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MARKETS

Fed Officials Near Plan to Finish Portfolio Wind-Down

The strategy would conclude an effort to drain stimulus from the financial system earlier than officials once anticipated

Federal Reserve governor Lael Brainard and other officials lately have signaled they favor ending the central bank's bond runoff relatively soon. PHOTO: KEITH BEDFORD/REUTERS

By Nick Timiraos

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Federal Reserve officials are zeroing in on a strategy to end the wind-down of their $4 trillion asset portfolio as soon as this year, which would conclude an effort to drain stimulus from the financial system earlier than they had once anticipated.

Fed officials could finalize more details of their strategy, including whether to slow the pace of shrinking their bondholdings, at their policy meeting next month.

Some officials signaled in recent days they favor ending the bond runoff relatively soon. The process "probably should come to an end later this year," Fed governor Lael Brainard said on CNBC on Thursday.

Cleveland Fed President Loretta Mester, in a speech Wednesday, said they would wrap up the planning at coming meetings.

The Fed began to reduce its portfolio in 2017 by allowing limited amounts of Treasury and mortgage securities to mature without replacing them. The holdings of bonds and other assets has fallen to about $4 trillion from around $4.5 trillion when the runoff began.

The Fed bought bonds between 2008 and 2014 to support the postcrisis economy, but officials in recent months have said they plan to end the runoff for reasons unrelated to any desire to provide more or less stimulus. Instead, the decision is being driven by a technical debate about the demand for reserves, the money banks deposit at the Fed.

After the runoff began, several Fed officials cautioned the asset holdings wouldn't ever decline to their precrisis level of less than $1 trillion because demand for currency, reserves and other Fed liabilities has grown substantially. Still, they said they wanted the portfolio to be as slim as possible.

Several Fed officials recently have said they don't want to reduce reserves to levels that might fuel volatility in short-term money markets. "I want reserves to be high enough where that's not a particular concern," said Boston Fed President Eric Rosengren in an interview Monday.

Reserves have fallen to $1.6 trillion last month from a peak of $2.8 trillion in 2014. A survey of financial institutions by the New York Fed indicated market participants thought reserves could probably decline to $1 trillion, which at the current pace of bond runoff would be reached in roughly one year.

Ms. Brainard said Thursday she would prefer to have a "substantial buffer" of reserves above whatever level is estimated to be adequate for regular market operations.

Mr. Rosengren appeared to share that view, and said determining an ample amount of reserves "is probably more art than science."

Fed officials reached one critical decision at their meeting last month when they agreed to operate monetary policy with a larger level of reserves than they did before the crisis.

When the Fed expanded its portfolio during and after the crisis, it pumped money into banks in exchange for bonds, increasing the amount of reserves in the financial system.

Initially after the crisis, some Fed officials wanted to wind down these reserves to precrisis levels, which would have meant shrinking the portfolio dramatically. Keeping reserves scarce would help them control interest rates as they rose from near zero, the thinking went.

Over time many officials grew more confident they could manage rates even with an abundance of reserves.

In addition to determining when to stop the runoff, officials have to decide how they will do it.

When the Fed began to shrink its holdings in 2017, it allowed $10 billion in bonds to run off every month for the first three months. Each quarter, it increased the monthly pace by $10 billion until reaching a ceiling of $50 billion last October. Actual redemptions have been running lower, closer to $40 billion per month on average, in part because of muted mortgage payoffs from low refinancing activity.

One question now is whether Fed officials will similarly taper the monthly pace as they approach the end. Officials debated such an approach in December but didn't come to an agreement.

Because demand for reserves isn't static and fluctuates depending on market conditions, slowing down redemptions could help officials minimize potential volatility in money markets if they find demand for reserves is strong enough to put upward pressure on their short-term benchmark rate.

"We don't have a precise understanding of this at all," Fed Chairman Jerome Powell said at a news conference last month. "The only way you can figure it out is by surveying people...and then, ultimately, by approaching that point quite carefully."

Officials also must decide what types of Treasury securities they purchase when they are done running down the portfolio. Officials plan to continue shrinking their holdings of mortgage-backed securities, and they will need to reinvest the proceeds of those maturing bonds into Treasurys.

"It won't be the first thing we work on but it will be one of the first things that we try to resolve," Mr. Powell said last month.

Fed officials' embrace of a larger portfolio than originally conceived has coincided with less political opposition to a bigger balance sheet, particularly from Republican lawmakers who for much of the past decade said the Fed kept policy too easy but now say it could be too tight.

One other set of decisions revolves around how officials communicate their plans. Markets have been on edge over the Fed's intentions.

Minutes from the Fed's January policy meeting, due next Wednesday, could shed more light on recent discussions, as could testimony from Mr. Powell before Congress later this month.

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