

The Fed's Balance Sheet

The 37th Annual Monetary and Trade Conference
Global Interdependence Center
Philadelphia, PA

May 6, 2019

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President and Chief Executive Officer
Federal Reserve Bank of Philadelphia



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The views expressed today are my own and not necessarily those of the Federal Reserve System or the Federal Open Market Committee (FOMC).

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Good morning and thank you; it's a pleasure to be here.

The tagline of this conference is Global Trade: Darkening Clouds or New Beginnings? And I want you to know that I valiantly resisted the temptation to make a bad joke — or worse, a pun — involving Churchill's "beginning of the end" or "end of the beginning." But there are some echoes of its essence in the subject of my remarks today. Life — and policy — is full of endings and beginnings that are part of a larger whole. So I'd like to talk today about the continuing process of normalizing monetary policy, and the unwinding of the Fed's balance sheet. If I were going to give in to the urge to make that joke, I might call it the beginning of the end of the middle of the end of the almost end of our road to normal. ... But, of course, I would never do that.

I will, however, add to my remarks a brief outlook on how I see the economy unfolding and what that means for my policy views. I'm approaching my four-year anniversary as a Fed president, and one of the first lessons I learned on taking that seat was to always give an economic outlook. Another was to always preface any remarks with the standard Fed disclaimer: The views I express today are mine alone and do not necessarily reflect those of anyone else in the Federal Reserve System.

Outlook

Starting with GDP, the initial readings of Q1 were a pleasant surprise, particularly as first quarters have tended to be slow in recent years. However, there are a few caveats. A good chunk of that boost came from inventories and net exports, which are unlikely to carry into the rest of the year. It's possible that the drag we usually see in first quarters will show up in Q2 this year, as inventories in particular tend to counter large boosts today with a drag tomorrow. Consumer spending, which has been the primary driver of growth, showed a slowdown from last year, as did business investment.

The net result of these components means my outlook for growth this year remains the same for now: a little above 2 percent. I also continue to see next year returning to trend, at about 2 percent.

The labor market continues to show remarkable strength, with strong job creation and continued low unemployment. I think the unemployment rate could move down even further, to 3.5 percent before edging back up a few tenths of a percentage point.

Inflation has softened in recent months, and it's an area I'm focusing my attention on. I haven't yet revised my medium-term inflation forecast, because I suspect some of the recent weakness is transitory. So I still see it running slightly above our 2 percent target for the medium term, but that projection is nowhere near written in stone; more like a dry-erase board.

If any component of the outlook were to affect my view on the appropriate path of monetary policy, it would be inflation. However, we're not there yet, and it would take more data to convince me. I therefore continue to see one increase at most this year; possibly one, at most, next.

Unwinding the Balance Sheet

Turning to the crux of my remarks today, as you know, the FOMC has made further moves regarding the balance sheet, which were laid out in its updates to the "normalization principles and plans" after our January and March meetings. There are three interrelated components to this. First, continued implementation of monetary policy in a regime of ample reserves. Second,

our intent to stop asset redemptions in September. And third, the anticipation that the size of the balance sheet will be constant for some time after that, letting the supply of reserves decline, very gradually, as currency and other non-reserve liabilities grow.

To clarify the Fed-speak, “monetary policy in a regime of ample reserves” means that policy will be executed as it is in normal times, with the federal funds rate acting as our primary tool. The fed funds, along with other short-term rates, will be managed mainly via administered rates, such as interest on reserves.

“Amplitude,” of course, can sound quite nebulous, but in the case of the fed funds market, “an ample supply of reserves” has a specific meaning: a level of aggregate reserves that can comfortably accommodate demand within our target range through all the volatility associated with seasonal demand and autonomous factors, without requiring active management. This means that, as long as economic and financial conditions unfold more or less as we expect them to, the balance sheet will remain largely on autopilot, left in the background, as boring as ever. While the current state of reserves certainly falls within that definition, the Committee has also made clear that we ultimately intend to hold no more reserves than necessary for efficient and effective monetary policy. I’m going to revisit that expression quite a few times, so it’s probably best if everyone adds mental quotation marks around “no more than necessary” and “efficient and effective” — I promise it reflects my adherence to careful policy wording, rather than a lack of imagination. Or a thesaurus.

As we’ve announced, our plan is to end the balance sheet runoff in September. Starting this month, the cap on Treasury redemptions will be lowered from \$30 billion a month to \$15 billion, to put a modest damper on the pace of redemptions.

When the runoff ends, reserves will likely still be *somewhat* more than necessary for that “efficient and effective” execution, rather than *no* more than necessary. Therefore, we intend to hold the size of the balance sheet roughly constant for a time. By doing so, we will let the supply of reserves decline gradually with growth in currency and other non-reserve liabilities.

For me, a key issue is that we only have estimates of the demand for reserves, and that uncertainty calls for a cautious approach. It may be that “ample” is more than we thought, and

reserve levels can't really drop much further without inflicting interest rate volatility and creating liquidity-management issues for financial institutions.

Additionally, the supply of reserves is notoriously volatile. Autonomous factors, such as the Treasury General Account and repo facilities, can move the aggregate supply of reserves by as much as \$90 billion in either direction in a single week. We have a good track record of forecasting these swings, and they do tend to reverse themselves. But those factors do inflict a substantial fluctuation in the supply of reserves to depository institutions.

So in metaphorical terms, it is a dark and stormy night, to quote *Peanuts*, and we are walking in the direction of a wall. In that situation, most of us would give the advice of "walk, don't run," and keep a bit of distance from where we think the wall is.

Walk, Don't Run

So we intend to walk toward the "efficient and effective" level, rather than charging at full speed.

The plan is to slow down the pace of decline in average reserves. We'll do that by keeping the size of our aggregate securities holdings constant for a time. During this period, we will see a very — and I do stress "very" — gradual decrease in average reserves as currency and other non-reserve liabilities grow over time. Average currency growth rarely exceeds \$10 billion per month, while asset redemptions have averaged more than \$30 billion a month. That said, more than half of the decline realized to date was unrelated to asset redemptions, and reserves have declined by more than \$1 trillion since their peak of \$2.8 trillion.

This slow and steady approach, which is based on work by the Philadelphia staff,¹ is not only the safer option, it has the additional advantage of reducing uncertainty about the evolution of asset redemptions. In fact, it effectively decouples asset and liability policies as we make our way to "no more than necessary." It also gives us additional time for monitoring and analysis,

¹ I would like to thank Roc Armenter for his research and insight.

and may even foster changes to how financial institutions manage liquidity. These factors both meet the FOMC's stated objective to proceed in a "gradual and predictable manner."

Keeping the Distance

We also want to keep a comfortable distance to avoid a collision with the wall. As I said, we only have estimates of the demand for reserves, and the parameters of "ample" may be closer than we think. Those autonomous factors I mentioned add something of a howling wind to our metaphorical late-night excursion, because their volatile effect makes it similarly difficult to navigate a narrow path for aggregate reserves. Both considerations call for additional aggregate reserves, creating a buffer zone to account for margins of error in our estimates and protect against large swings in autonomous factors.

A Little More Normalizing

As reserves continue to decline, they will eventually reach their efficient and effective level, at which point we'll resume asset purchases to maintain that level, keeping up with nominal growth.

Even at that point, though, we will not be "normalization accomplished" — though we will be normalization adjacent.

Because the next natural step in the balance sheet discussion is its composition.

Once the balance sheet's holdings do not exceed the need, they're unlikely to meet the want — at least not that of the long run. The FOMC has made clear that the portfolio will consist primarily of Treasuries, but currently, MBS account for more than 40 percent. There are no Treasury bills, and our Treasury holdings have a substantially longer remaining maturity than outstanding Treasury securities. While a significant number of Treasuries will reach maturity in the coming years, a sizable share has a remaining lifetime of 20 years or more.

As we discuss the question of composition, it's worth returning to the Rosetta Stone of policyspeak, particularly when we talk about the "longer run." The transition could easily take close to a decade, even if economic and financial conditions unfold as expected. Balance sheet

policies are inherently asymmetrical — that is, they are deployed when we need more accommodation than rates alone can deliver, never the other way around — so the portfolio composition will never average “normal” nor, in fact, will it be “normal” on anything like a regular basis.

While the longer run can be something of an amorphous concept, the near term is more concrete, and poses pressing questions. There will need to be decisions about how to distribute reinvestments and, eventually, outright asset purchases. Importantly, those decisions can have an immediate impact, and will need to be communicated clearly, as they will almost certainly be the subject of intense market attention.

I’m not going to weigh in on the functions, but I will say something about the philosophy.

For me, any discussion of composition has to be predicated on a set of grounding principles. While there are certainly more than just these two to consider, I would start with the doctrines of neutrality and flexibility.

Neutrality is grounded in the monetary policymaker’s Hippocratic Oath of doing no harm. In this case, our plans should avoid market disruptions. One way to do that is ensuring we spread holdings and purchases across maturities in proportion to their amount outstanding, avoiding cornering any one particular issue. In particular, recently issued Treasuries — often referred to as “on the run” — are vital to market functioning.

Flexibility involves the crucial ability to dip into our arsenal of balance sheet policies if the need arises. I want to stress that we would only revisit those options if we again found ourselves in a situation that called for more accommodation than the federal funds rate could provide on its own. But it is important to maintain that ability. One way to increase flexibility is by changing the maturity of the balance sheet’s composition. The shorter the duration of the portfolio, the larger the flow of maturing proceeds at any given time. That flow can be redirected, allowing for a swift change in the composition without expanding the balance sheet or having to sell assets outright.

One option, therefore, would be tilting the Treasury portfolio toward a somewhat shorter term. That could be done by simply increasing our holdings of Treasury bills, which have a maturity of a year or less.

It's important to note that there are many discussions still to be had, and that these principles are but two of many. Important ones, but in good company.

Finally, it is worth repeating that the normalization process, while an important policy decision, is not indicative of our monetary policy stance.

Conclusion

And so I come to the beginning of the end of my remarks.

We are on the path to normalization, though when this next step is complete, there will still be more to take. The conversations will continue, particularly about composition, and for me, the principles of neutrality and flexibility will be key.

With that, the end of my remarks and the beginning of the Q&A.