Bloomberg

Fed Exit Plan May Be Redrawn as Assets Near $3 Trillion

By Craig Torres and Josh Zumbrun - Dec 7, 2012

A decision by the Federal Reserve to expand its bond buying next week is likely to prompt policy makers to rewrite their 18-month-old blueprint for an exit from record monetary stimulus.

Under the exit strategy, the Fed would start selling bonds in mid-2015 in a bid to return its holdings to pre-crisis proportions in two to three years. An accelerated buildup of assets would also mean a faster pace of sales when the time comes to exit -- increasing the risk that a jump in interest rates would crush the economic recovery.

"There is certainly an issue about unwinding the balance sheet" in a way that "is effective and continues to support the recovery without creating inflation," St. Louis Fed Bank President James Bullard said in an interview in October. The central bank might have to "revisit" the 2011 strategy, he added.

The Fed is already buying $40 billion a month in mortgage- backed securities to boost the economy, and policy makers meeting Dec. 11-12 will consider whether to purchase more assets. John Williams, president of the San Francisco Fed, has proposed adding $45 billion of Treasury securities a month.

The bigger the balance sheet, "the riskier the exit becomes," Richmond Fed President Jeffrey Lacker said during a Nov. 20 speech in New York. "That is something we need to think carefully about."

Krishna Memani, director of fixed income at OppenheimerFunds Inc., said a too-rapid sale of assets risks disrupting the $5.2 trillion market for agency mortgage debt.

Finding Ways

"They have to find ways of unwinding the balance sheet without dumping all of it in the marketplace," said Memani, who oversees a bond portfolio of about $70 billion, including about $6 billion of mortgage-backed securities.

The central bank has been extending the maturities of its assets with Operation Twist, a program to replace $667 billion of short-term debt with the same amount of longer-term bonds that expires this month.

A decision to expand purchases could push the total assets to $4 trillion by the end of 2013, said Michael Hanson, a senior U.S. economist at Bank of America Corp. Total assets stand at $2.86 trillion, up from $869 billion at the end of June 2007.

"The more they add to the balance sheet, the longer it will take to normalize," said Hanson, who worked on designing tools that will be used in the Fed's exit strategy as an economist in the monetary affairs division at the Board of Governors in 2009.

Holdings Expand

The central bank's holdings expanded during the financial crisis as the Fed created several emergency loan programs. Chairman Ben S. Bernanke in November 2008 ordered the purchase of debt issued by housing agencies and mortgage-backed securities in a strategy that he called credit easing.

After the benchmark lending rate was cut almost to zero in December 2008, the Fed continued buying bonds as its primary easing tool. The Fed announced its third round of purchases in September without specifying a total quantity or end date.

Those central bank initiatives have helped push yields on Treasury and housing debt to record lows. The average fixed rate on a 30-year mortgage fell to 3.31 percent last month, according to a Freddie Mac index.

The yield on the 10-year Treasury note reached 1.39 percent on July 24 and, at 10:24 a.m. in New York, rose 0.03 percentage point to 1.62 percent after a report showed U.S. payrolls expanded last month more than forecast. U.S. Labor Department figures showed the U.S. added 146,000 jobs in November and the unemployment rate fell to 7.7 percent.

Transparency Push

The Fed announced the exit strategy in June 2011 as it sought to assure investors that it had the means to avoid igniting inflation once job growth, wages, and demand started moving up. The plan was part of Bernanke's push for greater transparency and predictability.

The goal is to return the balance sheet to a pre-crisis size in two to three years and eliminate holdings of housing debt "over a period of three to five years."

First, the Fed would allow assets to mature without being replaced, a process that will be slower now that the Fed has extended the average duration of its holdings. It would then modify its guidance on how long it plans to keep the federal funds rate near zero and begin temporary operations to drain excess bank reserves.

The Fed would next raise the federal funds rate, and finally, it would start selling securities.

The balance sheet averaged about 6.3 percent of nominal gross domestic product during the decade before the financial crisis. Today, a balance sheet of that size would be around $995 billion rather than

$2.86 trillion.

Long Exit

"The exit is going to take a long time," said Stephen Oliner, a resident scholar at the American Enterprise Institute in Washington and former Fed Board senior adviser. He estimates the Fed's holdings could rise to more than $4 trillion.

If the Fed were to start bringing its holdings back to their pre-crisis level today, it would have to sell almost $2 trillion over a period of two to three years under its current exit plan. Assuming holdings grow to $4 trillion, asset sales could come to $3 trillion over the same period.

Fed officials haven't publicly discussed an alternative plan for shrinking the balance sheet. One possibility, said Lou Crandall, chief economist at Wrightson ICAP LLC in Jersey City, New Jersey, would be to enlist the help of the U.S. Treasury.

One-time Swap

The Fed could ask to swap longer-term Treasury debt for short-term bills and notes, thus reducing the maturity of its portfolio to accelerate the runoff. The Fed and Treasury could do this partly in a one-time swap, and partly by allowing the Fed to bid on new issues and pay with its holdings of long-term Treasuries, Crandall said.

Because the Fed would have less debt to sell to return its portfolio to a normal size, it could be "more aggressive in the liquidation" of housing-agency securities, he said, which was a priority for Fed officials when they announced the exit strategy.

Asset purchases have made it harder to change the federal funds rate when the time comes to raise borrowing costs.

In the five years before the crisis, excess bank reserves averaged $1.7 billion, so the Fed could alter interest rates by buying or selling comparatively small amounts of short-term debt in open-market operations.

Those reserves are now more than 800 times larger at $1.4 trillion. To move the fed funds rate, the central bank will have to drain or lock up the supply of excess reserves.

Current Plan

Under the current exit plan, the Fed would soak up reserves by using reverse repurchase agreements or offering term deposits.

"I'm not sure we'll really know, until they undertake a real program, what the effectiveness is" of such measures, said Bank of America's Hanson. "The amount of reserves could be so large that the draining doesn't do a whole lot."

The central bank could lose credibility if its policy actions don't move the federal funds rate, said Marvin Goodfriend, a former adviser at the Richmond Fed.

"The Fed needs to delicately acquire inflation credibility in the exit," said Goodfriend, a professor at Carnegie Mellon University's Tepper School of Business in Pittsburgh. "We are used to tightly managed short-term interest rates."

The Fed's other tool is to extinguish reserves by selling bonds back to dealers. Even a fully-explained plan could push up home borrowing costs as traders account for hundreds of billions of dollars of new supply flowing back into the market.

"We are deep into experimentation at this point," Oliner said. "It's understandable that people are worried."

To contact the reporter on this story: Craig Torres in Washington at ctorres3@bloomberg.net; Joshua Zumbrun at jzumbrun@bloomberg.net

To contact the editor responsible for this story: Christopher Wellisz at cwellisz@bloomberg.net;