The consequences of shrinking the Fed’s balance sheet

by GAVYN DAVIES∗

The Federal Reserve is now actively considering its strategy for the “normalisation” of its balance sheet, which it has indicated will start before the end of the calendar year. The key question is whether the shrinkage of the balance sheet, which amounts to the reversal of quantitative easing, will remove the underpinnings from the US bond market and global risk assets. We think there are three good reasons for believing that the effects of balance sheet normalisation on the bond market will be fairly muted: first, the balance sheet will not return fully to its 2008 starting point, so the scale of the market impact will be much less than the original impact of QE; second, some of the effects of future balance sheet normalisation may already be in the market; and, third, the Fed stands ready to offset any bearish impact from the balance sheet by easing the intended path for short rate increases if necessary. For these reasons, we think that, with effective communication, the Fed can avoid a repeat of the 2013 taper tantrum when it announces its balance sheet strategy in coming months.

The Federal Reserve is actively considering a profound change in US monetary policy, in effect the reversal of quantitative easing (QE). In its March meeting, the FOMC discussed its strategy for the future run down of its balance sheet, and said that further debate would take place in upcoming meetings.¹

The FOMC has already concluded that “a change in the Committee’s reinvestment policy would likely be appropriate later this year” and that this would need to be flagged “well in advance”. The minutes to the May meeting (to be published on 24 May) will probably provide some further indication about their thinking on this important topic.

Investors are therefore beginning to focus on the possible consequences of the reversal of QE on interest rates and the shape of the yield curve.

In Davies (2017), I outlined the likely path for the US central bank balance sheet under the new policy, and predicted that this would cause global QE to turn negative in 2019, after being consistently positive by about 2 percentage points of global GDP in every year since 2011. The great unknown is whether this reversal of central bank support will remove the underpinnings from the bond market, risk assets and the global economic upswing.

I take the optimistic side of this debate, but investor opinion is sharply divided on the matter.²

The FOMC has already outlined some of the principles that will guide the shrinkage of its balance sheet. The central bank’s portfolio of treasuries and mortgage backed securities will almost certainly be run down in a gradual and predictable manner, allowing bonds to run off as they mature, instead of reinvesting the proceeds in more bonds. There will be no direct sales of bonds into the open market.

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The run down will start only when the normalisation of interest rates is “well underway” (probably implying a Fed funds rate of around 1.5 per cent), and when the FOMC is confident that there is little risk of needing to reverse the direction of monetary policy in the foreseeable future.

The FOMC is still deciding whether reinvestments should cease in a single jump, or whether they should be phased out more gradually. But the Committee clearly wants to set the balance sheet reduction on a predictable long term path, while relying on changes in interest rates to make shorter term alterations to monetary policy.

What would be the effect of fully reversing the quantitative easing that has taken place since 2007, a period in which the Fed’s balance sheet has risen by $3.5 trillion, from $0.9 trillion to $4.4 trillion? There have been many studies on the economic effects of this unconventional monetary easing, including Engegen et al. (2015) that has been quoted recently by Yellen (2017). This study presents conclusions that may be near the consensus of Fed thinking on the subject at present.

The Fed study suggests that the effect of the entire QE programme was to reduce 10 year term premium, and therefore the bond yield, by 120 basis points in 2013. This is estimated to have reduced US unemployment by about 1.25 percentage points and increased inflation by about 0.5 percentage points. On my reckoning, other results in the Engel et al paper indicate that the QE programme increased US equity prices by 11-15 per cent, and reduced the dollar effective exchange rate by 4.5-5 per cent.

These are obviously very large effects, and if we were to make the highly simplified assumption that they will be fully reversed during the unwind of QE, there would be plenty of reason to be worried.

However, that simplified assumption does not make much sense. There are at least three good reasons for believing that the effects of the run down will be much smaller than the impact of the original QE programme, quoted above.

First, the scale of reduction in the Fed’s balance sheet in the next few years will be nowhere near as large as the increase during the expansion phase. For various reasons related to changes in the Fed’s mechanism for controlling short rates, and in the demand for liquidity in the banking sector, it will be necessary for the central bank’s balance sheet to be permanently larger than it was before the crisis (see Davies, 2017).

The FOMC will probably publish the full path for the expected balance sheet before it even starts the run down. This is likely to show that the Fed will shed only around one third to one half of the assets it accumulated during the expansion phase, implying that the balance sheet will drop by $1.2-1.8 billion over several years. The total effect of this might be to increase 10 year bond yields by about 40-60 basis points, and the other economic effects quoted above would also need to be scaled down proportionately.

Figure 1 shows a likely path for the balance sheet (actually, the total securities held in the Fed’s System Open Market Account), compared to the desired long term or “normalised” size.
Second, some of the effects of balance sheet normalisation may already be in the market. According to the New York Fed’s Primary Dealer Survey in March, market participants already expect the run down to start in mid 2018, when the Federal funds rate has reached 1.63 per cent. \(^3\) Since the FOMC is very unlikely to shock the market by announcing a more hawkish path than this expectation implies, the impact of the event itself may be rather muted.

Third, the effect of balance sheet tightening may be offset by the Fed adopting an easier path for short term interest rates than it otherwise would have chosen. This is very different from what happened during the balance sheet expansion phase, when short term rates were fixed at almost zero.

The key point is that the future stance of monetary policy will not be determined by the balance sheet normalisation in isolation, but by its combination with the path for the Federal funds rate. If the adverse effect of the balance sheet run down on bond yields is larger than expected, it would quickly be offset by a more dovish path for short term interest rates.

\(\text{Yellen} \ [2017]\) has suggested that the expectation of balance sheet normalisation has already increased the bond yield in 2017 by 15 basis points, which she says is equivalent to two 25 basis point increases in the Federal funds rate. The market seems to think that the balance sheet run down will have an even larger effect on short rates than Yellen implies, which is perhaps why it is so reluctant to price in the full rise in rates implied by the FOMC’s “dot plot” for 2018-19.

The Fed is determined to avoid a repeat of the 2013 “taper tantrum”, when the tapering of its bond purchases caused major turbulence in the bond market. With careful communication, it can achieve this.

References


\text{ENGEN, E., T. LAUBACH, AND D. REIFSCHNEIDER}
