Payment Needs and the Size of the Federal Reserve's Balance Sheet

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This short note explains the challenges with shrinking the Fed's balance sheet. It shows that policies to reduce the balance sheet are synonymous with policies that reduce the demand for bank reserves. At the same time, it shows that controlling money market volatility while keeping the balance sheet as small as possible requires that the central bank commits to an elastic supply of reserves. This can be achieved by a standing repurchase facility open to banks, along the lines of the ones at the Bank of England or the ECB. It argues that objections to this arrangement that have so far appealed to stigma ultimately refer to supervisory failures that can and should be corrected.