

Composing the Fed's Balance Sheet

BY JOHN WEINBERG

During the Great Recession, the Fed engaged in a number of extraordinary policy steps, including reducing its short-term interest rate target to near zero and significantly expanding the size of its balance sheet by purchasing long-term Treasuries and other securities. Over the last few years, the Federal Open Market Committee (FOMC) has embarked on a process of monetary policy “normalization,” which includes raising interest rates above zero and reducing the size of the Fed’s balance sheet. Both of these tasks have now largely been completed.

After steadily raising its interest rate target throughout 2017 and 2018, the FOMC paused and then cut rates at its July and September 2019 meetings. This could be interpreted as signaling to the public that interest rates have reached a “normal” level, in the sense that the FOMC could now adjust rates up or down or hold them steady depending on economic conditions. Still, some might argue that the level of short-term interest rates remains lower than “normal,” at least by historical standards.

In its normalization principles, the FOMC said that it planned to reduce the size of the Fed’s balance sheet until it holds “no more securities than necessary to implement monetary policy.” In 2017, the Fed began unwinding its security holdings by a monthly amount that started small and gradually increased. At its July 2019 meeting, the FOMC announced that this unwinding would come to an end in August, suggesting that the size of the balance sheet has reached what might be considered its new normal for the time being. That said, the Fed will continue to exchange its holdings of mortgage-backed securities for Treasury securities. This raises one last question related to policy normalization: What mix of Treasury securities should the Fed hold? The minutes of the FOMC’s meeting at the end of April 2019 reported on a preliminary discussion of this topic, although no decision has been announced by the Committee. (I should be clear that, as in all of my columns, I’m speaking only for myself here and not for the Federal Reserve System.)

The Treasury issues securities with maturities ranging from one month to 30 years. The Fed has historically held a mix of Treasuries, but its holdings were weighted more toward shorter-term maturities compared with all Treasuries outstanding. During the Great Recession, the Fed purchased longer-term Treasuries and sold virtually all of its T-bills (the shortest maturity Treasury securities) in an effort to bring down long-term interest rates and provide additional monetary policy accommodation. The idea behind such balance sheet moves is that purchasing long-term securities bids up their price, which reduces the yield or interest rate. As a result of these operations, the Fed’s

balance sheet is weighted more toward long-term Treasury securities than usual.

This distribution creates a potential risk to the Fed’s net interest income. The Fed earns interest on its portfolio of securities, which it uses to pay operating expenses. Any remaining income is returned to the Treasury. When short-term interest rates rise, as they have until recently, the yield on outstanding long-term securities in the Fed’s portfolio doesn’t change. That means that while the interest the Fed pays out on reserves increases, the interest income it earns on its long-term securities stays roughly the same, reducing the Fed’s overall net income. From an operational and economic standpoint, this isn’t a big problem. The Fed’s unique ability to issue currency and bank reserves is not affected by its net income or net worth, so it can continue to conduct monetary policy. But this volatility in the Fed’s payments to the Treasury could draw additional scrutiny from government officials and prompt intervention into the Fed’s operations, which could threaten monetary policy independence.

Leaving the composition of the Fed’s balance sheet as it is could also limit the Fed’s ability to engage in maturity extension operations during a future crisis. There are varying estimates of the impact of the Fed’s balance sheet operations during the Great Recession, but being able to ease long-term rates by selling short-term and buying long-term securities arguably provided the Fed with an additional tool when short-term rates reached their effective lower bound. Recalibrating the balance sheet now in good economic times would ensure that this tool is available again in future crises. Even if the impact of this tool may not be large, there could be some value in saving as much room for balance sheet operations as possible for when they are needed most.

That said, there may be some costs to shortening the maturity of the Fed’s balance sheet. Selling long-term securities could have the effect of raising long-term interest rates, which in turn would make it necessary for the Fed to keep short-term rates lower for longer. Given that short-term rates are already low and have recently fallen, shortening the maturity of the balance sheet now could contribute to the Fed once again hitting the effective lower bound.

But such broader financial market effects could be less likely now than in the wake of the financial crisis, when financial markets were more fragile. Undertaking this transformation in a gradual and transparent way, as the Fed has sought to do with all of its policy normalization operations, is likely to avoid serious market disruptions. **EF**

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