

# Forget about the Policy Rate, It's the Balance Sheet

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What the Federal Reserve (Fed) does on rate policy next year will be important. What it decides for the balance sheet will be more important.

Fed Chairman Powell opened the door to a windstorm of volatility in early October with his comment that the neutral rate is a lot higher “probably.” In his climb down at the Economic Club of New York several weeks later, he noted that the federal funds rate had reached the low end of the range—containing most people’s estimates of the neutral rate. Debate has raged ever since. Did he or didn’t he blink? Will the Fed pause in 2019, or not? Will the dot plots ratchet lower or will the money market curve move higher?

Lost in the tidal wave of commentary which followed on the policy rate outlook and the Fed’s target variable  $r^*$ —which cannot be seen, measured, or calculated in any practical way—was the balance sheet.

The balance sheet is contracting at a steady pace of \$50 billion a month with nary a word from the Fed about what guard rails are in place to avert an accident. At least one Fed Governor has said that shrinking the balance sheet will be as exciting as watching paint dry. Fed officials have a history of making over-confident risk assessments that come back to slap them—and us—in the face. This could be one of them.

At a minimum the Fed should be approaching balance sheet reduction cautiously, because no one really has any idea what affect it will have. How quantitative easing (QE) worked in the first place remains a topic of extreme debate. Many thought it would lead to inflation but it did not. Others think it inflated asset prices. Some believe it had no effect at all. Economic and financial historians will be debating this policy for decades. QE was unorthodox, controversial, and remains poorly understood. How could the information uncertainty related to unwinding the balance sheet be any less controversial? Yet the Fed’s approach seems to be: crisis over, back to normal—including the balance sheet.

More disturbing are the reasons for thinking that balance sheet reduction could be as potent a form of monetary restraint as former Fed Chairman Ben Bernanke argued QE was a form of monetary reflation. Former Fed Chair Janet Yellen expressed concern about this possibility when she led the central bank but offered no guidelines for discernment. It sounds like there has not been much progress since. Fed Chair Powell fell back to monitoring the data in his New York *mea culpa* at least with respect to interest rates, but made no comments on the balance sheet.

There have been warnings all year. The now-outgoing Governor of the Reserve Bank of India wrote an Op-ed piece in the *Financial Times* earlier this year asserting that a scarcity of dollars was beginning to stress emerging markets. He pointed the finger at the Fed’s balance sheet policy and asked the Federal Open Market Committee (FOMC) to stop. The Fed’s reaction was tantamount to a dismissive shrug.

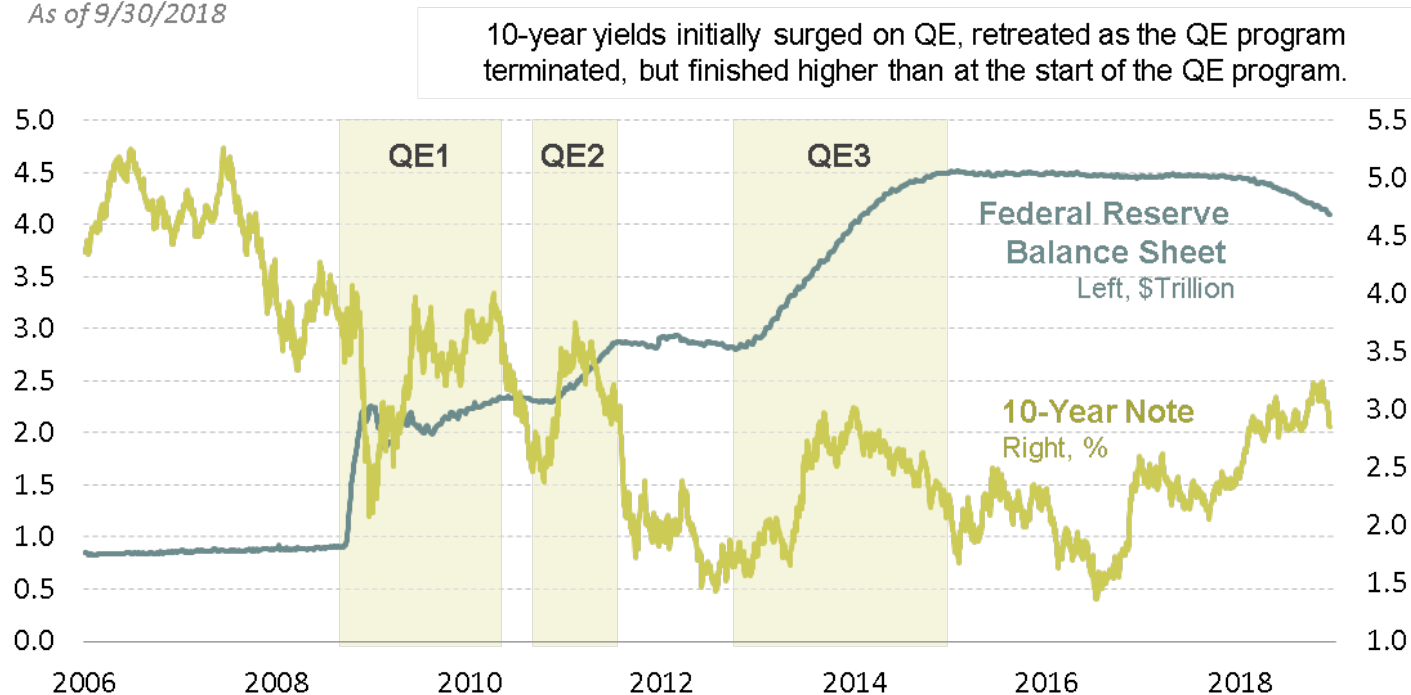
The Fed appears to have adopted the conventional view that QE worked by depressing the level of U.S. government long-term bond yields relative to what they would otherwise have been. Numerous studies have been published both in and outside of the Fed arguing that the cumulative effect of QE operations was to reduce the term premium on long bonds by 130-150 basis points (bps). Correspondingly, bond yields should move gradually higher as the balance sheet shrinks. This has become conventional wisdom.

Unfortunately, the idea that bond yields were depressed by Fed QE operations may say more about the models than the real world. Yes, bond yields were lower by the time the Fed’s balance sheet maxed out compared to where they were before the first wave of QE operations in 2008. But between 2008 and 2016, there was the Great Financial Crisis (GFC), the European Sovereign Debt Crisis, China’s attempt to deleverage its economy, and a bust in commodity and energy prices—not to mention sundry geopolitical disturbances like the Brexit vote. All these developments were deflationary and acted to depress bond yields.

Looking back, developments that occurred during each phase of QE provide contrary evidence to the conventional view. Each QE phase was quite dramatic and in each instance U.S. Treasury yields rose, at least during the initial phase of the balance sheet expansion (see [Chart 1](#)). Yields were always higher at the end of the balance sheet expansion than when they started out. So if QE is flipped on its head and there is quantitative tightening (QT), these observations suggest the possibility that yields might actually fall instead of going higher if the balance sheet is reduced too much.

### Chart 1: Bond Yields Ended Higher After Every Episode of QE

As of 9/30/2018



Source: Macrobond

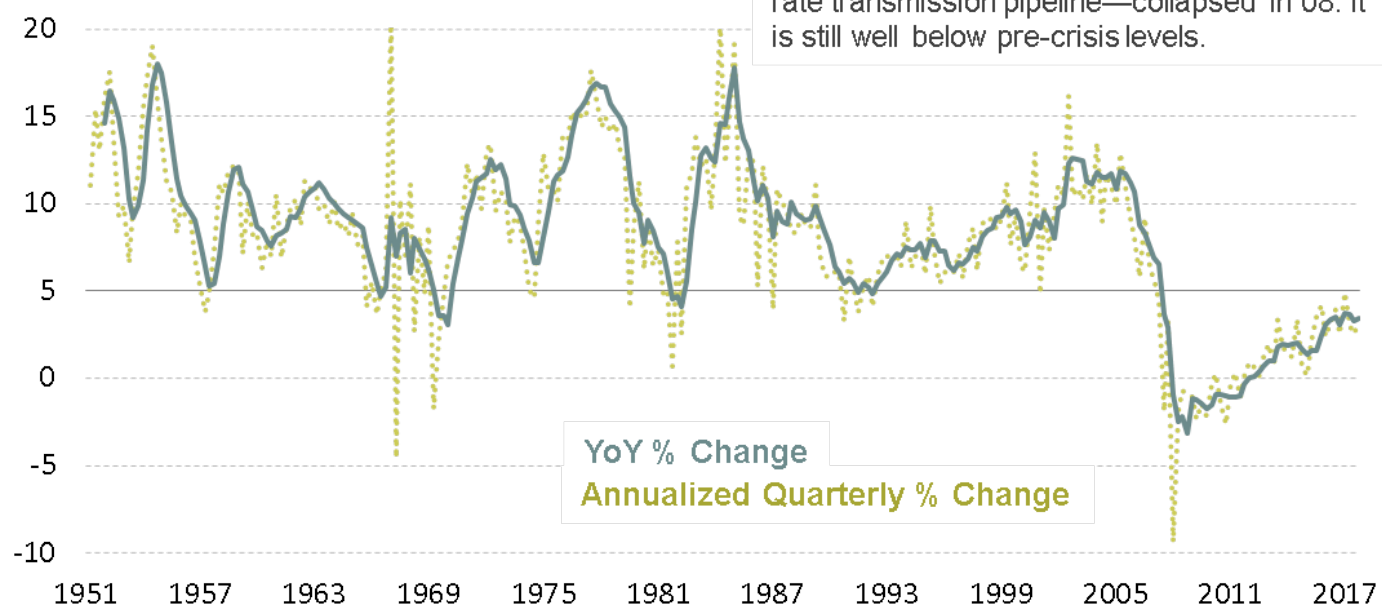
What's the narrative behind these observations and potentially contrary outlook?

The GFC was a story about a collapse in trust, an implosion in the plumbing of the financial system, and the greatest liquidity crisis since 1929. Investors wanted out of mortgage pools at almost any price, banks did not want to lend to each other because no one knew who was insolvent, businesses could not get cash, and inter-country lending collapsed. Household net worth plummeted under a double-barrelled barrage of falling equity markets and the first major decline in house prices in 80 years. Trust in the system evaporated. In its place, the demand for liquidity and safety mushroomed. Ultimately, the Fed moved to meet the demand for liquidity and safety with QE. And the effect was a reflationary palliative: the dollar retreated, bond yields rebounded higher—at least temporarily—stock and commodity prices rallied. Bank deposits grew steadily throughout the first years after the crisis as people put their increased savings into more safety, increasing the savings rate too. Investments in bonds soared. This was a demand for safety and liquidity which the Fed accommodated. Had it not accommodated this need for liquidity, the dollar would have been stronger and real rates positive through deflation in prices.

So the notion that the financial and economic system reflated through lower bond yields seems inconsistent with the facts. But it doesn't make a lot of sense either. The interest rate effect is the normal transmission pipeline between Fed policy and the economy, and it works by stimulating the demand for credit. But it was an historic collapse in credit and a break in the interest-rate mechanism which fostered the idea of an unorthodox approach in the first place. In 60 years of pre-crisis history, household credit growth never dropped much below 5%. In the final quarter of 2008 it dropped to almost -10% (see [Chart 2](#)). It took four years for household credit to climb back above zero. Even now, household credit growth remains below personal income growth.

## Chart 2: U.S. Household Credit Growth

As of 9/30/2018



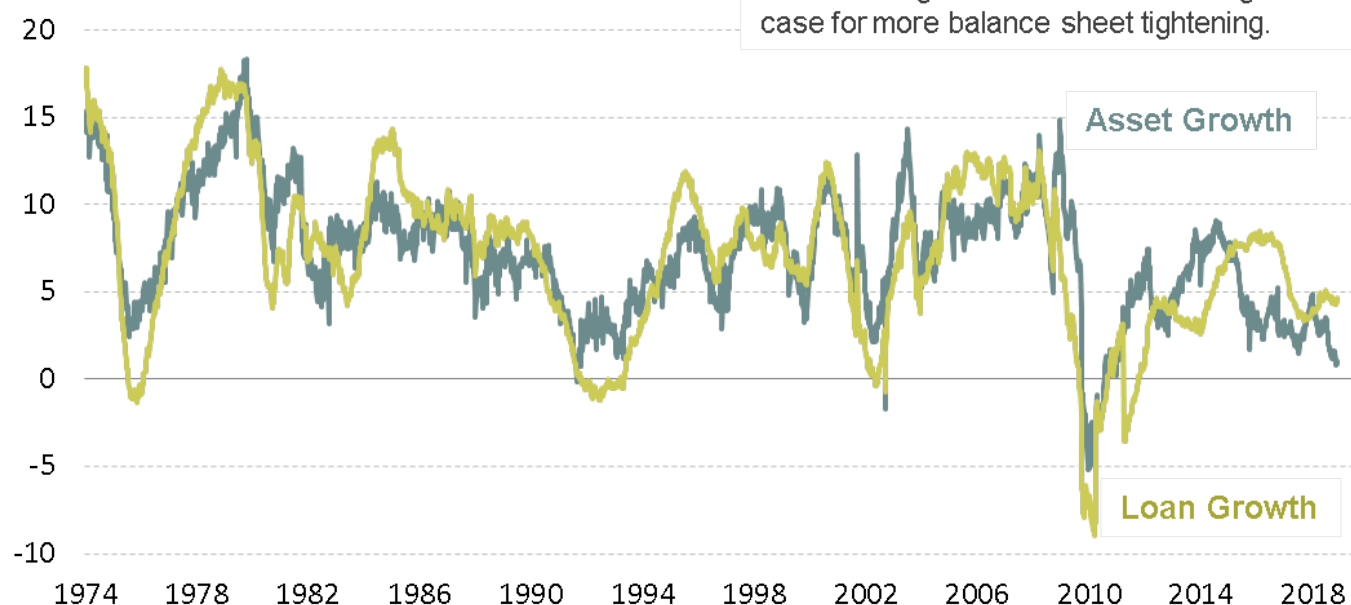
Source: Macrobond

What this narrative suggests is that credit growth is the key variable to monitor with respect to guidance on how fast the Fed should shrink the balance sheet. Commercial banks are sitting on trillions of cash assets mainly held in the form of interest-earning reserves at the Fed. These reserves amount to a monetary powder keg—if the demand for credit ever recovers. So far there isn't much sign of that:

- Household credit is growing at roughly a 3.9% annual pace, well below the growth rate of personal income and dramatically below growth rates that existed before 2008.
- Banks' willingness to lend keeps expanding but it is negatively correlated with corporate bond spreads which have started to widen. That willingness may be about to turn.
- Bank balance sheets are barely expanding (see Chart 3). Total loan growth is low. Money growth is slowing. The yield curve is flattening.
- Households have been the big purchasers of Treasury securities this year, another sign of an absence of credit demand.

### Chart 3: Commercial Bank Asset and Loan Growth

YoY % Change, As of 11/28/2018



Source: Macrobond

For the first time since 2008, the monetary base of the world's major central banks is beginning to contract, courtesy of the balance sheet reduction at the Fed. The effects in the emerging world are already apparent where any influence from U.S. dollar funding availability triggered by balance sheet reduction has been compounded by China's recent softening and the trade rhetoric. More recently, the combination of dollar strength, strength in the U.S. bond market, and the retreat in U.S. breakeven inflation rates could be a sign that QT is starting to have an impact at home. At some point in the first half of 2019 the Fed will have to deal with it.

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