Central Bank Balance Sheets: Misconceptions and Realities

By Eric S. Rosengren

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Federal Reserve Bank of Boston President Eric Rosengren explored misconceptions about the Fed's balance sheet – the assets the central bank holds, and the liabilities and capital used to finance those assets – in a speech in Hong Kong.

- Rosengren disagreed with the view that the market turbulence at the end of 2018 was caused by the Fed's ongoing balance sheet reduction.
- He also said "it is unrealistic to expect the Fed's balance sheet to return to the size it was before the financial crisis," as some have suggested, because factors not related to monetary policy impact the balance sheet's growth.
- Rosengren also emphasized that central banks may need to turn to balance sheet tools to stimulate the economy during the next recession, given a low-rate environment with limited room to reduce rates before they reach zero.
- He described the Fed's post-crisis approach to monetary policy implementation as requiring a larger balance sheet.

Rosengren said there seems to be little correlation between equity market movements and the relatively small and steady decline in the Fed's balance sheet. Markets recovered in early 2019 despite little change in the magnitude of the balance sheet's "still quite gradual" run-off. "In my view, concerns about the international economy, potential trade disputes, and a U.S. government shutdown are much more plausible explanations for the financial market turbulence."

Growth in the Fed's balance sheet, said Rosengren, is not solely related to monetary policy actions, as many assume. Growing liabilities not primarily determined by monetary policy are important too – such as currency, and Treasury deposits. "Part of the expansion of the Federal Reserve's balance sheet occurs as a normal consequence of a growing economy with a growing need for currency, a factor not related to monetary policy action." Simply put, "the change in currency holdings alone highlights that the Fed's balance sheet will not be able to shrink to earlier levels." He also noted that relative to GDP, the U.S. balance sheet is actually small compared to those of central banks in many other developed countries. Overall, "it is a mistake to focus primarily on the *size* of the balance sheet, with much less attention placed on the quantity of bank reserves and the duration of the assets being held."

Looking ahead, Rosengren explored how the balance sheet could be used to stimulate the economy in a hypothetical downturn. It may well be that many central banks have little room to reduce short-term rates. This will likely generate an increased need to utilize the balance sheet as a stimulative tool. "In my view, monetary policymakers should give more consideration to structuring the balance sheet to provide more leeway for policy measures to be taken when the next economic downturn occurs." To that end, he said that lowering the duration of securities held as assets may be an important goal as part of the normalization process, and "would give the Federal Reserve the flexibility to take the policy step of lengthening the maturity of its balance sheet assets the next time a significant economic downturn occurs."

Rosengren also noted the Federal Reserve's recent statements on policy implementation and balance sheet normalization. The Fed anticipates an ample supply of reserves (which are a balance sheet liability) to avoid volatility, and a floor system of administered rates controlling the level of the Federal Funds Rate.

Rosengren concluded by saying it is important for policymakers to continue to study how balance sheet operations influence the economy – “and I dare say it is important for market observers, lawmakers, and the public to become more comfortable with the benefits of central banks using their balance sheet tools to pursue the public interest.”

Rosengren was speaking at the Credit Suisse Asian Investment Conference, in Hong Kong.

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