Federal Reserve and Unwinding

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The FOMC has decided to maintain the target range for the Fed funds rate at 1-1.25% with an accommodative stance that will support further strengthening of the labour market conditions while keeping inflation at 2%. The Central Bank has raised the rate three times since December 2015 when the first hike was invoked (Dec 2016, March 2017 and June 2017) as the economy gradually improved.

How is the US economy looking according to the Fed?

- GDP growth forecast increased to 2.4% from 2.2% for 2017.
- Growth in business fixed investment has picked up in recent quarters.
- Household spending has been expanding at a moderate rate.
- Overall inflation excluding food and energy prices has declined this year and is below 2%.
- The Fed has reduced its outlook for inflation from 1.7% this year to 1.5% and from 2% to 1.9% in 2018.
- The labor market continues to strengthen and unemployment stable.

What are immediate concerns?

- Hurricanes Harvey, Irma, and Maria are expected to affect economic activity in the near term but unlikely to materially alter the course of the national economy over the medium term.
- Higher prices for gasoline and some other items in the aftermath of the hurricanes will likely boost inflation but only temporarily.
- The actual path of the Federal funds rate in future will depend on the economic outlook as informed by incoming data.

How about unwinding?

The move to unwind the portfolio of bonds acquired by the Fed during the crisis-era through bond-buying programmes was widely anticipated. The Fed will begin to roll off its $ 4.5 trillion balance sheet in October. The Committee will initiate the balance sheet normalization program as described in June 2017. The Fed will begin unloading $10 billion of debt from its balance sheet, including $6 billion in Treasury securities and $4 billion in agency debt each month through December.

The Fed, it may be recollected had pursued three rounds of quantitative easing between 2008 and 2014 to stimulate the economy after the 2007-2009 financial crisis and recession. The Fed had kept increasing its purchases of Treasury bonds and mortgage-backed securities following the financial crisis as part of the strategy to stimulate the economy by reducing borrowing costs. The Fed had already reduced its benchmark interest rate to zero and changed it by increasing it only in December 2015 after 7 years.

How will the unwinding take place?

The Fed has provided a formal timetable on how the operation will take place. Instead of reinvesting all the proceeds of its bond portfolio, the Fed will allow $10 billion to roll off at first, increasing quarterly in $10 billion increments until the total hits $50 billion starting in October 2018.

While the Fed stopped the QE in 2014, it did not mean that it stopped buying assets at that time. As QE was through bond purchases, on maturity the US government repaid the Fed, which then reinvested the amount in new bonds thus retaining the QE levels. This has kept its holdings roughly constant. Now it is going to reduce the amount that it 'reinvests'. Hence, from now on as more bonds mature its holdings will decline.

Any further rate cuts?

The majority of Fed policymakers signaled that they expect to increase rates one more time this year. Analysts however expect as many as three hikes in 2018 and two in 2019 with expectations of a stronger economy.

What can be the impact of unwinding?

- The 10-year yield could move towards the 2.5% mark this year once the unwinding starts and can rise further as the Fed shrinks its portfolio by to $50 billion a month.
- The ECB also said that it could be unwinding though no time lines have been provided. The BOJ is still buying bonds and may do so for the next 2 years until inflation moves towards the 2% mark.
- The dollar should ideally be strengthening with unwinding of the QE and increasing of rates reflecting a stronger US economy. But this has not happened so far. But once it does, it would definitely mean that other currencies would weaken.
- Indian monetary policy though not linked with global policy actions has to keep in mind this factor as the present interest rate differential between the US and India has opened options for foreign investors. This has been an important factor in stabilizing the balance of payments which is otherwise under strain with a widening current account deficit. With inflation remaining benign, there could hence be reason for the RBI to maintain status quo on interest rates.