

Dean Croushore Blog about Monetary Policy

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Will the Fed Reduce Quantitative Easing?

At this week's meeting of the Federal Open Market Committee (FOMC), the Fed will debate whether or not to reduce the amount of quantitative easing it has been engaging in. Under the quantitative easing program, the Fed has been purchasing \$85 billion of securities in the open market each month, thus increasing the amount of assets the Fed owns, which adds to the monetary base. The monetary base is held as currency by the non-bank public and reserves by banks.

Because of three rounds of quantitative easing, the monetary base is now about \$3.4 trillion, which is about four times as much as it was before the financial crisis in 2008, as Chart 1 shows.

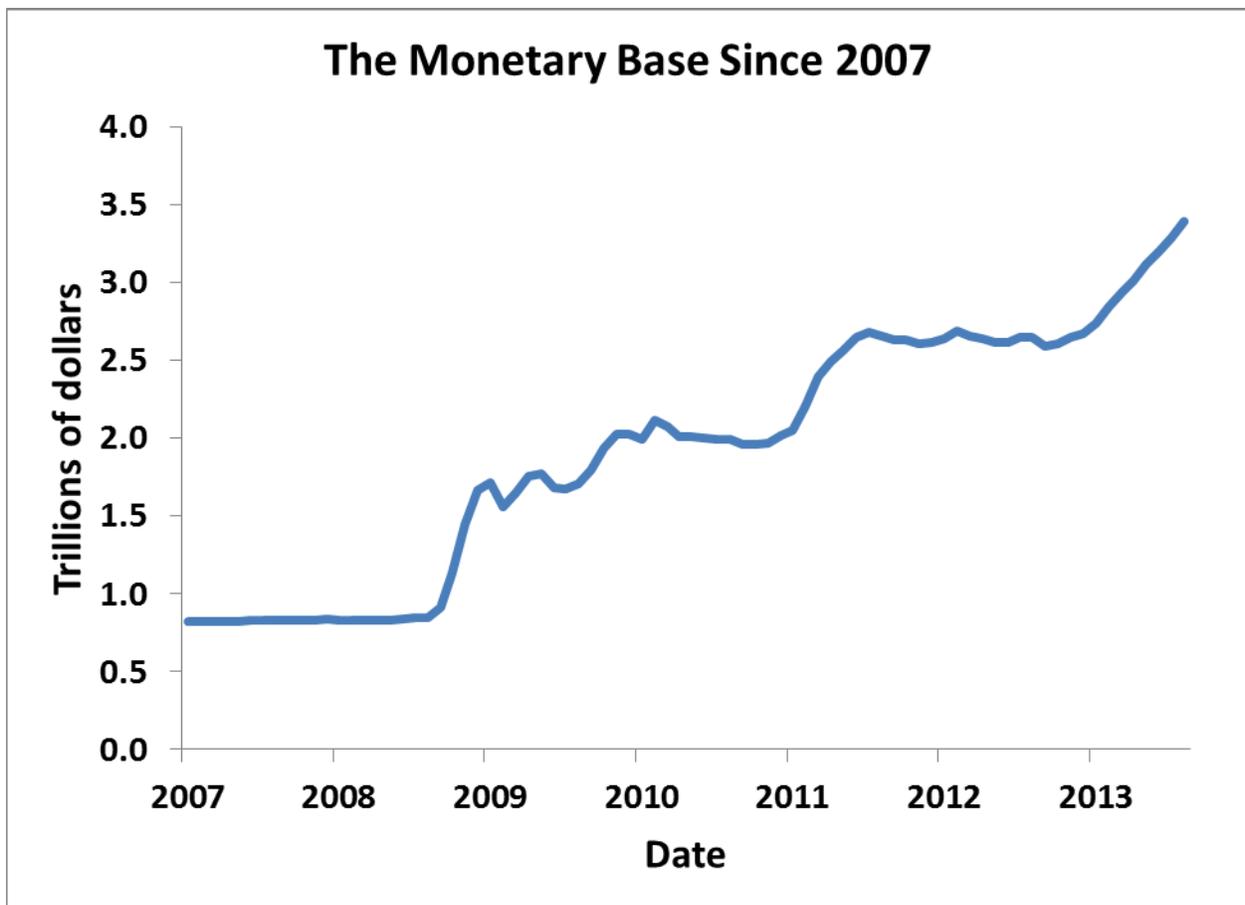


Chart 1. The Monetary Base Since 2007. The monetary base has grown substantially since the financial crisis in 2008, thanks to three rounds of quantitative easing by the Fed.

When the Fed began easing monetary policy during the financial crisis in 2008, the nominal interest rate on short-term bonds quickly declined to near zero and remains at that low level today. But interest rates on longer-term bonds were not as low. The Fed’s third round of quantitative easing was designed specifically to reduce long-term interest rates, to encourage investment by business firms in plant and equipment and to encourage households to buy homes or refinance their mortgages. As Chart 2 shows, quantitative easing was only partially successful (the third round began in September 2012) initially, as the 10-year interest rate on U.S. government bonds fluctuated around 1.7%. Of course, factors other than the amount of quantitative easing by the Fed influence the interest rate.

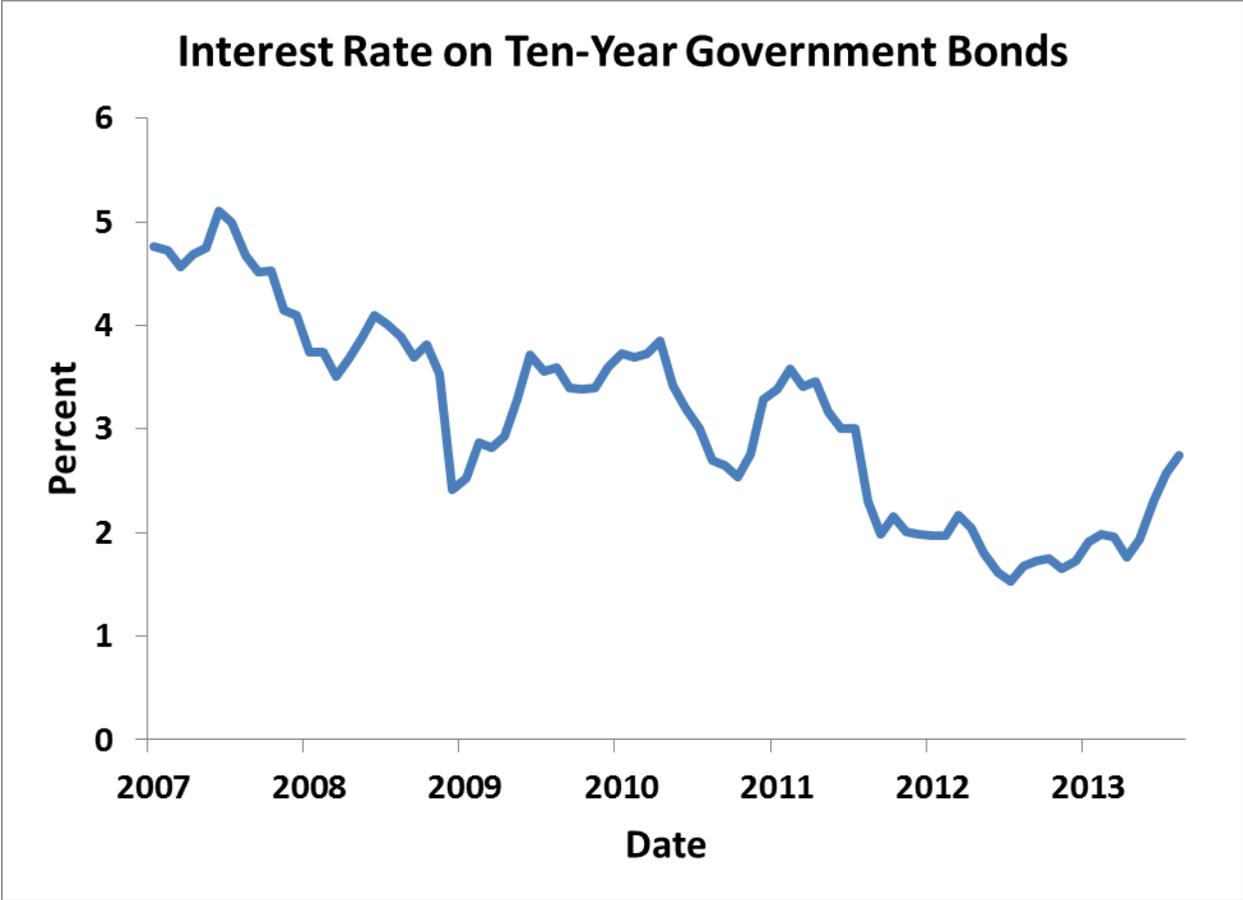


Chart 2. Interest Rate on Ten-Year Government Bonds. The data show that the interest rate on ten-year government bonds generally declined from 2007 to 2012. In recent months, the markets reacted to the Fed’s planned tapering of quantitative easing by a sell-off that led to higher long-term interest rates.

The Fed increased its quantitative easing in January 2013, and the ten-year interest rate fluctuated between 1.7% and 2.0% from January to April. (Note: From September 2012 to December 2012, the Fed sold short-term Treasuries and purchased long-term Treasuries of about \$45 billion each month, which did not increase the monetary base, but was designed to reduce long-term interest rates. The Fed also bought \$40 billion of mortgage-backed securities each month, which did increase the monetary base.

Then, in January 2013, the Fed ran out of short-term Treasuries to sell, but it kept buying long-term Treasuries and mortgage-backed securities, so the monetary base began rising more rapidly.)

In June 2013, the Fed began discussing the possibility of tapering the quantitative easing program somewhat, and the ten-year Treasury rate rose significantly, from about 1.75% in April to 2.75% in August, an increase of a full percentage point. And the rate is near 3% now in mid-September. Financial markets feared that as the Fed cut back on its bond purchases, bond prices would fall and interest rates would rise, so markets sold off the bond even before the Fed decided to take any action.

At the FOMC meeting this week, the Fed seems poised to taper the quantitative easing program. But how much will it taper and how will markets react? Markets seem to expect the Fed to reduce its bond purchases by about \$15 billion a month. If the Fed tapers the program less than \$15 billion a month, the interest rate on ten-year Treasuries might decline, but a more rapid tapering could lead the interest rate to rise more. The economic data on the real side of the economy support tapering, as GDP growth and employment growth have come in a bit stronger than expected. However, the inflation data suggest that the Fed should not taper quantitative easing, as the inflation rate in the core PCE price index is a paltry 1.2% over the past year, well below the Fed's 2% target.

In the long run, the Fed seems likely to have to reduce its bond purchases. As the economy gets healthier, which has been a slow, gradual process, the Fed's large monetary base seems likely to cause future inflation. So, not only must the Fed reduce its bond purchases, it will eventually have to sell all the bonds it has been buying. Whether or not the Fed can shrink its asset holdings without allowing inflation to rise or causing interest rates to rise sharply remains to be seen. The next Fed chair will have a difficult task, for sure.