Fed Policy. The Moderation and Withdrawal of QE.

Lest we forget, the job of the Fed is not to support equity and bond markets but to promote price stability and stable economic growth, the former a stated goal, the latter an implied one. Yet market participants continually watch the Fed as if it was the primary driver of asset markets, at least in the short term. For the last 20 years, the Fed has, for better or worse, acted to rescue the economy, and concomitantly, financial markets, from crises. The previous Fed chairman Alan Greenspan stated that averting a financial crisis was not feasible and that the best that could be done was curing a crisis situation after it had been precipitated. In the days when the only policy tool wielded by the Fed was the short term interest rate, it was clear that this policy had its limitations. Each rate cutting cycle was less effective than the last and in fact sowed the seeds of the next crisis. Thus interest rates trended lower and featured a cycle of rate cuts to address crises or recessions followed by rate hikes, not merely to cut of inflation but to reset the policy tool in case it was needed in future. That rates trended down meant that the policy was ineffective in that rates could not be reset fully before the each subsequent crisis.

Since the crisis of 2008, new policy measures have been adopted by the Fed to supplement short term interest rates, mainly in response to the scale of the crisis. Whatever the scale of the crisis or the policy employed to meet it, certain things remain. The Fed’s raison d’être remains price and growth stability. The unprecedented scale of balance sheet expansion of the Fed has led to a precarious position where the US economy is perched between high inflation and deflation. The current equilibrium of low inflation is an unstable one because on the one hand the economy remains weak and energy costs are falling leading to a deflationary environment and on the other the velocity of money multiplies through the money supply to obtain nominal output leading to high inflation risk. Any sign of self sustaining growth, even at low levels, must reasonably encourage the Fed to reduce the size of its balance sheet to avoid the tail risk of high inflation, and to be clear it is a tail risk and not a smooth risk. The size of the Fed's balance sheet and short term interest rates are loosely related, but sufficiently loosely, that it is reasonable given the low growth, even if self sustaining, that short rates will be held low even if the balance sheet is shrunk. It would be irresponsible of the Fed not to reduce the size of its balance sheet. Moreover, the extreme open market operations we call Quantitative Easing have a perverse impact on lending. Since 2008 much lending has taken on collateralized form with the collateral consisting mostly of low risk, high quality assets like treasuries and agency mortgage backed securities. By specifically targeting these assets in its asset purchase programs, the Fed is starving the financial system of collateral necessary to facilitate secured lending. Mortgage production has kept pace, however, a sustained recovery is improving government debt service burdens and resulting in a slowdown of US treasury debt issuance. The Fed's need to taper its QE is driven partly by the need to avoid buying an ever increasing portion of new issuance thus crowding out private and foreign participation.

A reduction of asset purchases and an eventual reduction of the balance sheet of the Fed is a desirable outcome for the economy. It resets a policy tool which was considered acutely unconventional when it was implemented to address the crisis, and which one hopes need never be used again. It also removes the tail risk of high inflation through a purely technical transmission system, and it puts back eligible collateral into the financial system. The conditions for a moderation of asset purchases is that the feeble growth in the economy today is at least self sustaining, that is that it will not be derailed by the withdrawal of QE. One aspect that has not been dealt with here is the management and expectations of QE withdrawal which bears some thought as well. The communications and management of expectations is as important as the actual withdrawal itself.

I guess if you wanted to skip the theory and causality, what I’m saying is that if the Fed shrinks its balance sheet, or even slows its growth, it’s a sign that the US economy is in good shape.