The Fed Is Shrinking Its Balance Sheet—But Why?

The worldwide bond market tops $100 trillion, and we live in a world (as we are incessantly told) of global capital markets. All told, there is more than $217 trillion in global debt outstanding, and that figure rises by many trillions every year, reports the Institute of International Finance.

The U.S. Federal Reserve, as widely reported, plans to start reducing its balance $4.5 trillion sheet, often described as massive or even "yuge."

But it turns out due to rising piles of U.S. paper cash in circulation, there is not that much bond-selling the Fed can do. Indeed, as noted by former Fed chair Ben Bernanke, the Fed will soon have to keep a bare minimum of $2.5 trillion on the balance sheet just to accommodate paper cash in circulation.

So, that being the case, the Fed might be able unload $2 trillion or less over the next few years into a global debt market that tops $200 trillion.

And this Fed sale of bonds will accomplish what? Are there reasonable prospects the Fed bond sale will alter the global interest rate picture in one way or another?

One Concrete Result

There will be one concrete result: U.S. taxpayers will lose, as they will have to make up for the interest lost on the Fed bond hoard. The Fed now collects interest on its bonds, and largely shuffles that earned interest through to the U.S. Treasury. Ceteris paribus, a tax reduction for taxpayers.

Perhaps the better question is, "Why not add to the Fed bond portfolio?"

If one grants that the Fed is really part of the U.S. government, then the Fed buying of bonds unburdens U.S. taxpayers in terms of principle owned, and the interest earned can offset taxes.

As for inflation, the Bank of Japan owns about 45% of Japanese government bonds now, amount that rises near daily, and the Nippon disease is still borderline deflation, despite an official unemployment rate of 2.8%.

So, other than orthodoxy and convention, why not a larger Fed balance sheet?

Inflation?

One recent writer for Forbes posits that if the Fed begins to unwind the balance sheet, but is forced to stop due to negative market consequences, then "that has huge inflationary consequences."

This may be a cousin idea to market monetarist David Beckworth's idea that the Fed from the get go should have identified QE as permanent (and skipped interest on excess reserves, but that is yet another conversation).

These are interesting ideas, Beckworth's certainly.

But here we are now, the Fed has a "large" balance sheet (though relatively smaller than the European Central Bank's or the Bank of Japan's) and inflation is below target.

In daily commerce, prices are set by supply and demand. Global and U.S. demand has been rising sluggishly, and many products are produced globally. How would manufacturers of smart-phones or automobiles charge more if the Fed stood still on its portfolio of bonds?

The Bank of Japan has never indicated it will ever sell its hoard of JGBs, and Japan is a long way from breaking out of deflation. Are the rules of macroeconomics different in Japan?

Conclusion

The Fed appears compelled by orthodoxy to sell off a couple trillion in bonds, even though its preferred measure of inflation, the core PCE, is running at 1.3% YOY in August, well below the Fed's putative "average" target rate of 2.0%.

Moreover, a large component of measured inflation is coming from U.S. housing markets in which demand is not the problem, but supply. The core CPI minus shelter index is up 0.88% YOY. In fact, core CPI minus shelter is at a lower rate now than any year since

1968—that is a far back as the FRED graph goes. A 50-year low-water market for inflation.

Yet the Fed insists on raising rates and selling bonds.

President Trump is correct to seek new leadership at the Fed.