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Lowering the Fed balance sheet

Releasing high-level collateral may have easing effect

by Otaviano Canuto in Washington

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At its meeting in March 2018 the US Federal Reserve raised the target range of the fed funds rate by a quarter point to 1.5%-1.75%. Fed officials are projecting a steeper path of rate increases for the next two years, and recent inflation data would hint at the central bank staying firmly on track for another quarter point increase in June.

In the light of rising inflation and a tightened labour market putting upward pressure on wage growth, it is unsurprising that some analysts now expect the Fed to lift rates a total of four times this year. At the same time, the Fed's long-term plan to shrink its unprecedently large balance sheet is in its sixth month. Janet Yellen and Jay Powell, the former and sitting Fed chairs, characterised moves on both these fronts as essential on the path towards policy normalisation after years of low interest rates and quantitative easing.

The Fed's balance sheet started to grow in late 2008, when it began to acquire assets such as US Treasuries and government-backed securities on a large scale. This was initially done to avoid a deepening of the financial destabilisation and bankruptcy of solvent-but-illiquid financial institutions, and subsequently to fight economic stagnation and deflation risks as private agents deleveraged substantially. On the liabilities side, bank reserves grew to exceed regulatory minimum requirements.

Between 2008, when the quantitative easing programme began, and October 2014, when Yellen announced its conclusion, the Fed balance sheet increased to around $4.3tn (around $2.5tn in Treasuries and $1.8tn in mortgage-related securities) from less than $900bn. Beginning in October 2017, the Fed has stopped reinvesting all the proceeds it received from maturing assets, starting a gradual contraction of the balance sheet. Furthermore, in accordance with plans announced in June 2017, the initial monthly portfolio reduction of $10bn is expected to reach $50bn by next October, a much slower pace than if outright sales of assets were to take place. Bank reserves have diminished accordingly.

The impact of the balance sheet reduction on short-term rates stemming from lower levels of reserve balances on the Fed's liabilities will be critical. Falk Bräuning, senior economist from the Boston Fed, estimates that by January 2019, assuming a portfolio reduction by $500bn, 'the overnight repurchase agreement (repo) spread (relative to the lower bound of the federal funds target range) will be 10 basis points higher and the fed funds spread will be two basis points higher than in October 2017'.

There are those, like Manmohan Singh, International Monetary Fund senior economist, who say the Fed's balance sheet unwinding 'may not be tantamount to tightening'. Releasing high-quality collateral such as US Treasuries to the market may have 'an easing effect' and diminish excess reserves kept by banks on deposit at the Fed. 'US Treasuries in the hands of the market, with reuse, are likely to lubricate markets, while excess reserves (or money) have remained idle in recent years,' says Singh. In the long term, higher availability and the reuse of this collateral by the market may damp interest rates.

Opposing views of QE underlie these observations on the two sides of its unwinding. On the one hand, if the expansion of the Fed's balance sheet was essential to preserve easy monetary conditions, the reduction of the former can be expected to tighten the latter. Conversely, if the Fed's asset hoarding was excessive, concerns about the macroeconomic effects of speeding up the tapering could be exaggerated.

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