The Fed Reveals its Game Plan

By Stephen Slifer *Wed, Apr 12, 2017*

'Given a snail's pace of removing excessive monetary policy accommodation, it is hard to envision Fed policy threatening the economy any time soon,' a former senior economist at the Fed who blogs at Numbernomics.

In the minutes of the most recent meeting of its Federal Open Market Committee the Fed indicated that it would most likely raise the funds rate another two times between now and the end of the year. That would boost the funds rate to 1.25%, which still leaves it far below the so-called "neutral" level of 3.0%. The Fed then plans to take a break from raising short-term interest rates and turn its attention to the reserves issue.

By year-end it will begin to eliminate excess reserves in the banking system. As part of its easing initiative in the wake of the recession the Fed embarked on an unprecedented bond-buying program. It purchased U.S. Treasury bonds and mortgage-backed securities from banks and put the proceeds from those transactions into a bank's checking account at the Fed, which is known as a "reserves" account. In the process the Fed's balance sheet exploded as did the volume of surplus reserves in the banking system.

Before the Fed embarked on its bond buying program excess reserves were $2.0 billion. They have since climbed a thousand-fold to more than $2.0 trillion. Thus far those funds have been sitting idle in commercial bank accounts at the Fed. Banks have been unwilling or perhaps unable to lend those funds to consumers and businesses.

As long as those funds remain at the Fed the economy receives no stimulus. But if banks suddenly become more willing and/or able to lend, those reserves could fuel a spending spree the likes of which we have never experienced. Hence, the Fed eventually needs to eliminate those excess reserves.

But when should the Fed begin? And how should it proceed? The Fed recently provided guidance.

One option would be for the Fed to sell securities to banks in the same way that it bought those securities earlier. But to do that the Fed would need to enter the market via its open market operations and announce to the world what it is doing. It is a very visible action and sends an implicit message that it is aggressively trying to slow the pace of economic activity.

That is not the Fed's intention. Rather, it wants to eliminate those reserves in a more subtle manner.

A second option for the Fed would be to hold U.S. Treasury bonds and mortgage-backed securities to maturity, and then not replace them. Like an outright sale this option would, over time, eliminate the surplus reserves in the banking system without sending a message to the world that it was aggressively tightening its monetary policy stance.

But because the average duration of the Fed's portfolio is about six years, if it chooses this option it would take years for all surplus reserves to be eliminated.

If the Fed were to raise the funds rate and simultaneously allow long-term securities to mature it would, effectively, be doing two forms of tightening at the same time – raising both short-term and long-term interest rates — which could jeopardize the expansion. Thus, the Fed has indicated its intention to raise the funds rate twice more this year, but then stop raising rates for a while as it allows some of its bond holdings to mature. It will probably choose that second option for most of next year.

The bottom line is that the Fed has begun the process of reversing its wildly accommodative monetary policy stance by returning interest rates to a more normal level and gradually shrinking its balance sheet to eliminate the volume of surplus reserves in the banking system.

The days of ultra-easy monetary policy have come to an end. But the Fed is well aware that it cannot move too aggressively without endangering the pace of economic activity. As long as the inflation rate climbs slowly it can afford to proceed at a leisurely pace — raising short-term interest rates for a while, then allowing some of its bond holdings to mature. Given a snail's pace of removing excessive monetary policy accommodation, it is hard to envision Fed policy threatening the economy any time soon.

Look for the economy to grow at a steady pace for years to come and ultimately produce a record-breaking period of expansion.