Why Is the Fed’s Balance Sheet Still So Big?

Council on Economic Education

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We are now in the longest expansion on record

Source: NBER
But back in 2009, the picture was not so rosy

<table>
<thead>
<tr>
<th>Unemployment Rate</th>
<th>Fed Funds Rate Target</th>
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<tbody>
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<td>10%</td>
<td>0.125%</td>
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Unconventional Monetary Policies
Forward guidance
Quantitative easing
Since then, unemployment has steadily declined...
....and the fed funds rate lifted off in 2015

Federal Funds Target Rate

As of 12/16/08, the target measured as the average of the upper and lower limits of the target range of the federal funds rate. Source: Federal Reserve Board/Haver Analytics.
So why is the Fed’s balance sheet still so big?

Source: Board of Governors
The Fed’s balance sheet: A look under the hood
Key elements of the balance sheet

- **Assets**
  - Treasury Securities
  - Agency Securities
- **Liabilities**
  - Currency
  - Treasury General Account
  - Reserves
The balance sheet is larger than before the crisis.
The balance sheet is larger than before the crisis.
Communicating with the broad public

* A Topic a Minute
FEDERAL RESERVE
The Fed’s larger balance sheet is here to stay

- Currency in circulation has increased
- Fed decided to conduct policy with “ample” reserves using interest on reserves to affect the fed funds rate
  - Provides advantages for monetary policy and financial stability
  - Differs from the pre-crisis system of “scarce” reserves
Pre-2008 policy was conducted with “scarce” reserves.

Increases in the supply of reserves lower the federal funds rate.
Policy is now conducted with “ample” reserves

Through arbitrage:
Increases in interest on reserves raises the federal funds rate
Monetary policy
in a low growth, low interest rate world
Slow growth is the problem of our time

Well you're looking rather sluggish yourself.

China

Europe

U.S.
What determines trend GDP growth?

Output depends on

(i) Labor force (worker hours)

(ii) Productivity (output per hour)
Demographics imply slow labor force growth

Actual growth in the working-age population: 16-64

Source: Census Bureau
Productivity growth has been modest

Average annual growth in GDP per hour

Source: John Fernald and Huiyu Li's 6/24/2019 FRBSF Economic Letter "Is Slow Still the New Normal for GDP Growth?"
Annual trend growth likely around 1.8%
Low growth is partly keeping interest rates low

Average FFR Decline during Recessions

Decline in policy space

FFR as of 9/27/19

Source: The average is as reported in Janet Yellen’s 8/26/2016 speech “The Federal Reserve’s Monetary Policy Toolkit: Past, Present, and Future.” The daily rate is as reported by the Board of Governors.
Low growth is partly keeping interest rates low

- Lack of conventional policy “space”
- Thus, unconventional policies are likely to be used during future downturns
- QE can be seamlessly implemented in a regime of “ample” reserves
QE seamlessly implemented with "ample" reserves

QE can be introduced without changing the implementation of monetary policy and the policy rate.
A few takeaways

• The Fed’s larger balance sheet is here to stay

• Policy will be conducted with “ample” reserves using interest on reserves to affect the federal funds rate

• Seamlessly accommodates QE when needed
Why Is the Fed’s Balance Sheet Still So Big?

Andrew Foerster and Sylvain Leduc

The Federal Reserve’s balance sheet is significantly larger today than it was before the financial crisis of 2008–2009. Rising demand for currency due to greater economic activity is partly responsible for this increase. The balance sheet will also need to remain large because the Federal Reserve now implements monetary policy in a regime of ample reserves, using a different set of tools than in the past to achieve its interest rate target.