Statement to the House Committee on Financial Services

Committee Hearing On: "Striking the Right Balance Sheet"

Wednesday, January 14th, 2025

Washington, DC

Submitted by:

Allison Schrager
Senior Fellow
Manhattan Institute for Policy Research
52 Vanderbilt Avenue
New York, NY 10017

About the Author

Allison Schrager is a senior fellow at the Manhattan Institute and a *City Journal* contributing editor, where her research focuses on public finance, pensions, tax policy, labor markets, and monetary policy. She is a columnist at Bloomberg Opinion and is also the author of *An Economist Walks Into a Brothel* and other ways to understand risk.

Previously, Schrager was a journalist at *Quartz*, led retirement product innovation at Dimensional Fund Advisors, and consulted to international organizations. She has been a regular contributor to the *Economist*, *Reuters*, and *Bloomberg Businessweek*, and her writing has also appeared in *Playboy*, *Wired*, *National Review*, *Foreign Affairs*, and *City Journal*.

She received her undergraduate degree from the University of Edinburgh and a Ph.D. in Economics from Columbia University.

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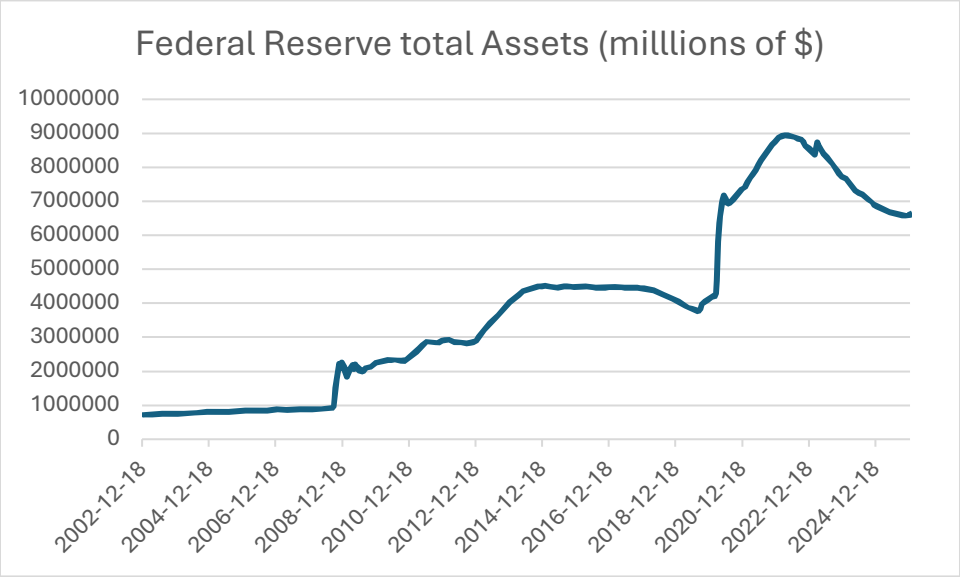
Statement

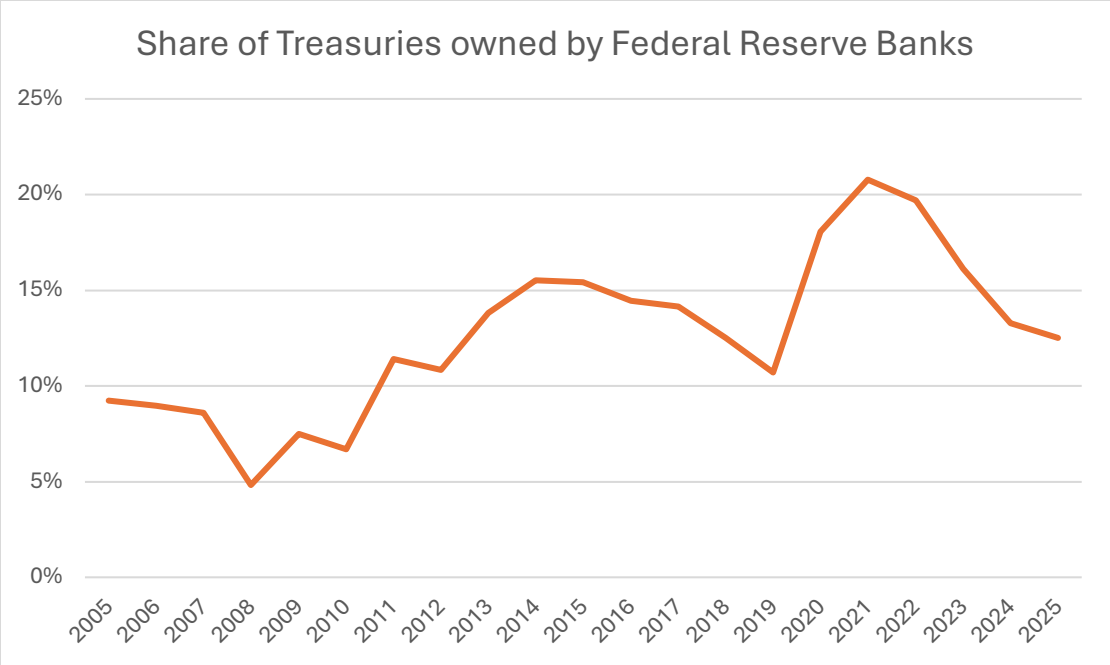
Thank you for the invitation to discuss with you today the size and composition of the Federal Reserve's balance sheet. I am a senior fellow at the Manhattan Institute, where I research fiscal and monetary policy and financial markets. I am also a columnist at Bloomberg Opinion.

The size of the Federal Reserve's balance sheet has grown exponentially since the start of the financial crisis. Changing its size and altering its composition has become one of the central tools of monetary policy. In August 2007, the balance sheet was around $870 billion, or about 6% of GDP. Today it is $6.6 trillion, or roughly 22% of GDP.



This has made the Fed a primary buyer of U.S. Treasuries. In 2006, the Federal Reserve Banks owned about 9% of total outstanding federal securities. That share peaked at around 20% during the pandemic and, even after years of so-called normalization, remains about 12%[1].

[1] US Treasury Bulletin



The balance sheet represents the assets and liabilities of the Fed. We can expect some growth in the balance sheet as the economy grows. Its extraordinary growth over the last twenty years is for two reasons. First, the Fed switched from a scarce-reserve system to an abundant-reserve regime, where it sets policy rates by paying interest on reserves. Paying interest on reserves means banks keep more reserves at the Fed, which increases the size of the balance sheet. This switch makes it easier to control the policy rate, especially when rates are near zero.

Traditionally, the Fed mostly bought short-term Treasuries with bank reserves, which—like reserves—are highly liquid and very short duration. But this changed in November 2008, when the first of four rounds of Quantitative Easing (QE) commenced and the Fed used reserves to make large-scale purchases of longer-dated bonds and mortgage-backed securities. The size and scope of QE is the other reason the balance sheet has grown.

The ample-reserve system can be justified. It may have made it easier to conduct expansionary monetary policy, within reason, without causing inflation. However, the growth of the Fed's balance sheet was not completely benign, because the composition of its assets can have a profound impact on the economy. Buying longer-term bonds and mortgage-backed securities has not only introduced distortions into the economy, it may also threaten Fed independence in the future.

Several prominent economists argued that the first rounds of QE would damage the economy, but when inflation did not appear, their concerns were dismissed. Enough so that when the pandemic arrived and we risked a severe recession and disruption in financial markets, the scale of the new QE program was unprecedented. Purchases in April 2020 alone exceeded $1 trillion. Cumulative purchases since 2020—"QE4"—exceeded $4.6 trillion, more than all three previous QE programs combined. The share of the Fed's Treasury portfolio that matures more than five

years into the future doubled from less than 20% at the end of 2006 to more than 40% at the end of March 2022.

The Fed did not just buy longer-term bonds; it also intervened in the mortgage market by buying mortgage-backed securities (MBS). The Fed first began large-scale MBS purchases in 2008, at the height of the financial crisis, when there was a collapse in confidence in the mortgage market. At the end of QE1, the Federal Reserve owned more than 20% of the agency MBS market. At the height of the pandemic, even though it was not the same kind of crisis in the housing market, the Fed bought MBS on a larger scale and continued to do so well into 2022. The Fed's MBS purchases totaled $1.33 trillion, equal to nearly 90% of the growth in MBS. By March 2022, the Federal Reserve's MBS holdings amounted to nearly 30% of outstanding agency MBS.

Like any policy, there are costs and benefits to maintaining such a balance sheet. My primary concern is the risks QE introduced to the economy with questionable benefits. It has gone from a policy that was supposed to be short-term in nature and used only in periods of extraordinary financial distress to a constant feature of our economy that has become part of the Fed's standard toolkit whenever there is a weakening in economic conditions.

It is not at all clear that QE provides much benefit to the macroeconomy. The hope is that when the Fed reduces the supply of long-duration assets in the hands of private investors, their prices will be bid higher, or long-term yields will fall, providing a stimulative effect on the economy. When short-term rates are near zero and cannot go much lower, this may offer the Fed another avenue to boost economic demand.

But whether the first three rounds of QE had a notable and long-term impact on interest rates is hotly debated among economists. One research paper observed that Fed economists estimate QE did lower the yield on 10-year bonds, but academic economists found little or only a fleeting impact[2]. The size and scope of QE4 was much larger, so it may be reasonable to presume that QE4 exerted some downward pressure on longer-term rates and may still. Though some economists question whether that is true[3].

Even if there is spotty evidence of QE's impact on bond yields, it can still have a distortionary impact on the wider economy. Traditionally, bond markets were segmented: the Fed had a significant impact on shorter-term rates, below five years, and little impact on longer-term rates, which are set in the market. This market price conveys important information about the price of risk in the economy and is the foundation of how many assets are priced. When the Fed attempts to alter this rate, or simply becomes a large and captive buyer, prices have less meaning. In that case, risk can be mispriced, causing bubbles and financial instability. It also poses a financial risk

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[2] Brian Fabo, Martina Jančoková, Elisabeth Kempf, Ľuboš Pástor,
Fifty shades of QE: Comparing findings of central bankers and academics,
Journal of Monetary Economics, Volume 120, 2021, Pages 1-20.

[3] Andrew T. Levin, Brian L. Lu, and William R. Nelson, "Quantifying the Costs and Benefits of Quantitative Easing," NBER Working Paper 30749 December 2022.

to taxpayers because longer-term bond prices are more volatile and have a longer duration than the Fed's liabilities. One estimate projects the cost of QE4 will be more than $760 billion.

The evidence is stronger that buying MBS has a notable impact on the mortgage market by lowering the spread between mortgage rates and bonds. When the Fed resumed QE in March 2020, there was apparent distress in the mortgage market. But the Fed kept buying MBS for another two years even when the housing market had not only fully recovered, but was extremely tight, as many Americans moved homes, refinanced, and home prices hit record highs. We still feel the impact of this policy error. More than 50% of mortgage holders have mortgage rates below 4% and cannot afford to move and take on a higher rate, which is constraining supply in the housing market and making Americans less mobile.

Another problem with QE is that while it is relatively easy to implement, it is very hard to end. When the Fed tried to phase out its bond buying in 2013, the result was a spike in yields—the taper tantrum—because markets had become accustomed to one large, captive buyer of Treasuries. Central bankers have since decided that ending QE, or Quantitative Tightening (QT), is best done by letting the portfolio mature rather than selling securities, and by communicating this plan far in advance. But this also creates financial-stability issues. There is an inherent asymmetry: QE can be implemented quickly when the economy is weak, but must be ended slowly when the economy is hot. Also, shorter-term bonds mature sooner, so the duration of the Fed's portfolio gets longer, worsening the duration mismatch with its liabilities. The Fed is already ending QT, and it is now buying assets again with its maturing debt.

Even more worrying, if QE becomes a regular feature of monetary policy, it poses grave risks to Fed independence. QE is a form of yield-curve control, where the government attempts to influence interest rates across all maturities. When this tool is in the Fed's toolbox, it is all too tempting to pressure the Fed to keep the entire yield curve low in order to reduce the cost of debt service or mortgage rates. Japan attempted this at the cost of introducing distortions into its economy. Firms stayed in business only because of the low cost of credit, and the misallocation of capital lowered economic growth and contributed to the lost decades. Even more concerning, QE leaves open the possibility of regularly buying corporate debt or even equities, as other countries have done. It risks causing the kinds of problems we now see in the mortgage market on a much wider scale.

Some increase in the Fed's balance sheet is not necessarily a concern; it is part of a healthy and growing economy. But the reasons why the balance sheet has grown as much as it has, and the changing composition of its assets, should be a matter of grave concern for policymakers. There may be some justification for buying assets other than short-term Treasuries in extreme instances of illiquidity, but any such program should last only a short time—perhaps six months—after the liquidity event has passed, and should not be used as a way to manage economic demand or directly influence asset prices.

Thank you, I would be happy to take your questions.