

The US economy: topic of the month

The FOMC's "Cruise Control" approach for reinvestment policy

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The minutes of the Federal Open Market Committee (FOMC) meeting held on May 2-3, 2017 was released on May 24th and showed that “most participants judged that if economic information came in about in line with their expectations, it would soon be appropriate for the Committee to take another step in removing some policy accommodation.” The use of the word “soon” in the minutes has its precedent and possesses important implications for the coming interest rate decision. The minutes of the January meeting revealed that many participants viewed that it might be appropriate to raise the federal funds rate again “fairly soon”. In view of the fact that the rate hike was decided at the next meeting, there is a high probability of a rate hike in the June meeting, barring large shocks in the U.S. economy and the global financial market.

Furthermore, the word “soon” was also used in the section on the reinvestment policy of the System Open Market Account (SOMA) of the latest minutes. “Policymakers agreed that the Committee's Policy Normalization Principles and Plans should be augmented soon to provide additional details” about the reinvestment policy.

The proposal provided by the staff was a preset approach of the reduction of the Federal Reserve Bank (FRB) balance sheet. According to this approach, the FOMC does not intend to change its new operation “as long as there was no material deterioration in the economic outlook.” This is quite different from the interest rate decision, which depends highly upon economic conditions. According to the latest minutes, “a set of gradually increasing caps, or limits” of the monthly reinvestment dollar amounts would be placed and announced beforehand (**Chart 1**). The terms “a set of caps” indicate that these caps and the schedule would be predetermined. The cap would be raised, not reviewed, every three months from initially low levels. Adjusting the cap or not would no longer be an issue to be discussed. After the cap achieves a certain “fully phased-in” level, it will be maintained as-is until the size of the balance sheet is normalized.

[Chart 1: New reinvestment policy with incremental caps]

- Prior announcement of a schedule of gradually increasing caps
- A monthly cap will be set on the balance sheet reduction amount (the amount that will no longer be reinvested)
- The initial cap will be set to a low amount. The cap will then be raised every three months until it reaches the fully phased-in level
- After the fully phased-in level is achieved, the cap will be held until the size of the balance sheet is normalized

Source: Made by MHRI based on FRB materials

The discussion on revising the reinvestment policy will continue in the June meeting. There are at least four factors to be decided for its practical implementation, namely (1) the initial level of the caps for Treasury securities and agency securities, (2) the size of the incremental every three months (if it would be constant), (3) the final cap level, and (4) the normalized (minimum) excess reserve amount.

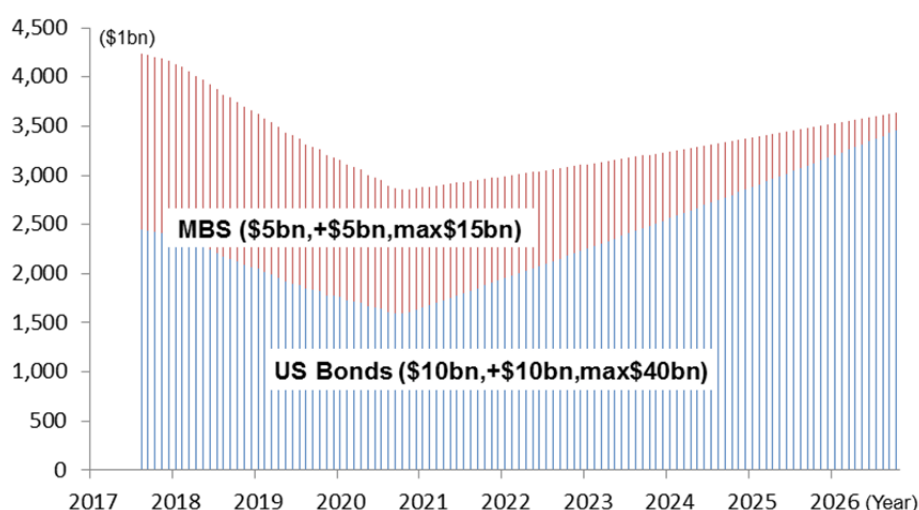
Once these factors have been decided, the pace of the balance sheet reduction and the timing of “normalization” will be determined.

According to my analysis, the initial level of caps for Treasury securities and agency MBS would be \$10 billion and \$5 billion, respectively. The size of the incremental would be \$10 billion and \$5 billion and the final level of caps would be \$40 billion and \$15 billion. In this scenario with the minimum excess reserve of \$500 billion, the Fed’s balance sheet will continue to shrink for three years (**Chart 2**). After that, it will turn to expand along with the growth of Federal Reserve notes (**Chart 3**).

The new exit strategy could be announced as early as the June meeting. The preset reinvestment policy would provide predictability for the Fed’s exit strategy and make “interest rate policy first” in adjusting monetary policy stance. However, it might also switch monetary policy into “reckless cruise control” mode. Will the FOMC keep its preset reinvestment schedule even in the event of market turbulence comparable to the summer of 2015? At that time, the FOMC was forced to postpone the first interest rate hike in the September meeting of 2015 despite the fact that such market turbulence did not lead to a material deterioration of the FOMC’s economic outlook.

The preset “cruise control” reinvestment policy will be seemingly desirable but not necessarily comfortable as in the case of highway driving. There is no guarantee that the global recovery during the last 12 months will continue in the future.

[Chart 2: FRB Balance Sheet: Investment-Side]

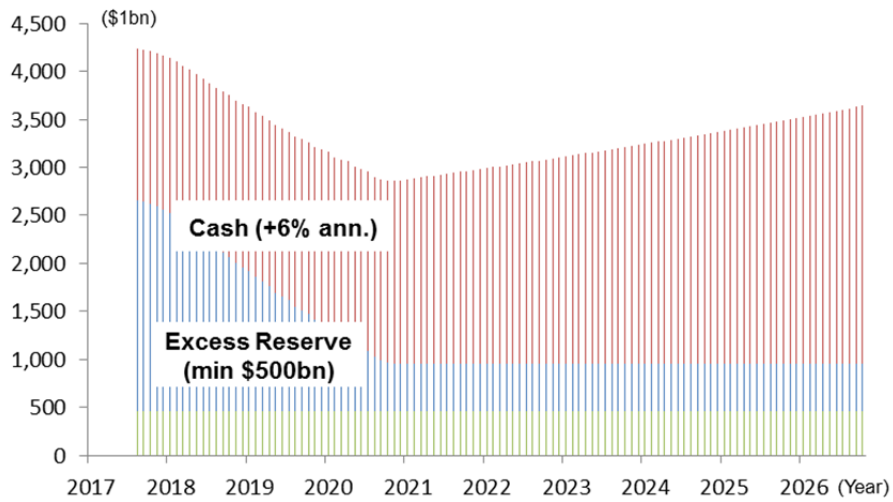


Note: The primary assumptions in the reinvestment are as follows. Numerical assumptions are: the initial reinvestment cap, the size of the cap increase, and the final (fully phased-in) level. Units are \$1 billion USD. U.S. Bonds = 10, +10, 40; Agency MBS = 5, +5, 15; Minimum normalized excess reserve level = 500. Start of reduction = September 2017.

Refer to the Makoto Ono (2017) “Direction of Reinvestment Policy by the FRB” Mizuho Insight (May 11th) (in Japanese only) regarding the initial cap.

Source: Made by MHRI based on FRB materials

[Chart 3: FRB Balance Sheet: Debt-Side]



Note: Same as Chart 2

Source: Made by MHRI based on FRB materials

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