Unwinding the Fed's Asset Purchases

BY JOHN A. WEINBERG

The Federal Open Market Committee (FOMC) announced in June that it "expects to begin implementing a balance sheet normalization program this year." In other words, it plans to start unwinding the large-scale asset purchases, known as quantitative easing, that it began in November 2008. How might we expect markets to react as the Committee begins to provide more specific information about the timing of normalization?

Of course, we can't know for certain how markets will react, as the unwinding of the asset purchases will be a large and largely unprecedented endeavor. The Fed's balance sheet, now standing at more than $4.4 trillion, increased from 6 percent of GDP before the financial crisis to 23 percent today.

The rationale behind the asset purchase program was that the Fed felt the need to add accommodation even after interest rates had been set at their effective floor. In particular, the purchase of longer-term assets was intended to put downward pressure on longer-term interest rates. Additionally, the Fed sought to support the housing market with purchases of housing agency debt and agency mortgage-backed securities; these housing-related securities now make up 40 percent of the Fed's assets.

Following its June meeting, the FOMC released a statement of the general principles it intended to follow in shrinking its portfolio. It stated that the process will be gradual and predictable, allowing progressively more of its bonds to run off as they mature rather than reinvesting the proceeds as the Fed has been doing. For Treasuries, the FOMC indicated that it will initially allow $6 billion to run off per month, an amount that is to increase in regular, predetermined steps at three-month intervals. For housing-related securities, $4 billion per month is to be run off, again with regular increases every three months. The Committee has not said when it expects to begin this process but has indicated that it will likely be later this year.

To get an idea of the market's likely reaction to this process, some may look to the "taper tantrum" episode of 2013. There, markets reacted abruptly to signals from the Fed's leadership that the FOMC would soon taper off its asset purchases, with long-term bond rates rising sharply. Some might look to this episode as a natural model for market reactions to major Fed balance sheet announcements.

The taper tantrum episode seems fundamentally to represent a volatile reaction to uncertainty about the Fed's intents. To be sure, while the FOMC has pursued a policy of transparency with regard to the unwinding, there are nontrivial open questions — to which markets will react to some degree once the FOMC answers. These include not only the timing of when the unwinding program will start, but also how much larger, if at all, the Fed's post-unwinding balance sheet will be compared to its pre-crisis balance sheet. In other words, just what does normalization mean?

Nonetheless, there's a significant difference in today's environment with regard to unwinding compared to the uncertainty that prompted the taper tantrum. The market's reaction in 2013 to the FOMC's announcement of tapering its asset purchase program reflected that market participants perceived it as a departure point in the future path of interest rates. In the minds of observers, a change in balance sheet policy presaged a change in interest rate policy. And as I noted in an earlier column, the market's sensitivity to the announcement was heightened by the fact that the historical relationship between the Fed's policy rate and economic indicators no longer held in an era of near-zero rates. Markets were limited in their ability to rely on past FOMC practice to gauge the likely course of its interest-rate targets because the period of near-zero rates represented a new policy regime. (See "Fed Communications in Unusual Times," *Econ Focus*, First Quarter 2014.)

As we move away from that era, balance sheet policy can be more divorced from interest rate policy. Where markets in 2013 were watching for signs of when target interest rates would take an upward course, the situation today is that the process of normalizing rates is well under way. In addition, because interest rates are no longer in a region where the FOMC is constrained by a zero lower bound, market participants may feel that they can again place greater reliance on economic indicators for the clues to the future course of policy rates.

This is not to say that balance sheet reduction will be a nonevent. The sheer size of the Fed's holdings could certainly mean that a change in its securities purchasing practices could have direct effects on market prices. But the additional uncertainty about the path of interest rate policy should be considerably reduced now, compared to 2013.

With the growing separation of interest rate policy and balance sheet policy, market participants will have less cause to perceive that the time frame for unwinding presages a major shift in the path of interest rates. The gradual and predictable nature of the Fed's announced policy for unwinding should also contribute to moderating the market's perceptions. Market participants thus will be less likely, all other things equal, to respond with the outsized reaction of 2013. In this, as in most things, market reactions are ultimately a matter of perceptions. **EF**

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