Yellen Sets High Hurdle for Reducing Fed's Bond Holdings

Wire service reports

Federal Reserve Chair Janet Yellen set a relatively high hurdle for shrinking the central bank's balance sheet, leading some analysts to conclude that such a move won't occur this year.

She told the Senate Banking Committee on Tuesday that the Fed's focus was on raising interest rates to keep the economy in balance and not on reducing its holdings of bonds.

Rates first need to reach sufficiently high levels that the Fed feels it has some room to cut them to offset a weakening economy. Only then would the central bank begin to shrink its $4.5 trillion balance sheet, she said.

"What we would like to do is to find a time when we judge that our need to provide substantial accommodation to the economy in the coming years is minimal," she said. The central bank also wants to be sure "that the economy is on a solid course and the federal funds rate has reached levels where we have some ability to address weakness by cutting it," she added.

Ward McCarthy, chief financial economist for Jefferies LLC in New York, said this meant no move to start shrinking the balance sheet in 2017.

Policymakers expect to increase the fed funds rate to 1.4 percent by the end of 2017, according to the median of their projections released Dec. 14. That would still leave it below the 20-year average of 2.3 percent.

The timing and scope of any moves to reduce the Fed's debt holdings could have big implications for the bond market and for the economy as a whole. That's because, as Yellen herself noted, they would represent an effective tightening of monetary policy.

"Allowing that process to take place," Yellen said, "will show that the economy is doing well."

The policy-setting Federal Open Market Committee has said it will continue to reinvest principal payments on the maturing bonds in its portfolio until "normalization of the level of the federal funds rate is well underway."

WIKIMEDIA

Federal Reserve chief Janet Yellen triggers clashes between Republicans and Democrats during congressional appearances this week.

In her House appearance Wednesday, Republicans and Democrats on the Financial Services Committee clashed over the role the Federal Reserve has played in helping the economy to recover from the Great Recession.

GOP lawmakers told Yellen that the Fed's ultra-low interest rates and massive bond buying left the economy growing at the slowest pace for any economic recovery in the post-war period. Democrats countered that the Fed's policies succeeded in creating nearly 16 million jobs and pushing the unemployment rate down to 4.8 percent, compared to the 10 percent jobless peak caused by the recession.

Yellen told the panel that the Fed is close to achieving the two goals it has been given by Congress — promoting maximum employment and stable inflation.

Lawmakers also used the hearing to argue over the impact of the 2010 Dodd-Frank Act on the nation's financial sector.

President Donald Trump is supporting an effort by congressional Republicans to overhaul the law. They contend it imposed burdensome regulations that have limited the ability of the banking system to make loans, especially to small businesses.

Democrats argued bank loans have actually been rising and repealing Dodd-Frank could bring back dangerous practices that led to the 2008 financial crisis.

GOP lawmakers asked that Yellen put a hold on any banking regulations until Trump is able to nominate an official to be the vice chairman for bank supervision at the central bank. Trump will have the ability in his first year in office to fill three vacant seats on the seven-member Fed board.

FURTHER GUIDANCE

In her prepared remarks Wednesday, Yellen said the Fed expects to move interest rates up at a gradual pace this year as long as the job market and the economy remain solid. She said it's too early to determine the impact Trump's economic program will have on the economy.

Yellen told the lawmakers Tuesday that the FOMC will discuss its strategy "in the coming months" with the aim of providing investors with "some further guidance" about its intentions.

The central bank will want to telegraph its plans well advance of their implementation so as to avoid upsetting financial markets, said Michael Feroli, chief U.S. economist at JPMorgan Chase & Co. in New York. He expects policymakers to do that in the second half of the year. The process of halting reinvestments though won't begin until the middle of next year, according to Feroli.

Yellen rejected recent suggestions by several Fed bank presidents that the central bank use its balance sheet as an active tool of monetary policy. Instead, the focus will remain on managing the fed funds rate in response to changes in the economy.

The Fed chair also said the reduction in its bond portfolio would occur in a "gradual and orderly way."

That's similar to the strategy the central bank employed when it tapered its asset purchases in 2014, reducing them in set amounts at each policymaking meeting.

More than $600 billion in Treasury securities in the Fed's portfolio are scheduled to mature this year and next, according to calculations by Bloomberg.

Yellen's four-year term as Fed chair expires Feb. 3, 2018, and she repeated that she has no plans to leave the central bank before then.

McCarthy said the next Fed chair might well take a more aggressive approach to reducing the balance sheet, although Feroli said it might be difficult to change the Fed's strategy once it has been put into place and digested by the markets.

Yellen told lawmakers that she expects the central bank to eventually end up with "a balance sheet that's substantially smaller than at the current time."

"In addition, we would like our balance sheet to again be primarily Treasury securities," she said. Besides Treasuries, the Fed portfolio also contains mortgage-backed debt and agency securities issued by Fannie Mae and Freddie Mac.

There's a limit to how far the balance sheet can be reduced, however. At a minimum, it needs to be big enough to cover the roughly $1.5 trillion in currency now in circulation, which is increasing every year.

Reporting by Bloomberg News and the Associated Press.