5 Apr 2017

OXFORD ECONOMICS

Viewpoint | US

FOMC swiftly preparing for balance sheet reduction

Kathy Bostjancic
Head of US Macro Investor Services
+646-503-3066

Terry Sheehan,
Economic Analyst SMRA
+609 683 5237 ext. 105

- **The minutes from the March 14-15 FOMC meeting illustrate that Fed officials are already considering different strategies surrounding the shrinking of the balance sheet. If economic conditions continue to evolve in line with Fed forecasts, many officials anticipate "that gradual increases in the federal funds rate would continue and judged that a change to the Committee's reinvestment policy would likely be appropriate later this year".**

- **Policymakers "reaffirmed" the approach in the "Committee's Policy Normalization Principles and Plans" from September 2014. In line with our baseline view, officials assert that reductions in holdings should be "gradual and predictable" and "accomplished primarily by phasing out reinvestments".**

Minutes show the FOMC is quickly developing a plan to shrink its balance sheet – implementation could be as soon as late 2017

The FOMC minutes show that Fed officials are moving quickly to develop a comprehensive plan of how to shrink the balance sheet, with a change to its reinvestment policy coming possibly later this year. However, no final decisions have been reached. While later this year is a sooner than our baseline view of 2018, most officials assert that the reduction in the balance sheet should be "gradual and predictable" and they favor phasing out the reinvestments to start, which is in line with our expectation. Abruptly ceasing reinvestments of maturing Treasury and mortgage-backed securities (MBS) debt could risk triggering financial market volatility. However, some opined that immediately ceasing reinvestments could be easier to communicate and lead to a faster normalization in the size of the balance sheet. The general consensus is that both Treasury securities and mortgage-backed securities (MBS) should be included in the reductions.

In line with our view, most favor phasing in a reduction in reinvestments in a "gradual and predictable" manner

As for the criteria to decide when to start reducing the reinvestments, "nearly all" participants preferred a decision based on "assessment of economic and financial conditions"; "several" indicated they preferred a quantitative threshold like the level of the fed funds rate; some others wanted a qualitative judgement based on "economic and financial conditions" extending to include the risks to the outlook. All agreed that any prospective change to the reinvestment policy should be communicated well in advance. Several FOMC members suggest that when the FOMC announces a change to its balance sheet policy it should also provide its projections for the size and composition of its balance sheet in the long run.

Most continue to assert that the federal funds rate should be the primary policy tool to adjust the stance of monetary policy going forward. Policymakers reaffirmed their view that if economic data remain within their expectations, then they should gradually raise short-term interest rates higher. This is consistent with our estimate that the FOMC raises rates two more times this year, lifting the median range of the federal funds rate to 1.38% by year-end.

Contact: Kathy Bostjancic | Kathybostjancic@oxfordeconomics.com

FOMC swiftly preparing for balance sheet reduction

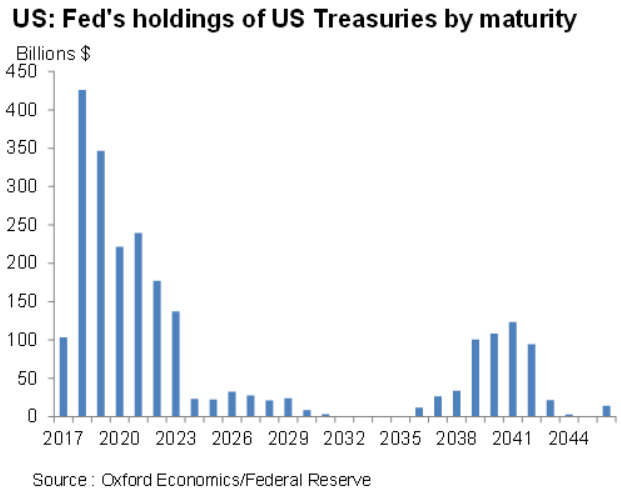
FOMC minutes support our call for two more rate hikes this year.

Participants stand ready to change "assessments of, and communications about, the appropriate path" of rates "in response to unanticipated developments." Such risks include stronger business and household spending, "appreciably more expansionary fiscal policy", and/or "a more rapid building of inflationary pressures".

With regard to the fiscal policy outlook, Fed officials continue to underscore the large uncertainty regarding the timing, size and composition of potential changes and the impact on the economy. Due to the uncertainty, only about half of the Fed officials explicitly factored fiscal stimulus into their economic forecasts. That said, most look for the bulk of the impact from fiscal stimulus to unfold in 2018 and see upside risk to their forecast from prospective stimulus.

A "number of participants" also noted "recent and prospective changes in financial conditions posed upside risks" to forecasts, "as well as downside risks" if there were a "significant correction" in financial markets.

Chart 1



The bulk of the Fed's Treasury holdings mature over the next six years.

Contact: Kathy Bostjancic | kathybostjancic@oxfordeconomics.com