The Fed’s Plan to Shrink its Balance Sheet is a Risky Proposition

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At its June 2017 FOMC meeting, the Federal Reserve Bank (the Fed), approved a Plan aimed at reducing the size of the Fed, which currently substantially exceeds the value of total assets needed to effectively manage its monetary policy directives of achieving sustainable growth and low inflation (see the text of the Plan in the Appendix at the end of this analysis). Without a well-designed plan accompanied by an effective execution, the Fed’s ability to manage monetary policy could be compromised and financial markets could be subjected to greater volatility. The Fed will most likely face numerous challenges as it navigates through unchartered waters.

Let’s put the size of the Fed’s balance sheet in perspective. In “normal times,” prior to the 2007 recession, let’s say December 2006, total assets of the Fed were $870 billion, or 6.3% of Gross Domestic Product (GDP), and peaked in December 2014 at $4.5 <u>trillion</u>, or about 26% of GDP! Total bank deposits at the Fed, which includes required and excess reserves, went from $12.7 billion in December 2006, to $2.4 <u>trillion</u> in December 2014. Such huge numbers could be characterized as an “asset bubble,” meaning it represents a high level of risk to the financial system.

The Fed’s balance sheet became that large when it sought to steer the economy through the rough 2007 – 2009 recession by providing massive liquidity support, mainly by purchasing U.S. Treasury securities, to help bring down interest rates; and, for the first time in its history, by purchasing about $1.7 trillion in mortgage-backed securities (MBS) to help the housing market get back on its feet again. The Fed thus became both a Central Bank and a commercial bank.

Interestingly, total assets of the Fed have not budged from the $4.5 trillion mark since December 2014 – about two-and-a-half years. It looked like their initial plan was to let the massive amount of liquidity just sit tight for the next five to ten years hoping that by then the size of the economy, as measured by the US$ value of GDP, would be substantially larger, and so $4.5 trillion could be spread over many more goods and services without igniting inflation. This has been done before, with mixed results, in other countries with similar problems.

The Fed’s recently released Policy Normalization Plan is thus a more aggressive strategy to shrink the size of its balance sheet, although it may be resting on the hope that it can drain a substantial amount of liquidity from the financial system without disrupting interest rates. However, the Fed could once again face market turbulence if there is a recession before the Plan has had time to achieve its goals, and the Fed has to once again pump a sizeable amount of liquidity into the financial system, which would then heighten the risk of an inflationary spiral.

The current Plan, as described in the Fed's website, may need to be more flexible to avoid disrupting the financial markets. Historically, the Fed's track record has been to move the Fed Funds interest rate – now the Fed Funds band, in small predictable steps, and in bigger steps on some occasions. Likewise, its asset deflation should proceed in moderate steps. Based on recent media reports of senior Fed officials' comments that a target would be to deflate the balance sheet down to $2.5 trillion, this would mean making a roughly $2.0 trillion reduction from the current $4.5 trillion in total assets. According to the Fed, the deflation is targeted to commence "once normalization of the level of the federal funds rate is well under way," which should occur sometime in the not too distant future.

The driver of the Fed's Plan will be the monthly payments of principal by the U.S. Treasury and by the mortgage-backed securities which it holds on its balance sheet. The Plan establishes certain limits – called caps, on the amount of the monthly reductions, or paydowns of the Fed's total assets. The caps on maturing Treasury securities will eventually reach $30 billion per month; and for the MBS, $20 billion. If the caps are applied without any exceptions, then it would take almost four years to reduce the size of the balance sheet down to $2.5 trillion, assuming that at that level total assets would not be considered as still too large for the Fed.

The Plan is thus based on a monthly depletion of $50 billion, once the monthly cap is reached, and on the assumption that this will result "in a declining supply of reserve balances." My calculation also assumes that current maturities of MBS securities will reach at least $20 billion per month. This shrinkage of assets as designed in the Plan could also result in an increasing duration of the Fed's balance sheet. The latter means that the assets of the Fed will be concentrated on the long-end of the maturity spectrum which could complicate the management of its own liquidity, not to mention interest rate risk.

While a start date has not yet been announced, some Fed officials have commented that it could happen before the end of this year. Nevertheless, I think that an aggressive deflation of assets can disrupt financial markets, risk higher inflation, and also compromise the Fed's ability to act decisively in the face of financial system liquidity problems as could occur during a recession.

The Plan is also based on the assumption that banks' excess-reserves deposits at the Fed would fall in tandem with the maturing U.S. Treasury and MBS securities held by the Fed. For example, as U.S. Treasury securities mature, and the Fed is paid cash by the Treasury, someone else has to "refinance" the Federal Government's debt, i.e. the banks that have cash deposited at the Fed, since our government is not expected to reduce the size of its debt in the foreseeable future. If there are not enough investors such as banks or individual investors willing to purchase Treasury securities then their yield would increase and thus the interest rates that consumers and businesses pay on their loans. In that case the Fed would probably have to repurchase more Treasury securities, thus backtracking on its asset deflation operation.

At the same time, the very large banks may not want to draw down their reserve deposits at the Fed due to the new liquidity requirements instituted by the Dodd-Frank Act, whereby deposits at the Fed are considered High Quality Liquid Assets that the banks are required to hold to cover their liquidity needs.

My previous experience with mostly emerging-market countries that have gone through similar situations involving bloated central bank balance sheets is that their shrinkage rates were much more moderate, but also had greater inflationary consequences. The Fed may thus have to make some difficult trade-offs when it begins to implement the Plan either by paring down its shrinkage rate – with risks to inflation, or by pushing interest rates higher, with more painful outcomes for the economy. The bottom line is that there will be a price to pay for getting our Central Bank's balance sheet closer to "normal."

Appendix

The following is the Fed's Plan as posted on
https://www.federalreserve.gov/monetarypolicy/policy-normalization.htm

At the June 2017 FOMC meeting, all participants agreed to further augment the Committee's Policy Normalization Principles and Plans by providing the following additional details regarding the approach the FOMC intends to use to reduce the Federal Reserve's holdings of Treasury and agency securities once normalization of the level of the federal funds rate is well under way.

- The Committee intends to gradually reduce the Federal Reserve's securities holdings by decreasing its reinvestment of the principal payments it receives from securities held in the System Open Market Account. Specifically, such payments will be reinvested only to the extent that they exceed gradually rising caps.
    - For payments of principal that the Federal Reserve receives from maturing Treasury securities, the Committee anticipates that the cap will be $6 billion per month initially and will increase in steps of $6 billion at three-month intervals over 12 months until it reaches $30 billion per month.
    - For payments of principal that the Federal Reserve receives from its holdings of agency debt and mortgage-backed securities, the Committee anticipates that the cap will be $4 billion per month initially and will increase in steps of $4 billion at three-month intervals over 12 months until it reaches $20 billion per month.
    - The Committee also anticipates that the caps will remain in place once they reach their respective maximums so that the Federal Reserve's securities holdings will continue to decline in a gradual and predictable manner until the Committee

judges that the Federal Reserve is holding no more securities than necessary to implement monetary policy efficiently and effectively.

- Gradually reducing the Federal Reserve's securities holdings will result in a declining supply of reserve balances. The Committee currently anticipates reducing the quantity of reserve balances, over time, to a level appreciably below that seen in recent years but larger than before the financial crisis; the level will reflect the banking system's demand for reserve balances and the Committee's decisions about how to implement monetary policy most efficiently and effectively in the future. The Committee expects to learn more about the underlying demand for reserves during the process of balance sheet normalization.

- The Committee affirms that changing the target range for the federal funds rate is its primary means of adjusting the stance of monetary policy. However, the Committee would be prepared to resume reinvestment of principal payments received on securities held by the Federal Reserve if a material deterioration in the economic outlook were to warrant a sizable reduction in the Committee's target for the federal funds rate. Moreover, the Committee would be prepared to use its full range of tools, including altering the size and composition of its balance sheet, if future economic conditions were to warrant a more accommodative monetary policy than can be achieved solely by reducing the federal funds rate.