Federal Reserve must shrink balance sheet to get all its tools back

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Markets are all but certain that the Federal Reserve will not raise interest rates at this week's Federal Open Market Committee (FOMC) meeting, and there is little reason to believe Wednesday's policy statement will say anything beyond the public comments of Fed officials. If anything is noteworthy, it will be what the Fed *doesn't* say about a very important subject it continues to ignore: the federal funds market.

It was a critical market before the 2008 crisis, and it is a critical market now. But it is operating far differently today. Due to Fed policy decisions since the crisis, the federal funds market's size, composition and mechanics have changed, with some of the most important financial institutions in the country effectively sidelined from participating.

The one thing that has not changed is how important the federal funds market is. The Fed's policy rate, the federal funds *rate*, is set in the federal funds *market*. As the federal funds rate rises, so too can the cost of various kinds of consumer credit, including mortgages, student loans, credit cards and anything that uses the federal funds rate as a benchmark.

Before 2008, the federal funds market was an interbank market dominated by domestic commercial banks that kept cash balances at the Fed to satisfy regulatory requirements and would lend *excess* cash, or reserves, to each other in the market as part of settling daily financial activity. The interest rate on these loans is the federal funds rate, and the Fed targeted that rate by adjusting the quantity of reserves available to the banking system, thereby raising or lowering the cost of those loans.

In October 2008, the Federal Reserve began something new: paying interest on both required and excess reserves. In December of that year, the Fed lowered its policy rate essentially to zero. It also implemented several unconventional programs, including large-scale asset purchases (more commonly known as quantitative easing, or QE), which drove the Fed's balance sheet up to $4.5 trillion, five times its pre-crisis size.

These actions dramatically changed the character of the federal funds market.

Due to the massive amount of excess reserves in the system resulting from QE, adjusting the quantity of reserves has no practical effect on the federal funds market anymore. Instead, the Fed has a new "key tool," as Chair Yellen called it: paying interest on excess reserves (IOER) to adjust short-term interest rates. Throughout the recent tightening cycle, the Fed has "raised rates" by setting IOER *above* its target for the federal funds rate.

These new Fed mechanics have effectively removed domestic commercial banks from the federal funds market. Domestic banks that used to borrow and lend reserves in the interbank market are now more than happy to leave that cash at the Fed — earning the higher IOER with essentially zero counterparty risk — rather than lend it to other banks. Furthermore, in a system awash with so many reserves, the need to borrow reserves in the market has precipitously declined for domestic commercial banks.

With the role of domestic commercial banks diminished, the question is: What entities are trading in the federal funds market today? Research from the Cleveland Federal Reserve has an answer.

Lending is now dominated by government-sponsored enterprises (GSEs), notably the Federal Home Loan Banks (FHLB), which have accounts at the Fed but are not eligible for IOER. Therefore, they lend excess cash and earn the federal funds rate.

Borrowing in the federal funds market is now done primarily by foreign banks whose accounts at the Fed are eligible to earn interest and are not subject to domestic FDIC fees. These banks can borrow at the federal funds rate (1.16 percent) and then earn the IOER (1.25 percent) on their accounts at the Fed for a positive return — though how often is limited by international Basel III regulations.

The changing composition has also changed the size of the federal funds market. While daily trading volumes have been rising during this tightening cycle, the federal funds market remains smaller than it was before the crisis. Last week saw $90 billion traded in a day, but that is far below the pre-crisis peak of $170 billion.

The size, composition and mechanics of its market has changed, but the federal funds rate remains a crucial factor in economic activity. In additional to affecting consumer credit, it is likely the most important price for interest rate derivatives, which is a market measured in the hundreds of trillions of dollars.

As the Fed normalizes its balance sheet to a size no larger "than necessary to implement monetary policy efficiently and effectively," it will regain the ability to adjust the quantity of reserves in the system as the mechanism for targeting the federal funds rate; and the federal funds market could return to its pre-crisis character. Announcing such an intention would be a welcome surprise coming out of this week's FOMC meeting.

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