Comments on Shrinking the Federal Reserve Balance Sheet

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Fed Liabilities

Federal Reserve Liabilities

NY Fed Proj
Steady State:
Reserves: 8%
Reverse Repo: 0%
Total: 22%

Chair Powell:
“2 to 2 1/2 years”
Ratchet Effect

- QE episodes don’t get fully reversed
- Acharya (2022) has structural explanation
Fed Assets

Federal Reserve Assets

Percent of Nominal GDP

- MBS
- Treasury
- Other
Maturity of SOMA Treasuries

- Fed’s convention has been to match WAM of marketable Treasuries
- WAM of SOMA Treasuries: 8.3 years
- WAM of marketable Treasuries: 6.2 years
- QT involves a policy of first redeeming coupons before bills which should bring WAM down
Likely scale of QT

- Pace about twice as fast as in 2017-2019
- $1 trillion decline in SOMA Treasuries
- Some shortening of maturity of SOMA holdings
- Gradual move out of MBS that should continue even after balance sheet resumes growth
  - Direct MBS sales are distinctly possible
Channels of UMP

- Some emphasize broad channels in which MBS and Treasury purchases are fungible

- Others emphasize very local effects

- To me most of the evidence points in the direction of narrow channels:

- May expect QT to have local effects
Effects of QT

QT is not simply the opposite of QE

- No signalling implications
- No promise that more will be done if needed
- No disrupted asset markets
- Away from the ZLB (Gagnon and Jeanne (2022))
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- Impacts are hard to identify

- Think of Treasury QT as equivalent to increase in amount and WAM of Treasury issuance pre ZLB
Effects on Treasury yields

- Regress 10Y term premium on maturity-weighted GDP with pre ZLB data (1961-2007)
  - Similar exercise to Greenwood and Vayanos (2014)

- A 1 unit increase in maturity weighted debt-to-GDP increases term premium by 33bps

- Robust to IV strategy
Effects on Treasury yields

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- Robust to IV strategy

- QT is plausibly about a 0.7 increase in MWD/G
  - 25 bp increase in term premia

- Crawley et al. (2022) estimate a 50 bp increase
  - They assume a larger QT
Broader effects

- Small “slope” shock should have small effects
- ESW (2020) estimates would imply a tenth on unemployment
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Caveats:
- TIPS might be more affected, distorting breakevens
- Treasury market liquidity might be hurt
- Effects of MBS sales
Measure of Treasury Liquidity: Mean Abs Pricing Error

Source: Bloomberg
SOMA MBS holdings by coupon

MBS Option Adjusted Spread
(Current Coupon: Fannie Mae)

Source: Bloomberg
Agency Gross MBS Issuance

Source: Bloomberg
How much *should* balance sheet shrink?

Arguments for scarce/ample reserves

- Nelson (2019); Fisher (2019)
- Bush et al. (2019); Copeland, Duffie and Yang (2021); Greenwood, Hanson and Stein (2016); McAndrews and Kroeger (2016)