US Federal Reserve normalising its monetary policy stance

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The US economy has recovered from the financial crisis. The unemployment rate in the United States has already fallen to the level prevailing before the financial crisis, and inflation has risen to a point close to the 2% targeted by the central bank, the Federal Reserve (Fed). The Fed has been in the process of winding down the unconventional monetary policies that it pursued during the financial crisis. It gradually ceased its net purchases of securities during 2014, and in December 2015 took its first decision to raise the federal funds rate. In September 2017, the Fed decided to begin in October to reduce the holdings of securities on its balance sheet that it had purchased in three different securities purchase programmes. Although, initially, holding securities was seen as a temporary measure, in public debate it has been suggested that there are grounds for leaving the Fed's balance sheet permanently above its pre-crisis level.

In spring 2013, US Federal Reserve Chairman Ben Bernanke stated at a Congress hearing that he felt the time was approaching to taper the monthly purchase volumes in the asset purchase programmes. This unnerved the international financial markets. Market volatility increased on the foreign exchange and fixed income markets, and a rise in interest rates turned international flows of capital away from emerging economies and towards the United States, which strengthened the dollar. This 2013 'taper tantrum' demonstrated that the financial markets are not indifferent to the manner and pace at which the unconventional monetary policies are dismantled.

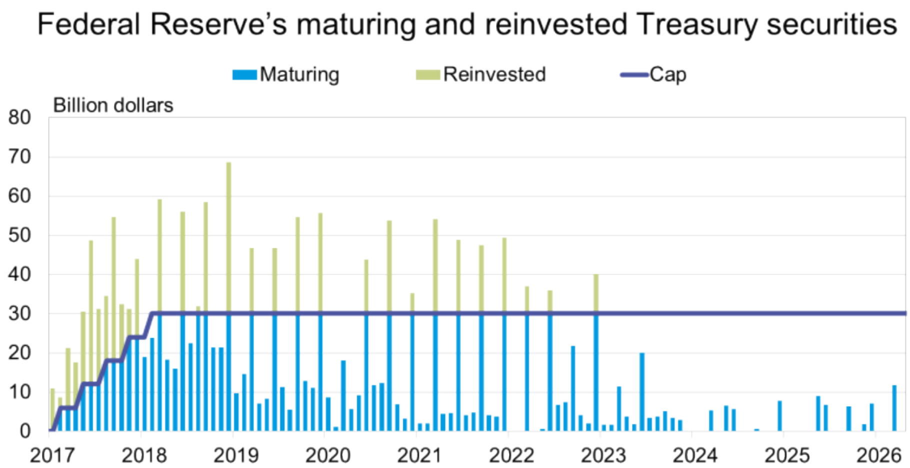
The Fed made the actual decision to scale back the asset purchase programmes in December 2013. It subsequently discontinued net purchases of securities in phases during 2014 and has since kept its securities holdings unchanged at approximately USD 4,200 billion by replacing maturing securities with new ones. Of the Fed's securities holdings, 57% are Treasury securities and the remainder are mortgage-backed securities.

Following the discontinuation of the purchase programmes, the Fed has regularly referred to its plans to reduce the holdings of securities acquired during the programmes. Based on the principles announced by the Fed, it intends to decrease its securities holdings gradually, proactively and only after the federal funds rate has been raised sufficiently.

At its June 2017 meeting, the Fed's Federal Open Market Committee (FOMC) published a more detailed report about the way in which the scaling back of the balance sheet is to be conducted. The FOMC will set a monthly limit on maturing Treasury securities, and this limit will be raised in stages during the year, from USD 6 billion to USD 30 billion. The corresponding figures for mortgage-backed securities are USD 4 billion and USD 20 billion. A year after the start of this scaling back, the amount of securities on the Fed's balance sheet will be decreasing monthly by USD 50 billion. In September, the FOMC decided, in line with the report published in June, that the scaling back of its balance sheet would begin in October 2017.

Most of the securities held by the Federal Reserve are Treasury securities with a maturity period of 1–3 years. This being the case, the amount of Treasury securities maturing monthly in the coming years will total an average of USD 30–35 billion (Chart). The Fed will replace some of the maturing securities by purchasing new Treasury securities on the maturity date. The maturities of mortgage-backed securities are, on average, considerably longer than the Treasury securities held by the central bank. The Fed anticipates that it will reduce holdings of these securities, too, by gradually selling some of them.

Chart.



The chart incorporates all System Open Market Account (SOMA) maturities, but excludes mortgage-backed securities. The calculations take no account of the type of reinvestments (amounting to more than USD 500 billion) and make no other assumptions about these either.
Source: Federal Reserve and calculations by the author.
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To avoid sudden movements in the prices and interest rates of securities, the Fed will decrease its securities holdings slowly. Further to this, the FOMC will seek to curb the rise in interest rates by issuing carefully worded announcements on a persistent basis about the normalisation of monetary policy. These announcements have already allowed the markets to price some of the effects of a shrinking balance sheet in advance. The FOMC's announcement on commencement of reducing the balance sheet had a number of immediate impacts on the markets. The dollar strengthened by over 1% against the euro, but the yield on 10-year government bonds rose by only 5 basis points (i.e. 0.05 percentage points).

The scaling back of the Fed's balance sheet could have longer-term impacts on the markets. When the Fed's securities holdings decrease, the amount of securities held by the private sector will correspondingly rise, which may increase their interest rates. Retaining the size of central bank purchase programmes and balance sheets through reinvestment has led, above all, to a fall in long-term interest rates. The impact has been felt in the term premium of interest rates for securities – i.e. the extra sum payable on top of the expected interest rate, due to uncertainty – and this has led to a decrease in the term premium. The tapering of the Fed's securities holdings can be expected correspondingly to increase this premium.

Although the Fed's aim is to reduce its balance sheet, it is likely in the future to hold more securities than it did before the financial crisis. In part this is because of the growth in the demand for cash, with some of this growth originating outside the United States. On the other hand, the regulatory changes aimed at securing the liquidity of the banks will encourage banks to hold funds in their accounts with the Fed. A number of researchers have suggested that the Fed's active role on the financial markets may reduce the incentive for market participants to engage in excessive risk taking.[1] This would require the Fed to practise an active balance sheet policy in the future, and for this it would need to hold more Treasury securities than hitherto.

Tags

central bank's balance sheet, Federal Reserve, mortgage-backed securities, Treasury securities, unconventional monetary policy

1. Greenwood, R., Hanson, S. and Stein, J. (2016) The Federal Reserve's Balance Sheet as a Financial-Stability Tool. Jackson Hole Symposium 2016.