Seacoastonline.com

Fed to start reducing 4.5 trillion balance sheet

Heather Long

September 22, 2017

The Federal Reserve said Wednesday the U.S. economy is strong enough for the central bank to begin reducing its $4.5 trillion balance sheet in October, gradually unwinding a massive stimulus program started after the economy entered a severe recession nearly a decade ago.

The Fed will scale back its holdings by $10 billion in October and raise that amount gradually in the months to come. After the 2008 financial crisis and ensuing recession, the Fed took the unprecedented step of beefing up its holdings of government bonds and mortgage-related securities from $900 billion to $4.5 trillion in an effort to turn the economy around.

The U.S. economy keeps getting better, according to the central bank. Consumers continue to spend, and business investment is “picking up,” the Fed said. It now projects even faster growth this year of 2.4 percent, an increase from it forecast of 2.1 percent earlier this year.

″ The reason for our actions today...is we think the economy is performing well,” said Federal Reserve Board Chairwoman Janet Yellen on Wednesday.

The Fed did not change interest rates, which remain in a range of 1 to 1.25 percent, but the central bank says it still thinks growth will be strong enough to merit another rate hike by the end of the year and three more in 2018 to bring rates above 2 percent.

The Fed also expects American companies to keep hiring and unemployment to fall further to 4.1 percent next year. The Fed believes inflation will remain below the bank’s 2 percent target until 2019.

Despite many encouraging signs in the economy, Yellen is opting to go slowly to reduce the central bank’s $4.5 trillion holdings. She wants to telegraph the Fed’s move clearly in an attempt to calm investors and the American public. Her term expires early next year, and it’s unclear if President Trump will re-appoint her to the job.

Yellen said Wedesday she has not met with Trump to discuss who will be the next Fed chair. She declined to say if she wants to stay on after her term expires in February.

Reducing the massive balance sheet was not without risks. There was no guidebook for the Fed’s balance sheet to grow so large, and there’s no guidebook now on how to shrink it back down. It’s the first time the Fed has done this. If it goes wrong, it could send stock and bond markets into a tailspin that could spill over into the broader economy.

“If I had to bet, I would bet things would go smoothly, but I wouldn’t bet the farm on it,” Joseph Gagnon said of the balance sheet reduction. Gagnon is a senior fellow at the Peterson Institute for International Economics who used to work at the Federal Reserve.

But if the bank moves too slowly, it could end up still sitting on a bloated balance sheet when the economy hits its next downturn - leaving it without the some of tools it needs to stimulate growth.

“It’s past time to reduce the Fed’s balance sheet, because its role in the economy is unnecessarily large,” said Tate Lacey, an economist at the Cato Institute, a libertarian think tank that has criticized the Fed for bulking up its balance sheet so much.

After nearly a decade of unprecedented efforts to pull the economy out of the 2008-2009 recession, the Fed’s work is yielding results. The economy has added more than 15 million jobs since the worst of the crisis, and the United States is in the midst of the third-longest economic expansion in the nation’s history.

The Fed is trying to avoid disrupting this growth by outlining its plans clearly to avoid the type of uncertainty that tends to unnerve investors and rattle markets. The Fed already released a plan in June to start small, unloading $10 billion worth of assets a month and then scaling up gradually over time until it is shedding $50 billion a month, starting in October 2018.

“We do not plan on making adjustments to our balance sheet normalization program,” Yellen said, although she added the Fed would reassess if something dramatic happens to the economy or markets.