The Fed's Other Lever

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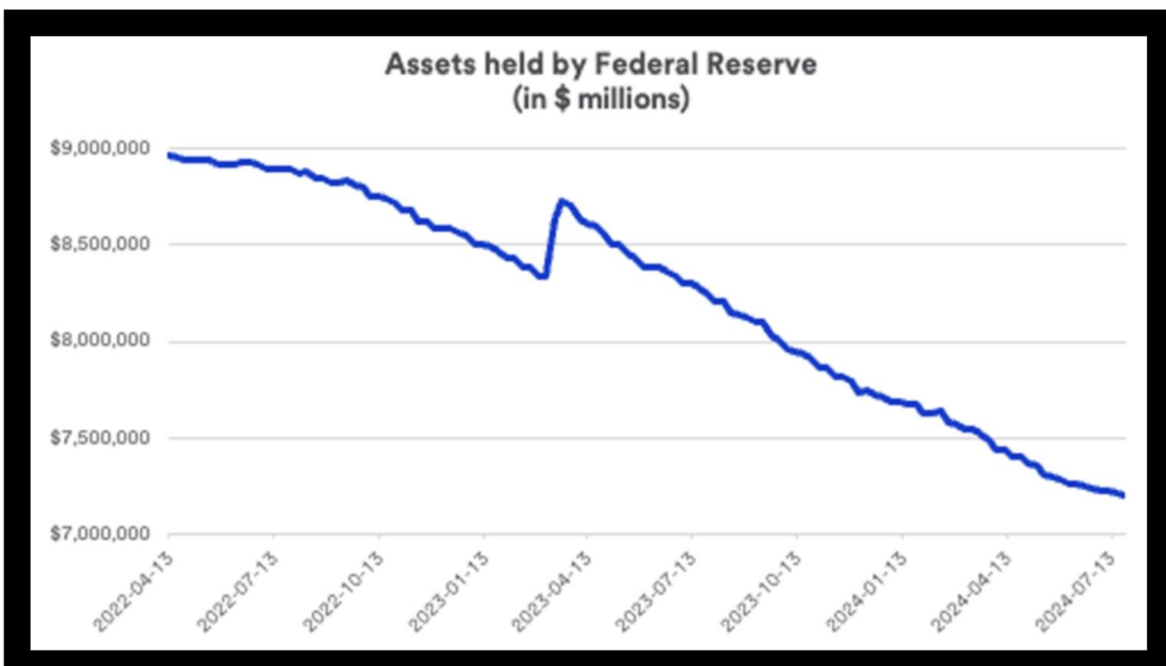
All eyes are pretty much always on what the U.S. Fed is doing, but most of the attention goes to only one aspect of its manipulation of our economy. You read about whether the Fed is thinking about raising or lowering interest rates, pundits offer up their opinions, economists read the tea leaves of the Fed meeting minutes and press conferences—and, well, from all that, it would be natural to believe that this is the only lever that the Fed is pulling when it wants to raise or lower the temperature of economic activity.

But the other handle is the Fed balance sheet. Whenever the Fed wants to give the economy a kick in the pants (think: the Great Recession of 2008-9 and the Covid-related decline) it makes money out of thin air and buys Treasury securities and mortgage-backed securities.



Source – Board of Governors of the Federal Reserve System (US), Assets: Total Assets (Less Eliminations from Consolidation) retrieved from FRED, Federal Reserve Bank of St. Louis As of July 31, 2024

Buying mortgage-backed securities helps lower longer-term interest rates that are generally not influenced by the Fed funds rate. The manufactured money used to buy these securities increases the money supply and lowers yields. When the Fed starts selling off the mortgage bonds, it does the opposite: it tends to reduce the money supply and cause longer-term interest rates to go up.

The same general principle holds for Treasury securities. When the Fed wades into the Treasury market, it tends to bid at lower yields, lowering what the government has to pay on the bonds (and taking pressure off of the federal debt) and lowering bond rates generally. The money supply is increased, and banks generally wind up with more money to lend at more attractive rates. More lending tends to equal more economic activity.

So what is the Fed doing today in this obscure corner of its policy machinations? The Federal Reserve system increased its balance sheet to a record $9 trillion (with a 'T') in the aftermath of the 2008 Great Recession crisis, and these so-called Quantitative Easing programs did, indeed, shock the economy back to life. Beginning in April of 2022, the Fed began cautiously allowing the bonds on its books to mature, which reduced its holdings up until the Covid crisis, at which point it entered into another (albeit short-term) purchase policy. As the reader can see on the chart, the Fed has gone back to net selling, so that today it holds just over $7 trillion on the balance sheet.

What's the goal? Nobody knows. It's possible that the so-called 'Quantitative Tightening' will take assets down to roughly the $4 trillion level that existed before the Great Recession. It's also possible that a recession is just around the corner, and depending on the depth of it, the Fed might decide to start buying again—or at least stop selling assets.

If and when that happens, all eyes will be on the Fed Funds rate. But ultimately, the changes in the balance sheet might have more real-world impact on the economy.

Sources:

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https://www.usbank.com/investing/financial-perspectives/market-news/federal-reserve-tapering-asset-purchases.html

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