Fed’s $4 Trillion Holdings Keep Boosting Growth Beyond End of QE

By Jeff Kearns - Oct 24, 2014

Quantitative easing may turn out to be a gift that keeps on giving for the U.S. economy.

As the Federal Reserve prepares to end its third round of bond buying next week, the central bank plans to hang on to the record $4.48 trillion balance sheet it has accumulated since announcing the first round of purchases in November 2008.

That will continue to keep a lid on borrowing costs, helping the Fed lift inflation closer to its target and providing support to a five-year expansion facing headwinds abroad, from war in the Mideast to slowing growth in Europe and China.

Holding bonds on the Fed’s balance sheet limits the supply of securities trading on the public markets, which helps keep prices up and yields lower than they otherwise would be. That provides stimulus to the economy just as a cut in the Fed’s benchmark interest rate would, according to Michael Gapen, a senior U.S. economist for Barclays Plc in New York and former Fed Board section chief in charge of monetary and financial markets analysis.

“Preserving it will continue to support the economy,” Gapen said. “The Fed message is we think we’ve done enough to generate momentum and keep the economy on the right track. Now we’re going to wait and see how things go.”

The Federal Open Market Committee plans to end its purchases of Treasuries and mortgage bonds at the next meeting Oct. 28-29, according to minutes of the last gathering.

Maintaining Holdings

Chair Janet Yellen opened the door to keeping a multi-trillion-dollar portfolio for years, saying a decision on when to stop reinvesting maturing bonds depends on financial conditions and the economic outlook. Shrinking the balance sheet to normal historical levels “could take to the end of the decade,” Yellen said at her press conference last month.

Fed quantitative easing has provided the Treasury market with a steady and consistent buyer, helping to keep yields lower than they otherwise would be. The central bank is now the largest holder of U.S. government securities.
If the Fed continues to hold the securities, it “will continue to put some downward pressure on rates relative to what they would have had the Fed not had this balance sheet,” said Josh Feinman, the New York–based global chief economist for Deutsche Asset & Wealth Management, which oversees $1.31 trillion, and a former Fed senior economist. “That’s a factor that I think will linger.”

**Lower Yields**

The 10-year Treasury note yielded 2.27 percent late yesterday in New York, down from 3.03 percent at the end of last year. It fell to a record low 1.39 percent in mid-2012. Yields averaged 2.65 percent since the first QE began in November 2008, compared with 6.95 percent before that in data since 1962. The average rate on a 30-year fixed mortgage was 3.92 percent this week, still near a record low 3.31 percent in November 2012, Freddie Mac data show.

The FOMC said in a supplementary statement at the last meeting that it expects to stop reinvestments of maturing securities once it starts raising the benchmark interest rate, a step that policy makers project they will take next year.

Richmond Fed President Jeffrey Lacker, who votes on policy next year, later said he opposes continuing to hold mortgage bonds. “This approach unnecessarily prolongs our interference in the allocation of credit,” Lacker said in a Sept. 19 statement.

The Fed’s balance sheet includes bonds bought in all three rounds of QE. The first two totaled $2.3 trillion through June 2011. The third round, announced in September 2012, differed from its predecessors in that it was open-ended, with no limit on the amount of purchases and no target date for halting them. The FOMC said it would buy $85 billion of bonds a month until the labor market improved “substantially.”

**Falling Unemployment**

The jobless rate when QE3 started under Chairman Ben S. Bernanke stood at 8.1 percent, and policy makers forecast it would fall to 6 percent to 6.8 percent by late 2015. It’s now 5.9 percent, near what most officials project is full employment, and monthly payroll growth has averaged 209,000 for the past two years, up from a 172,000 monthly average during the prior two-year period.

“The objective was to produce a substantial improvement in the labor market, and that’s occurred,” said Keith Hembre, a former researcher at the Minneapolis Fed who helps oversee $120 billion as chief economist at Nuveen Asset Management LLC in Minneapolis. “You’ve got a labor market that’s much improved and closer to full employment. It’s hard to prove what would have happened in the absence of the program.”

**Tapering**
The FOMC began tapering purchases in December 2013, when it slowed monthly buying by $10 billion. It made six more cuts of the same size at each of the following meetings, saying with each that it would respond to incoming data. The current pace is $10 billion in Treasuries and $5 billion in mortgage bonds.

“The flexibility allowed the Fed to continue to add stimulus until it achieved the goal it set out to achieve,” said Laura Rosner, a U.S. economist at BNP Paribas SA in New York and a former New York Fed researcher. “That’s what made this last one effective.”

While most policy makers agree with that assessment, not all of them are ready to declare mission accomplished.

St. Louis Fed President James Bullard, who helped lay the intellectual groundwork for QE2 in a 2010 paper calling on officials to avert deflation by purchasing Treasury notes, said in an Oct. 16 interview with Bloomberg News in Washington the “logical policy response at this juncture may be to delay the end of the QE” amid stalling growth in Europe and declining inflation expectations. Bullard will vote on policy in 2016.

**Low Inflation**

The Fed in 2012 set a 2 percent inflation target, saying that pace for the personal consumption expenditures index is consistent with its longer-run mandate. The gauge rose 1.5 percent in August from a year earlier, and hasn’t exceeded 2 percent since March 2012. Policy makers want to avoid deflation, because falling prices can encourage businesses and consumers to delay spending in the expectation of further price declines, reducing aggregate demand.


“The fact that we had a very large QE program played an important role,” Rosengren said in an Oct. 17 interview. “That was an important component of getting more confident the economy was going to go, that we were serious about returning the economy to full employment and inflation to 2 percent.”

**QE Effects**

San Francisco Fed President John Williams, who also supports ending QE, said in a presentation in Washington earlier this year that research shows purchases have “sizable effects” on lowering bond yields, though uncertainty remains about the magnitude of these effects and their impact on the overall economy. He cited several research papers showing QE2 lowered yields on the 10-year Treasury note by around 15 to 25 basis points.

Bernanke rattled investors worldwide by telling lawmakers in May 2013 the Fed may slow buying
“in the next few meetings,” spurring the so-called taper tantrum that pushed the 10-year yield up more than 1 percentage point in 15 weeks. Now that skittishness about stimulus withdrawal is long gone.

“We’ll live just fine without QE,” former U.S. Treasury Secretary Lawrence Summers said in an Oct. 21 interview with Bloomberg Television’s “Market Makers” with Stephanie Ruhle. “Interest rates at the 10-year are now much lower, not much higher, than they were before QE started.”

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