

## IMF/Treasury Conference

### What is the FOMC trying to do with its asset purchases?

The FOMC's asset purchases are intended to do what the FOMC always does when it wants to provide more monetary accommodation: It is using its policy tools to lower interest rates, improve broader financial conditions, and stimulate aggregate demand. So there is nothing unconventional in their *motives*.

### So what's "unconventional" about monetary policy today?

Normally, the Fed and other central banks set a target for a policy rate, typically a very short term rate, in the case of the Fed, the federal funds rate. To lower the policy rate the FOMC, for example, operates in the **overnight repo market**, carrying out open market operations by lending to or borrowing from banks, injecting or withdrawing reserves. This lowers the funds rate by **injecting reserves** activating the **portfolio balance** process whereby investors first move into longer term Treasuries, then risk assets (corporate bonds and equities), and assets abroad, lowering the dollar.

What is different today? Today the funds rate is near zero as a result of earlier conventional policy. As a result, to provide additional accommodation, the FOMC has to do its **open market operations in longer term Treasuries**.

When they buy longer term Treasuries, they lower their rates, again activating the portfolio balance process. So this is the first difference from conventional policy: operating directly in long-term government securities market. The second difference is that the FOMC is making *outright purchases* of Treasuries, rather than doing overnight operations in the repo market. As a result, **asset purchases expand the Fed's balance sheet**.

### **That leads us to the fourth difference:**

In normal times when the FOMC carries out operations by raising or lowering the funds rate, there are no costs doing so. However, the FOMC perceives there are **costs** associated with expanding the balance sheet. It therefore has to assess further purchasers, for example, under QE3, in terms of whether **the benefits of further expanding the balance sheet exceed the costs.**

Here are the costs the Committee has identified. One of them relates directly to the topic of this conference: the **liquidity** in the government bond market. I will let Brian and David take up this topic. Second, the larger the balance sheet, the **more challenging is exit**. This increases the risk of a **policy error**, specifically not in time to contain inflation. Third, the Fed could face **political backlash**, if and when it realizes capital losses when sells assets, lowering (or even ending for a time) the Fed's remittances to the Treasury. Fourth, and the cost that appears to be of most concern to the Committee today, is that, by lowering Treasury rates further, additional purchases would continue to incent investors to "reach for yield", taking on more duration and credit risk than otherwise. Up to this point, this is exactly what monetary policymakers **want to do**. But **carrying it too far**, expanding the balance sheet too much, lowering rates too much can make financial markets very vulnerable to surprises, which, in turn, can result in very sharp movements in asset prices, threaten the recovery or worse, lead to large losses to individual investors, and threaten the health or even solvency of some financial institutions.

## **How do you envision the Federal Reserve unwinding their portfolio?**

How will they unwind the portfolio? Easy! Very **carefully**, and **learning** along the way as they use operations and facilities they have never used before.

Exit has several **steps**. The Committee has identified these steps in its “exit principles.” First, end the **reinvestment** program, beginning runoff that lowers the portfolio, beginning a passive tightening. Second, change the **language** to signal the dance toward the first rate hike is under way. Third, **withdraw reserves** by reverse repos and auctioning term deposits to ensure better control of the funds rate). Four, **raise the IOER** rate, to drag up the funds rate. Five, **unwind** their portfolio, normalizing its size, composition and duration.

Until recently, the last exit principle was, unambiguously, to sell assets sometime after the first rate hike. The Chairman, in effect, yesterday **revealed the updated** this exit principal. The FOMC will rely on **runoff** alone during the period the **funds rate** is being normalized, but keep the **option** open of later selling MBS to speed getting MBS off the Fed’s portfolio and returning to an all Treasury portfolio.