The Fed’s Balance Sheet Can and Should Get Much Smaller

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The Repo Market Disruption: What Happened, Why, and Should Something Be Done About It?

The Brookings Institution
December 5, 2019
Outline

- The long-run versus the short-run demand for reserves
- The cost of a large balance sheet
- How the Fed can get smaller
Reserves necessary to be “abundant” have grown over time

- In April 2008, Fed staff estimated the level reserves balances needed to be abundant “…might be on the order of $35 billion but could be larger on some days.”

- The assumption rose to
  - $100 billion in 2016
  - $500 billion in 2017
  - $600 billion in 2018

- At the beginning of 2019 the estimate was probably about $1 trillion.

- I’d guess the current estimate is about $1½ trillion
Why has estimate of “abundant” grown?

- For nearly a decade, reserve were cheaper than other, similar, assets.

- Banks and supervisors became accustomed to an important role of reserves in banks’ liquidity risk management.

- Same dynamic led Norges bank in 2010 to switch from system with abundant reserves to system with more scarce reserves.

  “When Norges Bank keeps reserves relatively high for a period, it appears that banks gradually adjust to this level…With ever increasing reserves in the banking system, there is a risk that Norges Bank assumes functions that should be left to the market. It is not Norges Bank’s role to provide funding for banks…If a bank has a deficit of reserves towards the end of the day, banks must be able to deal with this by trading in the interbank market.”

  Norges Bank, 2010
Interest rate response to declining reserves has been sharper than to increasing reserves.
In late 2015, the Board and LISCC were informed that the FOMC would not be able to shrink reserve balances any lower than the level bank supervisors were encouraging banks to hold. 

In May 2018, Vice Chair Quarles was asked if supervisors were telling banks that a material part of their liquid assets must be reserves because, if so, the FOMC would not be able to get its balance sheet much smaller. He responded:

“I do know that that message has been communicated at least in some supervisory circumstances in the past. I would say that that’s in the process of being rethought.”

Vice Chair Quarles in Cochrane, Palermo, and Taylor (2018)
Fed’s Senior Financial Officer Survey’s did not find that supervisory expectations, guidance, or regulations were important determinants of banks’ demand for reserves.
- That’s probably because the Fed did not include those possible reasons on the surveys!

BPI survey conducted in January

Banks’ elevated demand for reserves also reportedly stems from an unwillingness to risk running a daylight overdraft in their account at the Fed.

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<th>Reason</th>
<th>Percent of respondents</th>
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<td>Reg YY liquidity requirements</td>
<td>77</td>
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<tr>
<td>LCR</td>
<td>71</td>
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<td>Examiner expectations</td>
<td>40</td>
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<td>Resolution requirements</td>
<td>36</td>
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Cost of large balance sheet, my views

- It costs taxpayers money because term premiums are negative. $1½ trillion in reserves will cost taxpayers about $15 billion a year.
- It reduces the ability of the Fed to conduct QE.
- It puts Fed independence at risk.
  - Large interest payments to large domestic and foreign banks will serve as fodder for those who would attack the Fed.
  - Large balance sheet will prove irresistible to Congress as a way to pay for things.

From the Green New Deal:
“As the checks go out, the government’s bank — the Federal Reserve — clears the payments by crediting the seller’s bank account with digital dollars. In other words, Congress can pass any budget it chooses, and our government already pays for everything by creating new money.”
Cost of large balance sheet, FOMC views

- Minutes of November 2018 FOMC meeting
  “Potential drawbacks of an abundant reserves regime included...the need to maintain relatively sizable quantities of reserves and holdings of securities, and relatively large ongoing interest expenses associated with the remuneration of reserves...but [FOMC participants] thought that reserve supply could be reduced substantially below its current level while remaining in such a regime...Participants judged that if the level of reserves needed for a regime with abundant excess reserves turned out to be considerably higher than anticipated, the possibility of returning to a regime in which excess reserves were limited and adjustments in reserve supply were used to influence money market rates would warrant further consideration.”

- President of New York Fed, 2 weeks ago:
  “I don’t see any real need to seriously reconsider this. The fact that reserve levels are higher than perhaps we were anticipating a year or so ago doesn’t fundamentally change this calculus that this is a very effective and efficient way to run monetary policy.”
How to get to a smaller large balance sheet

- Control volatility in reserve balances.
- Root out any bias of bankers and supervisors toward reserves as a liquid asset.
- Restart the gradual decline in the System’s portfolio of securities.
Reasons for the volatility of reserves
How to get to a smaller large balance sheet

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