# US monetary and fiscal policy 2014 – 2017

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I believe it is inevitable that QE tapering will happen. This is driven by the need to control the growth, and one day shrink, the Fed’s balance sheet which is currently at 4 trillion USD and growing. The dangers of maintaining a balance sheet of this size are high. Any pick up in the velocity of money could cause nominal output to surge and capacity may not be able to expand as quickly. That said a reverse repo facility may mitigate much of this risk by being able to remove excess liquidity from the system very quickly. The other risk is that an unconventional policy tool has now been used quite some time with limited impact on the real economy and the Fed needs somehow to reset at least one of its policy tools in case another crisis should follow. Since QE had limited impact on the real economy, it has had significant impact on asset prices, the impact on the real economy of its gradual withdrawal should be orderly. Based on these considerations, I would say the risk of QE tapering is moderate and acceptable and the Fed will do it fairly soon.

The market has erroneously linked short term interest rates to QE tapering. QE is an attempt to monetize debt and to control the mid and back end of the curve, not the front where the Fed already has good control. A number of things suggest that the Fed will maintain its low interest rate policy for another 3 years at least (that is into 2017.)

Now there has been some talk of optimal control theory which is of limited use. Control theory is a methodology and tells us little about the actual path of interest rates or the intentions of policy makers. What the rhetoric and the introduction of control theory do is to widen the spectrum of potential determinants of monetary policy beyond inflation and growth. The definition of the Loss Function can include everything from traditional measures such as inflation and growth, but can also include multiple objectives such as unemployment, distribution of wealth, and even softer targets.

Forward guidance is another new policy tool which has been added to Large Scale

Asset Purchases. Again there is little content in forward guidance. With interest rates at their lower bound, and the Fed’s balance sheet at acutely inflated levels, it seems that new and innovative ways of controlling the mid to back end of the term structure need to be found, and that forward guidance is a ‘cheap’ way of achieving this as the costs and risks are low. There are non-financial costs and risks, however, as it requires that the Fed is fairly accurate with its forecasts, and that the Fed’s credibility can be maintained. Choice and judgment are crucial in a complex and leveraged system as optimal control solutions are not unique, they yield a continuum of solutions, and the probability is high for boom and bust trajectories. The widespread adoption of forward guidance among the world’s central banks is somewhat troubling. On the one hand, if realized state variables deviate sufficiently from forecasts, central banks may lose credibility and the efficacy of forward guidance may be impaired, and on the other, such loss of credibility may lead to a more structural decline in central banks as influencers in the economy which is possibly a positive outcome.

For unclear and unspecified reasons, forward guidance and optimal control seem to imply to the market low interest rates for the next 3 years. I agree with this conclusion but present a simpler, cynical and causal explanation for my expectation. The clues to this expectation come not from the US Federal Reserve but from the US Treasury. The introduction of Floating Rate Note (FRN) issuance by the US Treasury supports the view of low interest rates for longer. As a borrower, the US Treasury has to provide investors or lenders with terms which are favorable to them in order to attract their capital. Investors are duration risk averse and seek low duration instruments. The US Treasury would like to finance itself over a longer term without steepening the term structure, and with the US Fed moderating its asset purchases, such funding terms may not be achievable. Funding itself with FRNs is useful in that it provides the US Treasury with longer term financing while providing investors with a low duration investment. The typical coupon for an FRN resets every quarter to some fixed level over the 3 month USD LIBOR or some other similar benchmark. For the US Treasury to maintain a manageable debt service profile, the US Federal reserve has to maintain short interest rates at close to zero. This is a cheaper funding strategy than longer maturity fixed coupon issuance that has to be monetized by the Fed via LSAPs.

**What are some of the implications?**

Short term interest rates will be kept low for some 3 years or so. The rest of the term structure will be determined less by LSAP but by market forces. Longer maturity volatility will rise, and yield levels are very likely to rise as well.

Conditions conducive to carry trades will arise. This will favor banks and deposit taking institutions. Hedge funds may also capitalize on this.

Implications for highly leveraged companies are complicated. Capital intensive industries will struggle with ongoing funding. In the current period, bond buybacks are accretive, however, over the longer run, this encourages consolidation over growth. Share buybacks will be more expensive as well, so expect a slowdown in volumes.

Increased yields and yield volatility will have real economy impact. Increased yields will discourage issuance and at least make it more expensive to finance with longer dated debt. Businesses may choose to issue more floating rate debt. On the demand side, increased yield volatility will cause investors to demand higher rates of compensation.

It is difficult to guess where the yield curve will settle without central bank large scale asset purchases. One of the more damaging consequences of QE has been to impair the allocative and productive signaling properties of the yield curve.