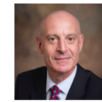
Balance Sheet Policy Takes the Spotlight

Uncertainty as Fed seeks to stabilize short-term lending markets

February 2020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KEY INSIGHTS

- Volatility in short-term lending markets has complicated policymakers' plans for balance sheet normalization.
- The Federal Reserve is expanding its balance sheet as it seeks to guarantee liquidity in short-term lending markets by replacing repos with Treasury bills—a policy that risks asset inflation.
- Meanwhile, rate policy is likely to remain on hold in 2020, although changes in forward guidance bear watching.

Speaking at a roundtable in May 2017, Philadelphia Federal Reserve President Patrick Harker described policymakers' goal of making the normalization of the Fed's balance sheet as "predictable, slow, and as boring as possible . . . the policy equivalent of watching paint dry." The Fed's aim, as he described it, was a process "essentially on autopilot" that would allow the Fed's securities holdings to gradually run off, reducing reserve deposits to the minimum level consistent with the effective conduct of monetary policy.

Ironically, the Fed's balance sheet adjustments are likely to be far from uninteresting in 2020. The evolving program to right-size the stock of reserves has a high degree of uncertainty attached as the Fed tries to balance different objectives. If anything, it is the Fed's interest rate policy that is more likely to be like watching paint dry over the coming year, with either cuts or hikes unlikely. The conclusion of the Fed's "Strategic Framework Review" may have a greater impact than its "evolutionary, not revolutionary" billing would suggest, however.

Re-leveling Reserve Balances: Painting a Moving Target

In early 2019, the Federal Open Market Committee (FOMC) announced that it would "continue to implement monetary policy in a regime in which an ample supply of reserves ensures that control over the level of the federal funds rate and other short-term interest rates is exercised primarily through the setting of the Federal Reserve's administered rates, and *in which active management of the supply of reserves is not required."* ("Statement Regarding Monetary Policy Implementation and Balance Sheet Normalization," January 30, 2019. Emphasis added.)

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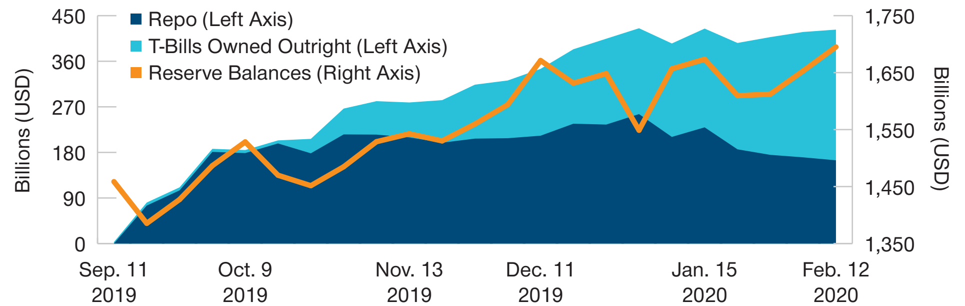
Fed Is Replacing Repos With T-Bills

(Fig. 1) Aim is to provide permanent lift to reserves.



As of February 12, 2020.
Sources: Federal Reserve/Haver Analytics.

Credit markets were already signaling that the Fed might have to switch off the autopilot, however. Overnight lending rates had been moving higher within the federal funds target range since early 2018, signaling that the market for reserves was no longer operating on the flat portion of the demand curve. Nonetheless, policymakers took no action, relying instead on large banks' estimates of their minimal acceptable levels of reserve holdings. The central bank's securities portfolio fell by an additional USD 400 billion in the year through July 2019, with reserve deposits falling USD 260 billion over that span.

The growing imbalances in the short-term lending markets came to a head in mid-September, with overnight lending rates spiking as high as 10% on September 10. The Fed's first response to the disruption in funding markets was to flood the market with liquidity via overnight and term repurchase agreement operations (repos). Policymakers quickly concluded that reserve deposits had fallen through the floor of the range consistent with the ample reserves regime and commenced outright purchases of Treasury bills to rebuild the supply of reserves.

Treasury Bill Purchases Likely to Continue Through June

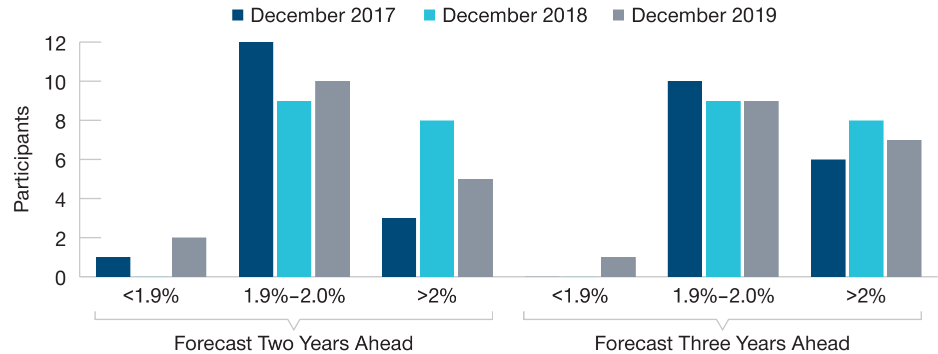
The Fed's current guidance is that it will continue repos at least through April, while it plans on purchasing T-bills at least through the first half of this year. The Fed's broader plan is to continue with outright purchases of Treasury securities until the demand for repos goes away. This may happen in the third quarter of this year, when the Fed should have a USD 1.8 to USD 2.0 trillion stock of reserve deposits on its balance sheet. At that point, it will likely keep overnight repo offerings in place until a more permanent safety valve, such as a standing repo facility, is devised. As Fed Chair Jerome Powell explained on January 29, 2020, the USD 1.50 trillion early September 2019 level of reserve deposits mentioned in the Fed's guidance would be a floor. “Most of the time, reserves will be moving in a range substantially higher than that” (Powell press conference, January 29, 2020).

This won't be the end of the story, however. After this one-time re-leveling, the Fed will continue to allow its balance sheet to grow in line with demand for its liabilities, which now include not only currency in circulation, but also reserve deposits. Thus, what defines an “ample” supply of reserves is and will remain a moving target that is likely to grow over time. It will also reflect the risk appetites of financial intermediaries, which obtain repo financing through banks.

Given the uncertainty around the appropriate level of reserves and

FOMC Outyear Inflation Forecasts

(Fig. 2) Most policymakers still see inflation above 2% as unlikely.



As of December 2019.
Source: Federal Reserve.

> ...erring on the side of oversupplying liquidity to financial markets carries the risk of fueling asset inflation.

the Fed's commitment to suppress volatility in overnight rates, there is a risk that unexpected spikes in funding rates—historically, a signal of stress or deteriorating position quality somewhere in the financial system—may now be taken as an indication that the demand for reserves has risen on a lasting basis above supply. In turn, this would prompt the Fed to shift higher its targeted range for reserves. In my view, erring on the side of oversupplying liquidity to financial markets carries the risk of fueling asset inflation.

Rate Changes Are Likely on Hold Through the Rest of the Year

In delivering the Fed's semiannual Monetary Policy Report to Congress on February 11, Chair Powell reiterated the FOMC's belief that the current stance of monetary policy is appropriate to support continued economic growth, a strong labor market, and inflation returning to the Committee's symmetric 2% objective. This substantive guidance is confirmed in the Committee's most recent "dot plot," which indicates that policymakers expect interest rates to remain unchanged this year.

This doesn't mean that the Fed would be unresponsive to a change in the economic outlook. But with a modestly accommodative policy stance in place after 75 basis points (0.75%) of rate cuts last year, the change in the outlook would have to be "material" to warrant further easing. Even less likely, in my view, are conditions that would prompt a rate hike this year. These would entail not only stronger-than-anticipated growth, along with faster labor market tightening and rising rates of wage inflation, but also a sustained rise in core personal consumption expenditures inflation above the Fed's 2% inflation objective.

Will the Fed Effectively Communicate a Symmetric Inflation Target?

Around midyear, the Fed is due to present results of its Strategic Framework Review, a primary goal of which is achieving greater success in meeting the central bank's symmetric 2% inflation objective. Some form of inflation averaging—allowing inflation to exceed 2% when the economy is strong in anticipation of periods of undershooting in recession and early recovery—seems to have support. As San Francisco Fed President Mary Daly put it in a speech on February 10, in order to establish credibility for a symmetric 2% objective, "we need to embrace the mindset that inflation a bit above target is far better than inflation a bit below target in today's economic environment."

As it stands, the most common inflation forecast two to three years ahead in the Fed's Summary of Economic Projections (SEP) is 1.9% to 2.0%. This casts the 2% inflation objective more as a ceiling than a midpoint—though the balance around that most-likely (or modal) forecast shifted to the high side in the December 2018 SEP. If policymakers are truly willing to take the policy steps to achieve a symmetrical target, their modal forecasts over the next two or three years should shift higher.

For these reasons, the Fed is likely to communicate a more accommodative policy path—my best guess is that this will occur in the SEP released following the September 15–16 FOMC meeting, but Chair Powell may signal changes before then. Moderating the trajectory of anticipated policy rates in 2021–2022 would offer an additional fillip to risk assets, even with spot rates unchanged.

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