The Fed’s Exit Strategy

By Editor Test *Mon, Oct 29, 2012*

William C. Dudley, president of the New York Fed, spoke at the Oct. 15 meeting of the National Association for Business Economics in Manhattan. In this excerpt from his prepared remarks, he addressed the Fed’s exit strategy from its current low-interest policy.

Exit from this regime [quantitative easing] could prove difficult. In particular, some observers worry that the expansion of the Federal Reserve’s balance sheet could ultimately prove inflationary. If that were the case, then I would regard the costs as exceptionally high.

Fortunately, I am confident that such fears are misplaced. That is because we now have the ability to pay interest on excess reserves (IOER). This means we can keep inflation in check regardless the size of our balance sheet. If the recovery got underway in earnest and credit demand surged, we could slow down the rate of credit creation by raising the interest rate we pay on excess reserves.

Banks wouldn’t lend out funds at lower rates than what they can earn from holding reserves with us. As a result, a hike in the IOER would raise the level of interest rates throughout the economy and this would dampen any expansion of credit. Our ability to pay interest on excess reserves is an essential tool that we can use to avoid future inflation problems.[4]

We are mindful of the fact that there could still be confusion about how exit will take place. This could increase financial market volatility. To reduce this risk, the FOMC has published a set of exit principles. These principles lay out a roadmap about how exit is likely to occur:

- First, the end of reinvestment of maturing securities;
- Second, an increase in short-term interest rates, and,
- Third, the gradual sale of mortgage backed securities to shrink the magnitude of excess reserves in the system and ultimately to restore the Fed’s balance sheet to a predominately all-Treasury portfolio.

A degree of humility is appropriate given the lack of experience as to how markets will respond when economic conditions eventually cause investors to anticipate exit. When asset purchases are anticipated to end or when asset sales begin to be anticipated, this will affect term premia in ways that cannot be precisely predicted in advance. That said, I do expect the repricing will prove manageable. We will seek to communicate so as to avoid generating sharp shifts in term premia and in long-term interest rates. Also, we will play close attention to ensure that financial institutions are managing their interest rate risks appropriately.

The third set of costs is the impact of higher short-term rates on the Federal Reserve’s earnings and balance sheet when exit occurs. When we ultimately raise short-term interest rates, this will squeeze the Fed’s net interest margin. Also, when the Fed sells long-term assets, there is some prospect for losses on these sales depending on the level of long-term interest rates at the time when such sales occur. This means that the Fed’s earning could fall sharply or even turn negative in a given year. We look at this issue very closely to understand the risks here.

The good news is that a very large proportion of our liabilities—those associated with currency outstanding—has no interest cost. This mitigates the risk of a sharp net interest margin squeeze. Moreover, our analysis shows that the cumulative income generated over the period in which the balance sheet has been unusually large is likely to exceed normal levels under a wide range of scenarios.

In my view, while the costs are real and need to be carefully evaluated, they pale relative to the costs of not achieving a sustainable economic recovery. A failure in that regard would lead to widespread chronic unemployment. Not only would that be tragic for millions of people, but it also would generate chronic shortfalls in the nation’s potential output and fiscal capacity. Relative to the costs outlined above, the benefits from avoiding such an outcome seem overwhelming.