aimed at facilitating management of the federal funds rate.

The Balance Sheet Is Shrinking Slowly but Surely

Starting in the fall of 2017, the Fed stopped reinvesting all of its maturing securities, with the result that its balance sheet has been declining (graph 1). On a monthly basis, the first securities

the Fed allowed to lapse without reinvestment were US\$6B in Treasury securities and US\$4B in agency securities, primarily mortgage-backed securities (MBS). The Fed had previously announced that these levels would increase over time, reaching US\$30B for Treasuries and US\$20B for agency securities in October 2018. Currently, therefore, the Fed's balance sheet can contract by US\$50B per month. However, this only happens when enough securities are maturing.

GRAPH 1
The Federal Reserve releases assets



Sources: Federal Reserve, Datastream and Desjardins, Economic Studies

The Fed's balance sheet decreased by about US\$375B in 2018. The decrease could be slightly higher in 2019 if the Fed makes no changes. The decline will probably not exceed US\$300B for Treasury securities, factoring in the projected maturities according to [data](#) released by the New York Fed. Agency securities, for their part, could drop by less than US\$200B. This assumes that the limit established for reducing these securities is achieved in proportions similar to last year. In total, failing changes, the Fed's balance sheet could contract by close to US\$500B in 2019.

¹ Federal Reserve: [Statement Regarding Monetary Policy Implementation and Balance Sheet Normalization](#), Press Release, January 30, 2019; [Minutes of the Federal Open Market Committee January 29–30, 2019](#), 21 p.

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Better to Concentrate on the Reserves

A reduction of this magnitude would take the Fed’s balance sheet to around US\$3,600B at year-end; it would still be very large, historically speaking. That being said, we cannot expect it to drop below the US\$1,000B mark, where it was prior to the Great Recession of 2008–2009.

To better assess the degree of normalization of the Fed’s balance sheet, it is preferable to focus on excess reserves, which are recorded as liabilities (graph 2). These reserves are a better metric for the surplus liquidity in the financial system. Banks holding such surpluses deposit them with the Fed. At the end of 2018, excess reserves totalled just over US\$1,500B, down US\$540B from the end of 2017.

The Fed Is Not Aiming to Wipe Out Surplus Liquidity Completely

The Fed apparently does not want to take excess reserves close to zero, as was the case before 2009. It is even signalling that it could stop trimming its balance sheet before the end of the year. This scenario would keep excess reserves above US\$1,000B. They could then drop more slowly, based on the increase in the amount of cash in circulation. Assets could be repurchased to offset this effect, however.

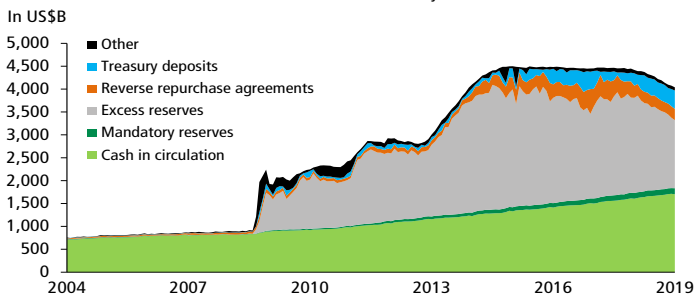
An excess reserve would not be maintained out of a desire to keep monetary policy accommodative, but rather to help control the federal funds rate. Before the last crisis, the Fed was operating in a system without excess reserves, and regularly had to inject or remove liquidity to stabilize the federal funds rate at the desired level. The Fed currently thinks that demand for and the supply of excess reserves is probably more volatile than before. This means that more interventions in the market would be needed to stabilize the federal funds rate. It would therefore be more effective to maintain the current regime, in which the federal funds rate is essentially controlled by the interest rate on excess reserves and the interest rate in reverse repos.

Different Movement by the Federal Funds Rate Lately

Rather than announcing a specific target for the federal funds rate, the Fed is announcing a range, as well as the interest rate on excess reserves. Initially, the effective federal funds rate tended to stay in the centre of the target range, with a few incursions toward the bottom, where reverse repo operations occur. As the Fed raised its key rates and excess reserves dwindled, the federal funds rate began to hold closer to the top of the range, where the rate on excess reserves was set (graph 3).

GRAPH 2
The decrease in excess reserves is more evident than the decrease in the size of the Federal Reserve’s balance sheet

Main Federal Reserve liability items



Sources: Federal Reserve, Datastream and Desjardins, Economic Studies

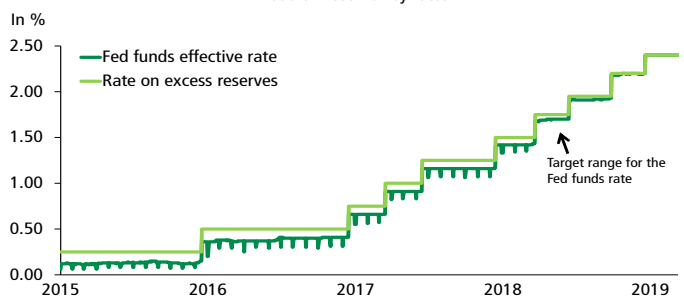
Excess reserves have dropped more than the Fed’s assets, and the decline started earlier. For excess reserves, the peak, US\$2,700B, dates to the summer of 2014. The earlier decrease is due to adjustments over time to other Fed liability items, including the amount of cash in circulation. Stronger demand for cash, associated with such things as economic growth, reduces excess reserves.

Reverse repurchase agreements carried out by the Fed to help it control the federal funds rate have also had a major impact on the level of excess reserves. These operations consist in lending securities held by the Fed in exchange for funds, which drain off some of the excess reserves. Reverse repurchase operations totalled more than US\$500B at the end of 2016. They decreased substantially in 2017, and then stabilized at around US\$250B.

Taking into account an annual US\$100B increase in cash and no changes with respect to the Fed’s other liability items, the excess reserves could, in the end, drop by nearly US\$600B this year. This would bring them at a level of less than US\$1,000B at the end of 2019. At this pace, excess reserves would disappear completely toward mid-2021.

GRAPH 3
The effective rate on federal funds moved close to the top of the range

Federal Reserve key rates



Sources: Datastream and Desjardins, Economic Studies

Some see this movement by the federal funds rate as a signal that the Fed has to put the brakes on reducing excess reserves. However, others have noted that the U.S. Treasury had issued more Treasury bills in 2018, and their slightly higher yields

generated some competition which pushed the federal funds rate up. In any event, the Fed responded by setting the rate on excess reserves below the top of its target range. A spread of 5 basis points was created in June 2018; it was widened to 10 basis points in December. Since then, the federal funds rate has been holding very close to the rate on excess reserves, which is now close to the mid-point of the Fed's target range.

There is some logic in having the federal funds rate very close to the excess reserve rate. Usually, central banks bracket their target for the overnight rate with a deposit facility and lending facility. The Fed's rate on excess reserves is more akin to a rate on a deposit facility, and should normally constitute a floor for the federal funds rate, rather than a ceiling. However, not all financial institutions can amass reserves with the Fed, which can lead to divergences.

The slow disappearance of excess reserves could very well have decreased such divergences. Another substantial reduction in reserves could make the federal funds rate occasionally exceed the interest rate on excess reserves. Given this possibility, we can see why the Fed is also considering introducing a lending facility at the top of its target range. This facility would make it easy to add liquidity when necessary. However, for now, maintaining a certain level of excess reserves that could prevent heightened volatility in the federal funds rate seems to be the most efficient solution, from the Fed's perspective.

Would This Be Equivalent to the End to Monetary Firming?

As the expanding balance sheet was clearly identified as expansionist monetary policy, many are now reading the shrinking balance sheet as a restrictive policy. Therefore, if the Fed stopped decreasing its balance sheet, it could be construed as halting a form of monetary tightening.

However, such reasoning would be incorrect, as James Bullard, President of the St. Louis Fed, showed in a [recent speech](#). Broadly, his reasoning is as follows. During the period in which the balance sheet was expanding, it did, in fact, have a stimulus effect. However, this primarily derived from the fact that the securities purchases increased the Fed's credibility on maintaining very low interest rates for a long time. This mechanism does not really work in a period in which key rates are going up.

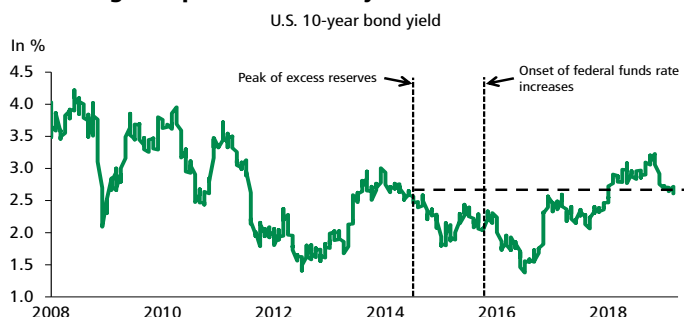
The Fed has never used balance sheet reductions to send a signal about the pace of future interest rate increases. Other communication tools are used to do that, like the publication of interest rate forecasts from the Fed officials. If the Fed had wanted to convince markets that it wished to normalize its monetary policy rapidly, it could perhaps have backed up this signal by rapidly shrinking its balance sheet. It did not have to go that route, however. So far, movement by the economy and inflation have not required any kind of rush.

The Asymmetry Thesis Can Be Defended Empirically

Many studies have been published on the effectiveness of the Fed's atypical monetary policy between 2009 and 2014. The findings tend to show a significant impact, particularly on interest rates. In short, it led to a further 150-basis-point decrease in 10-year bond yield.²

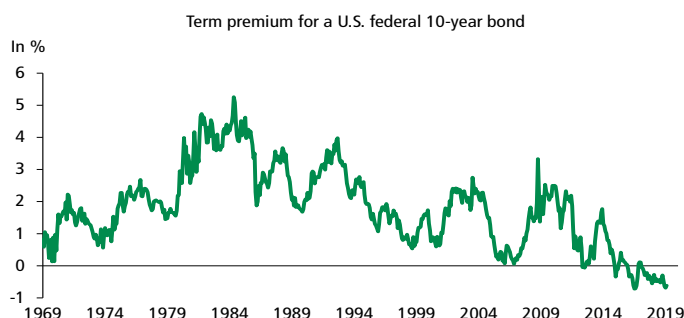
Bond yields have gone up very little since the onset of the key rate increases (graph 4). For the 10-year yield, the increase is approximately 40 basis points between December 2015 and today. The advance is even smaller if we take the summer of 2014 as a point of comparison, which is when the excess reserves were at their highest point. This does not suggest that reducing the balance sheet and, in particular, excess reserves, has a major impact on bond yields. We can also see that the term premium has remained very low (graph 5). The Fed's stance seems to have a lot more impact: from the beginning, it has been

GRAPH 4
Despite the Federal Reserve's actions, long-term bond yields have not gone up much in recent years



Sources: Datastream and Desjardins, Economic Studies

GRAPH 5
The term premium has essentially been in negative territory since 2016



Sources: Federal Reserve and Desjardins, Economic Studies

² Kenneth N. KUTTNER, *Outside the Box: Unconventional Monetary Policy in the Great Recession and Beyond*, The Brookings Institution, Hutchins Center Working Paper #47, October 2018, 25 p.

stressing that key rates would come up very slowly. Low inflation fears also seem to be having an effect. More recently, the central banks have increased their caution due to concerns over the state of the economy, putting downside pressure on a number of rates worldwide.

Lastly, Eventual Changes Would Confirm Some Type of Stability...

In short, what primarily seems to motivate the Fed to amend its balance sheet normalization program is maintaining the current management framework for the federal funds rate. Allowing the excess reserves to dry up entirely would force the Fed to change its approach, particularly by intervening more often in the interbank market to stabilize the federal funds rate. The challenge, however, lies in finding an optimal level for the reserves. The Fed could provide further details on that shortly, which would also reassure the markets, which are now finding the lack of clarity on this subject problematic.

A decision to maintain excess reserves would be unconnected with the degree of monetary easing the Fed wants. This is because an asset purchasing program and a balance sheet reduction program do not have symmetrical effects on interest rates and the economy. That being said, this interpretation may not be universal. Some could still see it as a signal that the Fed will postpone its future interest rate increases further, or even stop tightening. Interpreted like that, a halt to the Fed's balance sheet normalization would help keep many interest rates low.

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