

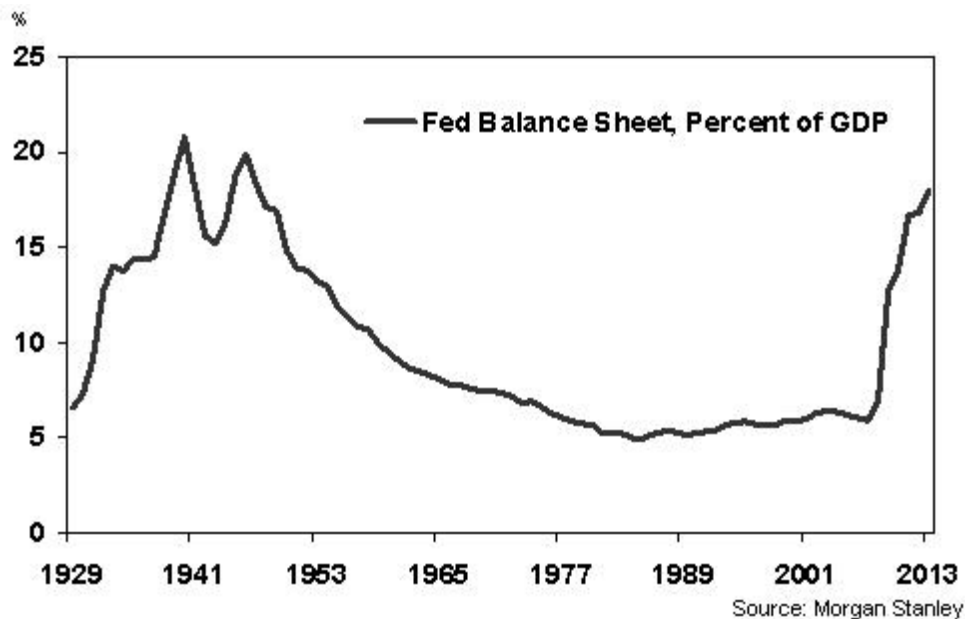
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# Huge Fed Balance Sheet Has Historical Precedent

By Michael S. Derby

The massive and growing size of the **Federal Reserve's** balance sheet is the source of enduring angst for many central bank watchers, but a note from **Morgan Stanley** observes that on a relative basis, we've been here before.

The bank told clients that twice before the size of the Fed's holdings have reached a share of the nation's gross domestic product comparable to where the central bank appears to be heading. Economist **Vincent Reinhart** wrote that during the Great Depression and during World War II, the Fed balance sheet topped out at around 20% of GDP. The current size of Fed holdings, which stand at just over \$3 trillion, are short of that mark, but not by much.



Given that the Fed is widely expected to press forward with its campaign to buy around \$85 billion a month in Treasury and mortgage debt for some time to come, it's clear that on a proportional basis, the size of the Fed's holding could soon reach a share of GDP that matches or even exceeds what was seen during those two historical episodes. The Fed is meeting on Tuesday and Wednesday in a gathering most expect will keep the bond buying moving forward.

Mr. Reinhart warns that what happened in the 30s and 40s has a somewhat chilling message for central bankers today. He warns huge levels of Fed holdings relative to the rest of the economy can ultimately threaten central-bank independence, and run the risk of making the central bank the servant of fiscal policy makers.

The economist wrote that Fed holdings grew so large relative to the rest of the economy in the 40s in large part because the Fed was operating under orders from the Treasury to keep long-term borrowing costs down.

This greatly alarmed the policy makers who sat on the monetary-policy-setting **Federal Open Market Committee**, Mr. Reinhart said. They worried that a policy undertaken in response to the emergency wartime conditions was running the risk of becoming the normal stance for the Fed. Central bankers count as a given that when their institution buys too much government debt, it risks a major breakout in inflation, which the Fed is charged with keeping under control.

The situation was resolved by what was known as the “The Accord” in 1951 where the Fed was given back its monetary policy freedom in exchange for assisting in a restructuring of some of the government’s debt, Mr. Reinhart said.

When it comes to the Fed’s current situation, historical precedents will only get you so far. There have been huge changes in the economy and finance, as well as changes in the Fed’s mandate, in the century the central bank has been in business. For one thing, the rapid expansion of the Fed’s balance sheet over recent years has been driven by the central bank itself.

That said, the huge pace of Fed buying has made the Fed a huge player in the market for government and mortgage bonds. Many now worry that if the Fed carries on too much farther with its asset purchases, it risks severely disrupting the basic functioning of these key markets.

At the same time, some critics contend the very low borrowing costs the Fed is engineering via its asset buying have lowered Treasury yields so much that elected leaders have been able to avoid making the hard choices about cutting deficits. That’s because with the Fed trying to keep yields low, the Treasury is able to dodge the rising borrowing costs that would traditionally attend huge levels of deficit spending.

More broadly, the continued expansion of the Fed’s balance sheet comes with inflation risks. Recently, a prominent group of economists argued in a paper that U.S. government borrowing levels were testing levels that could risk a loss of investor confidence, leading to a sharp surge in market rates, which could in turn severely compromise the Fed’s ability to effectively conduct monetary policy.

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