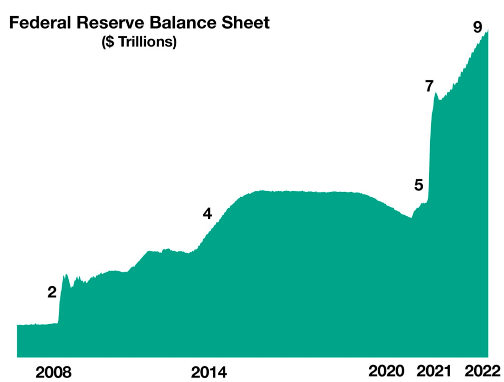
What Is The Fed Balance Sheet & Why It Is So Consequential Now - Monetary Policy Overview

Like any large financially driven entity, the Federal Reserve maintains and modifies a balance sheet made up of assets and liabilities. The Fed uses the balance sheet as a monetary policy tool, meaning that it has the ability to cause rates to rise or fall by making adjustments to the balance sheet. The majority of the assets on the Fed's balance sheet are U.S. Treasury bonds and mortgage bonds, which happen to be critical fixed income components within the U.S. economy.

Since the Federal Reserve has access to such massive amounts of capital, it can buy and sell enormous volumes of Treasury and mortgage bonds in the open market, thus controlling increases and decreases in supply nearly instantaneously. So by buying vast amounts of Treasury and mortgage bonds and placing them on its balance sheet, it is essentially removing supply from the markets, thus causing an increase in bond prices resulting in decreasing rates. Should it sell bonds from its balance sheet into the fixed income markets, then bond prices would fall with rates rising inversely.

The Fed announced that it intends to start shrinking its balance sheet once it has started increasing short term rates this March. The Fed balance sheet began to expand during the financial crisis of 2008, when it starting buying massive amounts of bonds in order to maintain liquidity in a rapidly deteriorating market, while also keeping rates low in order to help stimulate economic activity. The size of the Fed balance sheet has grown from $888 billion in mid-2008 to over $8.8 trillion this past month, the largest amount ever.



Source: Federal Reserve