US Daily: The Fed's Balance Sheet Runoff: Tapering to Avoid a Tantrum (Abecasis/Marshall)

- Last May, the Fed cut the pace of quantitative tightening (QT) in half in order to shrink the balance sheet more cautiously and facilitate the redistribution of reserves across banks. Since then, the Fed's balance sheet has shrunk by another $400bn to $7tn, which has been largely absorbed by a $330bn decline in the reverse repo (RRP) facility.
- Key indicators of money market conditions suggest that bank reserves remain "abundant." However, noticeable increases in money market rates at the end of September and a modestly higher sensitivity to changes in reserves in some pockets of funding markets over the last couple of months suggest that runoff is slowly bringing reserve levels towards the "ample" region that the FOMC is aiming for.
- Fed officials appear to be in no rush to end QT given that reserves are still abundant. However, the combination of ongoing balance sheet runoff with the reinstatement of the debt limit—which will keep reserve balances temporarily elevated by squeezing the Treasury General Account (TGA)— will likely make it hard for the FOMC to gauge when to stop QT in the first half of next year.
- To give the Committee more time to evaluate conditions in money markets and avoid rate spikes when TGA balances start rising again, we expect the FOMC to slow the pace of runoff further at the January meeting. The most likely implementation is for the FOMC to stop runoff of Treasury securities and keep the current $35bn cap on mortgage-backed securities (MBS) unchanged, consistent with the Committee's goal of tilting the balance sheet towards Treasuries over time. This would likely slow the realized monthly pace of runoff to around $20bn going forward (vs. $40-45bn currently).
- Given the slower pace of runoff, we now expect QT to stop at the end of 2025Q2 (vs. 2025Q1 previously), when reserves are around 13% of bank assets and the balance sheet is around 22% of GDP. We continue to expect the Fed's remaining balance sheet runoff to have modest effects on interest rates, financial conditions, growth, and inflation. We also expect these changes to have minimal effects on net Treasury supply, as two fewer months of runoff than our prior forecast (worth $50bn) are offset by a later start of MBS reinvestments into Treasuries (worth $50-60bn), which we expect to begin once QT ends.

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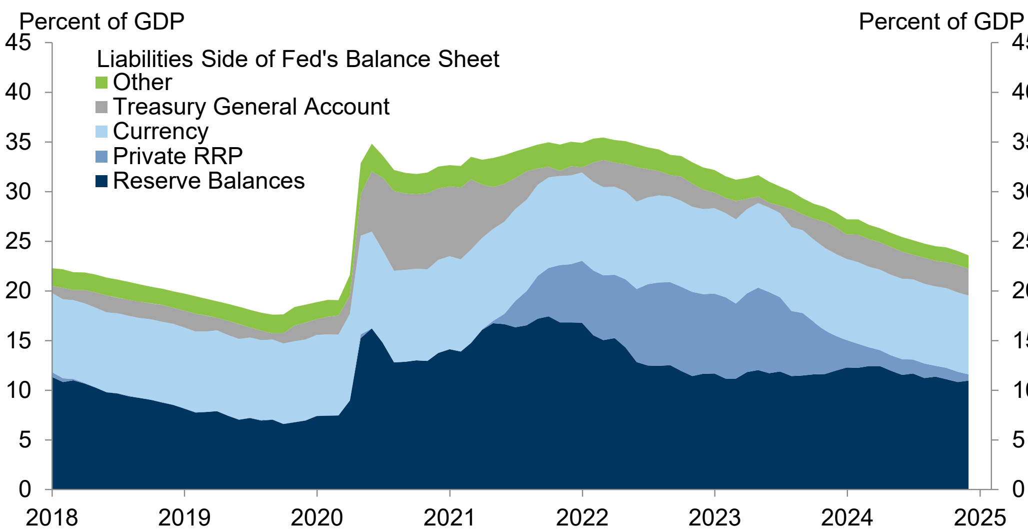
The Fed's Balance Sheet Runoff: Tapering to Avoid a Tantrum

Last May, the Fed cut the pace of quantitative tightening (QT) in half in order to shrink the balance sheet more cautiously and facilitate the redistribution of reserves across banks. Since then, the Fed's balance sheet has shrunk by another $400bn to $7tn (Exhibit 1).

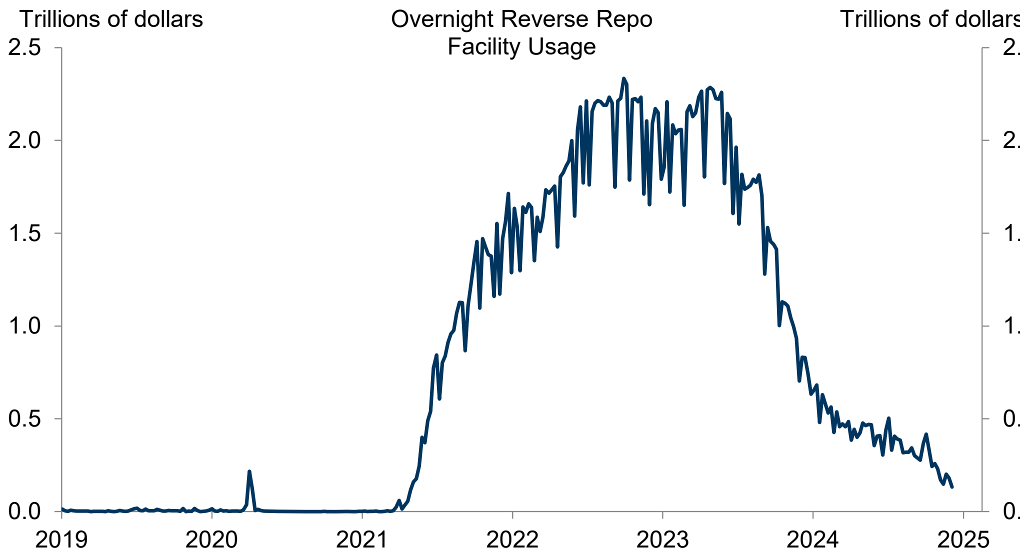
Exhibit 1: The Fed's Balance Sheet Has Continued to Shrink Over the Last Year



Source: Goldman Sachs Global Investment Research, Federal Reserve

So far, the decline in the size of the Fed's balance sheet has been largely absorbed by a $330bn decline in the reverse repo (RRP) facility. With RRP balances down to $130bn from a peak of $2.3tn in 2022, further reductions in the Fed's balance sheet over the next year will mostly come out of bank reserves, holding other liabilities constant (Exhibit 2).

Exhibit 2: Balances at the RRP Facility Have Declined to Low Levels, Which Implies That Further Balance Sheet Runoff Will Have to Come Out of Bank Reserves

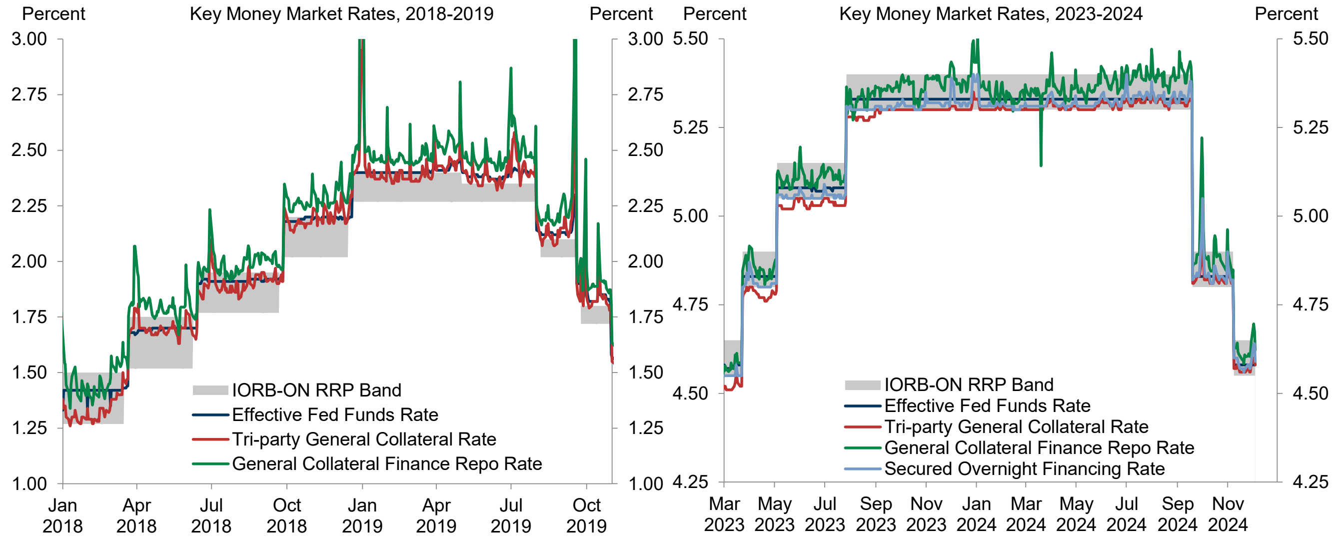


Source: Goldman Sachs Global Investment Research, Federal Reserve

Key indicators of money market conditions suggest that bank reserves remain abundant. As shown in Exhibit 3, the spreads between key money market rates and the interest rate on reserve balances (IORB) remain well below their 2019 levels. That being said, some spreads have increased slowly over the last few months, and in September the secured overnight financing rate (SOFR) spiked above the top of the Fed's target range for the first time since March 2020.

Like the smaller spikes in repo rates over the last year, this increase was likely driven by temporary intermediation challenges in the repo market, as banks seemed to pull back from intermediating trades that increase the size of their balance sheet. And while ending QT would not directly address these problems, it would stabilize liquidity in the system and reduce the supply of Treasuries that the private sector needs to absorb. These balance sheet constraints probably explain why the Fed's Standing Repo Facility (SRF)—which is designed to be a liquidity backstop and prevent rate spikes—remains mostly untapped, since its use also expands banks' balance sheets.

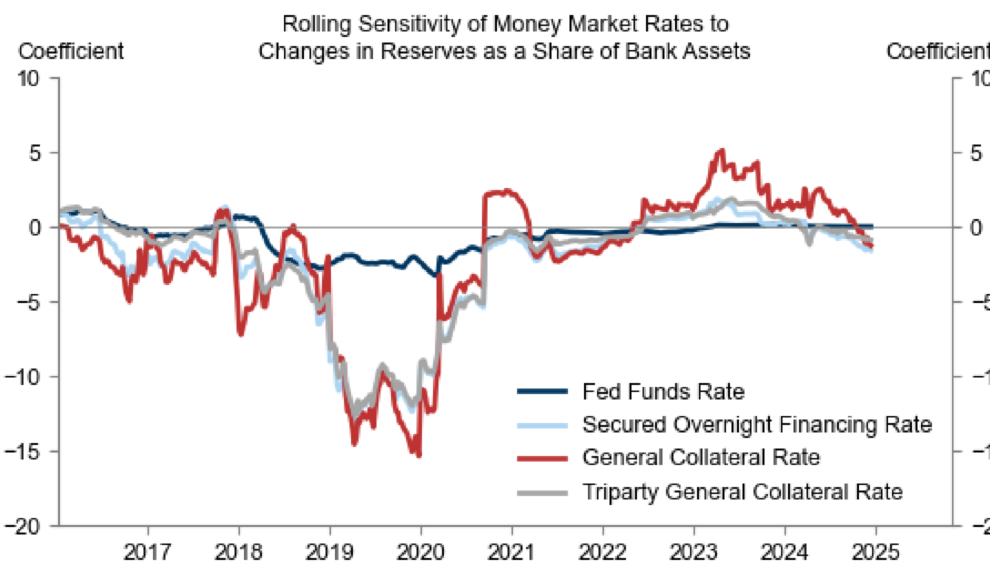
Exhibit 3: Key Money Market Rates Have Moved Up Somewhat but Their Spreads to Interest on Reserve Balances (IORB) Remain Below 2019 Levels



Source: Goldman Sachs Global Investment Research, Federal Reserve

The sensitivity of money market rates to changes in reserves—the key indicator of whether reserve balances are moving into a steeper region of the reserves demand curve that could cause instability in money markets—remains around zero, suggesting that reserves are abundant (Exhibit 4). While the sensitivity of the fed funds rate to changes in reserves has remained near zero, other money market rates—which tend to see higher trading volumes—have become slightly more sensitive over the last couple of months.

Exhibit 4: Money Market Rates Remain Less Sensitive to Changes in Reserves Than in 2018-2019, Suggesting Reserves Remain Abundant



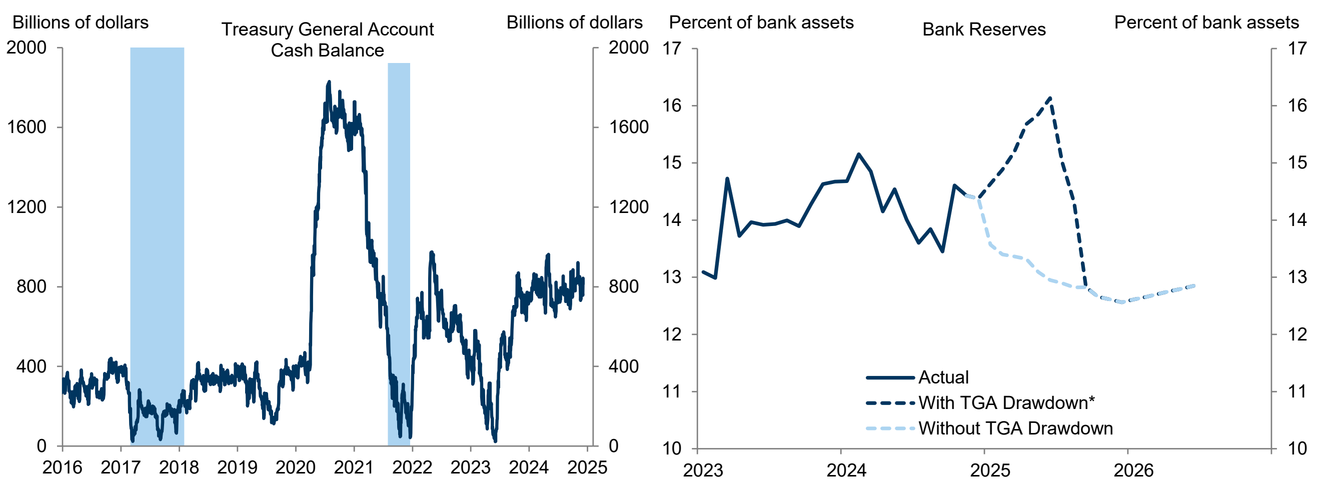
Source: Goldman Sachs Global Investment Research

Consistent with this, Fed officials appear to be in no rush to end QT. However, the combination of balance sheet runoff with the reinstatement of the debt limit will likely make it hard for the FOMC to gauge when to stop QT in the first half of next year. Although the debt limit will almost certainly be suspended next year, prior episodes in which one party controlled both the White House and Congress in 2017 and 2021 still featured a gap between the reinstatement of the debt limit and its subsequent suspension. During this period, Treasury needs to draw on its balance in the Treasury General Account (TGA) at the Fed to fund spending (left side of Exhibit 5). As TGA balances flow to the private sector, bank reserves increase, making money market conditions artificially easy. Once the debt limit is suspended again and Treasury rebuilds its TGA balance, reserve balances will likely decline rapidly.

These swings in TGA balances will make assessing money market conditions especially challenging in the first half of next year, just as reserves as a share of bank assets approach the 12-13% level that we and others expect to be the optimal stopping point for QT. If runoff proceeds at its current pace, the Fed risks disruption in money markets once Treasury starts rebuilding the TGA. The Fed staff has already briefed the Committee on this possibility at the November meeting.

While conditions in money markets are easier today than in 2019, the market turbulence that forced the Fed to end QT early in September 2019 was partly triggered by similar dynamics. At the time, tax payments at the end of the quarter also quickly drained reserves from the banking system towards the TGA. We think that Fed officials will try to avoid a similar situation next year.

Exhibit 5: The Reinstatement of the Debt Ceiling Next Year Will Likely Force Treasury to Draw Down TGA Balances and Artificially Inflate Reserves, Which Argues for More Caution as Runoff Continues



Note: Shaded areas indicate prior debt ceiling episodes under one-party control of the White House and Congress.

* We assume TGA balances fall $100bn per month through June and rise back up to $850bn by August.

Source: Goldman Sachs Global Investment Research, Federal Reserve

As a result, we expect the FOMC to slow the pace of runoff further at the January meeting. Specifically, we expect the FOMC to stop runoff in Treasury securities and keep the current $35bn cap on mortgage-backed securities (MBS) unchanged, consistent with the FOMC's goal of tilting the balance sheet away from MBS and towards Treasuries over time. This would imply a monthly realized pace of runoff of around $20bn going forward (vs. $40-45bn currently). We also think there is a chance that the Fed could conduct temporary repo operations of the same size of the TGA swings early next year to offset temporary changes in reserves and get a clearer read of money market conditions.

Given the slower pace of runoff, we now expect QT to last until the end of 2025Q2 (vs. 2025Q1 previously). We continue to expect runoff to end when reserves are a touch below 13% of bank assets and the balance sheet is around 22% of GDP (vs. 23% currently and 18% in 2019). These changes in the pace of runoff will likely have a minimal effect on net Treasury supply, as two fewer months of runoff than under our prior forecast (worth $50bn) are offset by a later start of MBS reinvestments into Treasuries (worth $50-60bn), which we expect to begin once QT ends.

We expect the Fed's remaining balance sheet runoff to have modest effects on interest rates, broader financial conditions, growth, and inflation—much less than the impact of fed funds rate changes. We likewise do not expect these changes in the pace of runoff to have meaningful effects on the economy.

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William Marshall

Disclosure Appendix

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We, Jan Hatzius, Alec Phillips, David Mericle, Ronnie Walker, Manuel Abecasis, Elsie Peng, Jessica Rindels and William Marshall, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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