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ECONOMY

Fed Faces Crucial Decision on Mix of Treasurys in Its Portfolio

Favoring short-term notes is seen as giving central bank more flexibility if economic growth slows

Federal Reserve Chairman Jerome Powell has signaled the central bank is likely to set a date this week for when it will stop running off its $4 trillion portfolio. PHOTO: SAUL LOEB/AGENCE FRANCE-PRESSE/GETTY IMAGES

By Nick Timiraos

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Markets have cheered the Federal Reserve's imminent announcement that it will stop shrinking its asset portfolio later this year, but determining that date is just one challenge facing central-bank officials.

Now, they are turning to the arguably more sensitive task of determining the composition of the Treasury securities the central bank will hold.

Specifically, they need to decide the right combination of Treasurys of varying duration to hold —whether mostly short-term bills or a mix that also includes more longer-term notes and bonds. This composition will be a matter of intense interest to the markets for those securities, with implications for the economy and monetary policy.

The composition "is more policy-relevant than many of the things people have discussed about the balance sheet," such as the size, said Boston Fed President Eric Rosengren in an interview last month.

Fed Chairman Jerome Powell has signaled the central bank is prepared to announce Wednesday, after its two-day policy meeting, when it will end the runoff of its $4 trillion portfolio later this year. Officials are likely to take up the composition question this week, though the discussions are likely to continue for at least through their next meeting, which concludes May 1.

Several Fed officials in recent interviews and public statements have expressed a preference for boosting their holdings of short-term bills, but they want to do it in a way that won't rattle markets.

The Fed purchased trillions of dollars of mortgage-backed securities and longer-dated Treasurys between 2008 and 2014 to spur growth. Officials believe holding long-term securities stimulates financial markets and the economy by lowering long-term rates and driving investors into stocks and bonds. They think a portfolio weighted toward short-term Treasurys provides little stimulus.

Before the 2008 crisis, the average maturity of the Fed's Treasury holdings was less than four years. Now, it's around nine years. The average maturity of all Treasury debt outstanding is nearly six years.

After the portfolio stops shrinking, the Fed will likely continue reducing its mortgage holdings by letting them mature, currently by around $15 billion a month. It could choose to invest the proceeds from maturing mortgage bonds into Treasurys.

Fed officials are considering two different approaches to the composition question. Minutes from the central bank's December meeting show more officials favor weighting their holdings toward shorter-maturity holdings, returning the portfolio composition to something that reflects its precrisis configuration.

A few officials at the meeting supported maintaining a mix of short-, medium- and long-term securities in proportions that would reflect the outstanding Treasury market. Kansas City Fed President Esther George, in an interview in January, said she prefers this strategy.

Under the theory that buying and holding longer-term securities provides more stimulus, the first approach would be less stimulative to financial markets.

The key appeal of this approach is that the Fed could more easily move to stimulate growth in a downturn by shifting back into long-term securities without first increasing its holdings, as it did during the bond-buying campaigns known as "quantitative easing."

"It gives you more quantitative-easing ammunition if you define quantitative easing as not just size but duration," said William Dudley, who served as New York Fed president from 2009 to 2018, in a recent interview.

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"It would be nice to have maximum room to use that instrument. If the Fed had a shorter-duration Treasury portfolio, they'd have more room," he said.

Mr. Rosengren has noted the Fed will have fewer tools to respond to the next downturn because lower nominal interest rates will leave the central bank with less room to cut them.

He said in a February interview the Fed should consider shortening the duration of the Treasury portfolio now "so that whenever we have that next recession, we have the ability to lengthen the maturity and take some of the duration out of the market."

The Fed doesn't currently own any Treasurys with maturities of one year or less, which represent 15% of outstanding Treasury securities. "What's remarkable is whichever of the two approaches they choose, they're going to have to buy a bunch of short-term paper," said Seth Carpenter, chief U.S. economist at UBS who previously worked at both the Fed and the Treasury.

One key consideration is how fast to transition to any new normal. One possible argument against moving to a bill-heavy portfolio is that it might tighten monetary policy more rapidly than some officials would want right now, though doing so more slowly could alleviate this concern.

Fed officials agree they should move over time to a portfolio of only Treasury holdings, but this could take many years because their mortgage bonds won't fully mature for decades. At the recent pace of home refinancing, the Fed could still own around $500 billion in mortgage holdings at the middle of the next decade.

Officials aren't eager to discuss the possibility of selling mortgage bonds because they don't want to do anything to disturb an already fragile housing market.

"At some juncture there might be a more active approach [to reducing the mortgage holdings], but that is certainly not something that I see as relevant in the shorter term," said Fed governor Lael Brainard earlier this month.

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