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Possible Plans for Transitioning to a Long-Run Operating Regime[1]

Participants at the Committee's November 2018 meeting cited advantages of remaining in a regime of abundant excess reserves, but also noted uncertainty about the ultimate quantity of reserves required for such a regime as well as potential costs associated with maintaining a large balance sheet. Consideration of these tradeoffs between balance sheet size and implementation regime is consistent with the FOMC's September 2014 Policy Normalization Principles and Plans, which indicate that the Federal Reserve will, in the longer run, hold no more securities than necessary for the efficient and effective implementation of monetary policy. The 2014 Principles also indicated that these holdings should primarily consist of Treasury securities. Since 2017, the Committee has been gradually reducing its asset holdings. The memos in this package describe a variety of possible plans that might be employed, individually or in combination, to transition to a long-run regime of lower reserve levels and a smaller balance sheet composed of primarily Treasury securities, consistent with the Committee's previous communications.

Before considering how that transition might proceed, it is useful to review the evolution of money markets since balance sheet normalization began. In the current regime, interest rate control mainly works through the setting of the interest rate on excess reserves (IOER). Over the last year, this approach has proven sufficient to keep the federal funds rate within the Committee's target range and maintain effective transmission to broader financial markets. The modest upward pressure on the federal funds rate and other money market rates experienced in recent months has been countered by lowering IOER within the target range. To some extent, staff have been able to anticipate sustained periods of upward pressure on the federal funds rate, allowing for effective market and timely communication on the technical adjustment to IOER.

As reserves decline further, the federal funds rate and other money market rates may continue to rise along a smooth and gradual path relative to IOER. Alternatively, as rates rise above IOER, we may see different and less stable dynamics. In particular, there is some risk that frictions in the mechanisms that redistribute liquidity in money markets could create transitory volatility in interest rates as reserves decline. Moreover, policymakers might want to allow the balance sheet to continue to run off even as signs of money market pressures become more persistent, either in order to give banks an

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incentive to further economize on their holdings of reserves or to clearly test the point of reserve scarcity.

The first memo in the package, "Detecting and Approaching the Long-Run Level of Reserves," describes how money markets might evolve as reserves decline and how staff will monitor conditions to detect when the system has reached the lowest level of reserves consistent in the long-run with an efficient and effective regime of abundant excess reserves. In particular, the memo describes how staff plan to distinguish between temporary pressures, which might emerge as banks and market participants adjust to lower levels of reserve supply, and more permanent pressures, which would indicate that any further reduction in reserve supply would place the system on a steep part of the demand curve for reserves. Distinguishing between these two types of pressures is difficult. Nonetheless, staff outreach and analysis will help to identify the point at which reserves would be scarce over the longer-run, so that policymakers can avoid stopping the balance sheet runoff too early in response to transitional pressures, and can ultimately decide between regimes of limited and abundant excess reserves with more certainty about where the boundary between those regimes lies.

The first memo also considers steps policymakers might take to promote a smooth transition to lower reserve levels. These steps could include, at the outset, conveying a preference for a substantially lower reserve level in the long run, which would signal to market participants a need to adjust their practices for a lower reserve environment. In case the pace of decline in reserves proves to be faster than the pace at which market participants can adjust, the Committee could also choose to slow the pace, or smooth the path, of reserve decline to reduce potential rate volatility and provide more time for market participants to adjust.

The second memo, "Interest Rate Control during the Transition to a Long-Run Operating Regime," reviews approaches that can be implemented to provide greater assurance of effective rate control during the transition. For instance, should the spread between market rates and IOER proceed along a gradual upward path, a strategy of adjusting IOER lower in the target range may be adequate to keep the federal funds rate from rising above the target range. The memo also considers potential enhancements to this approach to guard against volatility in rates or allow for more visible testing of lower reserve levels. The considered approaches include increasing the width of the target range to allow more room for the target rate to rise above IOER, while maintaining appropriate distance at the bottom of the range between IOER and the ON RRP rate, as well as modifying discount window operations or open market operations with financial institutions to help create a firmer ceiling on rates.

The strategy for maintaining rate control during the transition interacts in several ways with the strategies described in the preceding memo for detecting stopping points and for smoothing the transition. First, if policymakers choose to employ repos or other operations with financial institutions to maintain rates within the target range, the scale and persistence of their use could be an important indicator of whether the aggregate level of reserves is at the minimum necessary for a regime of abundant excess reserves. Second, if a tool is in place to ensure rate control in case of upward pressure on the federal funds rate and other money market rates, it would be possible to attempt further reductions in reserve demand and take a less conservative approach to deciding when to stop reducing reserves. Third, to the extent that financial institutions appear to be adjusting slowly to the decline in reserves, policymakers might need to weigh the costs of slowing the balance sheet normalization process to provide more time for adjustment against the costs of using other methods to maintain rate control while adjustment takes place.

In case the demand for reserves proves surprisingly high, the third memo, "Possibilities for Reducing the Long-Run Size of the Federal Reserve's Balance Sheet," describes ways to reduce the size of the Federal Reserve's liabilities or to reduce the perceived drawbacks of maintaining a large balance sheet by putting the size of the overall balance sheet in greater context for the public. The memo catalogs a variety of options to achieve these goals. Importantly, many of the items are within the scope of the Federal Reserve System's responsibilities but do not fall under the purview of the FOMC; the relevant governance bodies would ultimately need to consider the issues. The memo also reviews the benefits provided by each of the Federal Reserve's liabilities.

A different type of plan is described in the final memo on "SOMA Portfolio Composition." This memo describes options for the long-run composition of holdings in the System Open Market Account and for transitioning to that target composition. Having plans in place to return the portfolio to a historically normal composition could further demonstrate the unwinding of crisis-era asset purchase programs and thus may have some benefits for public acceptance of unconventional policy tools. The memo considers potential principles guiding the ultimate composition of the Treasury portfolio, choices about an active or passive reduction in MBS holdings and about the speed of adjustment in the composition of Treasury holdings, as well as some macroeconomic implications of these options.

Collectively, these memos highlight issues for consideration during the transition to a system with lower reserve levels. In light of the potential paths of adjustment for money markets, the Committee may wish to consider actions that will help smooth the transition or increase confidence in monetary control. At some point, the Committee will also need to consider how to react to emerging money market pressures – whether, or

under what circumstances, it would be preferable to allow greater money market pressures and potentially encourage banks to economize on reserves, or instead to cease reserve reductions when pressures emerge. Should reserve scarcity occur at a higher level than desired, policymakers could investigate possible ways of further reducing liabilities or changing their communications about the size of the balance sheet. In addition to these considerations related to balance sheet size, the Committee may consider approaches to normalizing the asset composition of the balance sheet.