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Balance Sheet Reduction: Sooner and Faster

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Summary

- The more interesting information in the minutes of the FOMC meeting on December 14-15 related to the discussion on balance sheet normalization.
- Since inflation is higher, the labor market is stronger, and the balance sheet is larger than last time, the FOMC expects to start balance sheet normalization sooner after the first rate hike than last time, and also to take place at a faster pace.
- Of course, the longer-run size of the balance sheet was also discussed. However, in reality another asset purchase program is going to be launched well before we get there.
- Seeing balance sheet reduction on the horizon spooked US stock markets, pushed up US treasury yields while flattening the curve, and pushed down EUR/USD.

Introduction

Forget about tapering, forget about rate hikes, balance sheet normalization is coming! The minutes of the FOMC meeting on December 14-15 confirmed that the FOMC does not see the Omicron variant of COVID-19 as a game changer. Doubling the pace of tapering, hiking earlier and more often than anticipated at the September and November meetings are not the only consequences of higher inflation and the improvement in the labor market. The FOMC also expects to reduce the balance sheet earlier and faster than last time.

Enter the balance sheet

According to the minutes, participants observed that growth of economic activity appeared to have been strong in the fourth quarter after having slowed in the third quarter, and they generally expected robust growth to continue in 2022. Many participants noted that the emergence of the Omicron variant made the economic outlook more uncertain; several remarked that they did not yet see the new variant as fundamentally altering the path of economic recovery in the United States. Participants generally noted that, given their individual outlooks for the economy, the labor market, and inflation, it may become warranted to increase the federal funds rate sooner or at a faster pace than participants had earlier anticipated. However, this was already evident on December 15 from the decision to double the pace of tapering and the upward shift in the dot plot for 2022. For more details we refer to our FOMC Post-Meeting Comment. Instead, more interesting was the remark on the start of balance sheet normalization: "**Some participants also noted that it could be appropriate to begin to reduce the size of the Federal Reserve's balance sheet relatively soon after beginning to raise the federal funds rate."** In fact, the minutes showed that a discussion on policy normalization had taken place, preceded by staff presentations.

Balance sheet normalization: then and now

Compared to the previous (attempt at) balance sheet normalization, participants remarked that **the current economic outlook was much stronger, with higher inflation and a tighter labor market than at the beginning of the previous normalization episode**. They also observed that the Federal Reserve's balance sheet was much larger and that the current weighted average maturity of the Federal Reserve's Treasury holdings was shorter than at the beginning of the previous normalization episode. Some observed that, as a result, depending on the size of any caps put on the pace of runoff, the balance sheet could potentially shrink faster than last time if the Committee followed its previous approach in phasing out the reinvestment of maturing Treasury securities and principal payments on agency MBS. However, several participants raised concerns about vulnerabilities in the Treasury market and how those vulnerabilities could affect the appropriate pace of balance sheet normalization. A couple of participants noted that the Fed's standing repo facility (SRF) could help to mitigate such concerns. Participants also judged the Federal Reserve to be better positioned for normalization than in the past, as the ample-reserves framework and the Federal Reserve's current interest rate control tools, including interest on reserve balances and the overnight reverse repurchase agreement (ON RRP) facility, are in place and working well. Some participants judged that a significant amount of balance sheet shrinkage could be appropriate over the normalization process, especially in light of abundant liquidity in money markets and elevated usage of the ON RRP facility.

Almost all participants agreed that it would likely be appropriate to initiate balance sheet runoff at some point after the first increase in the target range for the federal funds rate. However, participants judged that **the appropriate timing of balance sheet runoff would likely be closer to that of policy rate liftoff than in the Committee's previous experience**, when balance sheet normalization started almost two years after the first rate hike. They noted that current conditions included a stronger economic outlook, higher inflation, and a larger balance sheet and thus could warrant a potentially faster pace of policy rate normalization. However, they emphasized that the decision to initiate runoff would be data dependent.

Some participants commented that removing policy accommodation by relying more on balance sheet reduction and less on increases in the policy rate could help limit yield curve flattening during policy normalization. A few of these participants raised concerns that a relatively flat yield curve could adversely affect interest margins for some financial intermediaries, which may raise financial stability risks. However, a couple of other participants referenced staff analysis and previous experience in noting that many factors can affect longer-dated yields, making it difficult to judge how a different policy mix would affect the shape of the yield curve.

Many participants judged that **the appropriate pace of balance sheet runoff would likely be** faster than it was during the previous normalization episode.

To summarize, balance sheet normalization is coming earlier than last time and will be faster, because this time inflation is higher, the labor market is stronger, and the balance sheet is larger.

The elusive balance sheet target

Of course, the longer-run size of the balance sheet was also a topic of discussion. This is a highly hypothetical debate, because in reality another asset purchase program is going to be launched well before the elusive long run equilibrium for the balance sheet is reached. How far did we get last time?

Anyway, the discussion did not get very concrete. Several participants noted that the level of reserves that would ultimately be needed to implement monetary policy effectively is uncertain, because the underlying demand for reserves by banks is time varying. In light of this uncertainty and the Committee's previous experience, a couple of participants expressed a preference to allow for a substantial buffer level of reserves to support interest rate control. Participants noted that it would be important to carefully monitor developments in money markets as the level of reserves fell to help inform the Committee's eventual assessment of the appropriate level for the balance sheet in the longer run.

Some participants expressed the view that the SRF would help ensure interest rate control as the size of the balance sheet approached its longer-run level; several participants noted that the SRF could facilitate a faster runoff of the balance sheet than might otherwise be the case; several participants raised the possibility that the establishment of the SRF could reduce the demand for reserves in the longer run, suggesting that the longer-run balance sheet could be smaller than otherwise.

Participants also discussed the composition of the Federal Reserve's asset holdings. Consistent with the previous normalization principles, some participants expressed a preference for the Federal Reserve's asset holdings to consist primarily of Treasury securities in the longer run. To achieve such a composition, some participants favored reinvesting principal from agency MBS into Treasury securities relatively soon or letting agency MBS run off the balance sheet faster than Treasury securities.

Conclusion

Seeing balance sheet reduction on the horizon spooked US stock markets, pushed up US treasury yields while flattening the curve, and pushed down EUR/USD. After pussyfooting around the start of tapering for months, the Fed theme changed rapidly to faster tapering, and earlier and more rate hikes. Now we can add earlier and faster balance sheet reduction.

Table 1: Median projections of FOMC participants (December 2021)

Variable	*2021*	*2022*	*2023*	*2024*	*Longer run*
GDP growth	5.5	4.0	2.2	2.0	1.8
	(5.9)	(3.8)	(2.5)	(2.0)	(1.8)
Unemployment	4.3	3.5	3.5	3.5	4.0
	(4.8)	(3.8)	(3.5)	(3.5)	(4.0)
PCE inflation	5.3	2.6	2.3	2.1	2.0
	(4.2)	(2.2)	(2.2)	(2.1)	(2.0)
Core PCE inflation	4.4	2.7	2.3	2.1	
	(3.7)	(2.3)	(2.2)	(2.1)	
Federal funds rate	0.1	0.9	1.6	2.1	2.5
	(0.1)	(0.3)	(1.0)	(1.8)	(2.5)

Source: FOMC, December 15, 2021 (September 22, 2021)

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A summary of the methodology can be found on our website