Capping QE

Dr Robert Gay | Fenwick Advisers | 09 June 2017

After next week's FOMC meeting, we are likely to hear a lot more about the central bank's plans to unwind their experiment with asset purchases of public and private debt securities as a therapy whatever ails the economy during periods of financial stress. Indeed, Fed officials already have made clear that they intend to begin to shrink their balance sheet later this year through some process of attrition.

For those observers who have a long view on monetary issues and the efficacy of financial markets, this news should come as a welcome relief, because central banks in general should not make a habit of such large-scale interventions lest they cause permanent distortions and collateral damage to financial markets. Others with shorter horizons will fret about the dangers that any exit strategy has the potential to create volatility, reminiscent of the 'taper tantrum' of 2013, and to tighten monetary conditions enough to undermine the economy's slow-moving recovery.

Of course, Fed officials must take the long view and hence tend to believe they can engineer a graceful exit. Their plan is somewhat akin to 'cap and trade' schemes for weaning the world of pollutants. Unlike those supposedly market-based plans, which can be more complicated and less effectual than advertised, the Fed's exit strategy seems to have considerable flexibility including the option to change course if need be.

Granted, the Fed has not been entirely clear yet on how the 'caps' might work, so I am speculating on details that may harbor the devil. Nonetheless, the idea is to set 'caps' on the dollar amount of various classes of holdings that will be allowed to mature without reinvestment. At the onset, the caps would be quite low, so that a relatively small portion of the portfolio would shrink. As conditions permit, the Fed would gradually raise the cap, thereby allowing more securities to mature. This scheme could be very slow-paced, especially if adjustments to the caps were 'data dependent' as a means of retaining flexibility. If the economy backslides or financial conditions tighten more than expected, the FOMC simply could call it quits until conditions improve.

In a sense, such an exit scheme introduces a potentially lengthy phasing out of reinvestment, as opposed to one in which the Fed would announce that it simply is letting short-dated bonds mature, which has much greater potential for disrupting carry trades. Under the 'cap' scheme, carry traders can persist in leveraging their arbitrage trades, albeit with slightly less assurance each month that they can unload their bonds and notes to the Fed.

In short, the current cozy comfort of knowing the Fed's asset purchases are a low-risk exit strategy will fade away gradually rather than end abruptly, which is exactly what carry traders

feared during the 'taper tantrum' of 2013. By making adjustments in the caps dependent on favorable data flow on the economy, the Fed would introduce considerable flexibility into this ingenious 'cap' scheme.

And that innovation is the reason, I believe, all FOMC members suddenly seem to be on board with beginning the process of shrinking the balance sheet sometime later this year. It also offers some hope of avoiding the market turbulence of the 'taper tantrum'.

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