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Fed Thoughts: **Follow the Money**

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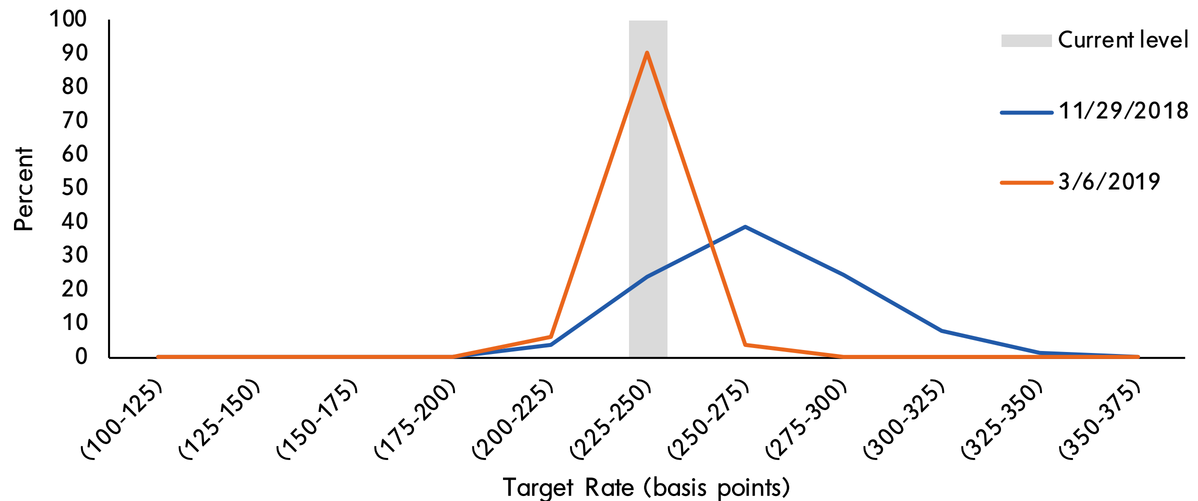
There is no point discussing the policy-rate decision for the upcoming Federal Open Market Committee (FOMC) meeting. Federal Reserve (Fed) officials already made up their collective mind to put policy on pause earlier this year. By dint of precedent, as long as they include the promise to be "patient" in setting policy in the statement, they are contracting not to act at the next meeting. It was there in January, so there will be no action in March.

Federal Funds Rate in December 2019

As implied by futures



Source: CME Fedwatch tool, accessed 3/7/19.

Market participants got the message, which explains why the near-term fed funds futures contract treats inaction as a lock. The near certainty in financial market prices that the pause persists, seen in the December contract, is more difficult for us to understand (for the reasons spelled out here). Economic data have disappointed of late, to be sure, but this is not too surprising given the slowing in some important trading partners, the not-unrelated uncertainties stirred up by the US-China trade dispute, and the distraction of the longest US government shutdown the since the British burned the White House in 1814.

More telling about the future than the past, Chinese officials mostly reversed their efforts to rein in financial-sector leverage and stepped up fiscal impetus. With a trade deal reportedly imminent, the second-largest economy in the world should pick up in the second half of the year. This provides a boost to growth in trade-sensitive Europe, as does the provision of additional liquidity, earlier than we had expected, from the European Central Bank. Closer to home, jobs continue to be created at a rapid clip, and wage growth is creeping higher. Once the first quarter is in the rear-view mirror, real GDP growth should settle at a run rate slower than the 3 percent pace of 2018 but still above that of its longer-run trend.

If FOMC participants share this view, they should also expect the unemployment rate to go further below its natural rate. That is why a majority of FOMC participants probably believe it is appropriate to raise the policy rate within the next 1¾ years. That is, more dots in the infamous Summary of Economic Projections chart will cluster above the current target of 2½ percent than at or below it. This may prove jarring to some, given all the talking Fed-heads fretting about risks and extolling the virtue of patience.

Our explanation from last month was that this tonal shift owed to a change in communications strategy rather than a marked downgrading of the economic outlook or a sudden rethinking of the Fed's objectives. The sharp selloff in December and flurry of tweets showed that the denizens of Wall Street and the occupant of the White House are skittish about economic momentum. Fed Chair Powell and company concluded that leading this pack from the front invited shots in the back. They have dropped to the rear, behind the cover that all decisions are data dependent. We believe the market will not move toward our expectations through guidance from the Fed but when data show a continued intensification of pressure on resources and a pickup in inflation.

Unless, of course, we are wrong. The bitter taste of defeat probably comes in a combination of three flavors. First, scale matters, and the sheer amount of stimulus Chinese officials have to throw at their problem may throw off their aim. Second, if disinflation gains steam in the economies of the Asian Pacific Rim, the external drag of US inflation might allow the Fed to run the labor market hotter for longer. Third, while the US-China trade dispute appears to be in its ninth inning, the game may enter extra innings or the US administration may be planning to a play a double header. As for the latter, we worry that, with a still-confidential report on the national security risks posed by auto imports sitting on the President's desk, the White House may pivot to confront the European Union (EU) on trade. After all, it fits three criteria for why the president believes trade disputes are winnable. Comparing the US and the EU, auto trade is more important to them than to us, we have more cyclical momentum, and their tariffs on us are generally higher than ours are on them.

Even though there is not much to talk about concerning the policy rate, the FOMC meeting will still take two days (March 19 and 20), perhaps revealing that many of the visiting Reserve Bank presidents bought nonrefundable airplane tickets. Fear not, as they will fill the time nailing down their plans for the balance sheet. Prior to this year, our thought, shaped by statements of many Fed officials, was that the caps on reinvestment of maturing and prepaying securities would remain in place until spring 2020. If so, the balance sheet would level off at $3½ trillion. About $1 trillion of the space on the liability side would take the form of excess reserves. By stopping this fall, the FOMC signals that it is comfortable with about one-quarter trillion more heft to its balance sheet, mostly in reserves. The prior forecast already left reserves well out on the flat portion of reserve demand, implying shifts in the sloped portion of demand would not add to the volatility of the federal funds rate, a desideratum of policy makers.

Federal Reserve Balance Sheet

Millions (US Dollars)

Assets		Liabilities	
Securities Held Outright	3,785,438	Federal Reserve Notes	1,671,653
Treasury	2,175,420	Reverse Repurchases	237,132
Agency	2,409		
MBS	1,607,609	Treasury Deposits	213,611
		Bank Deposits	1,801,666
Other Assets	183,696		
		Other Liabilities	5,884
Total Assets	3,969,134	Total Liabilities	3,929,946
		Capital	39,188

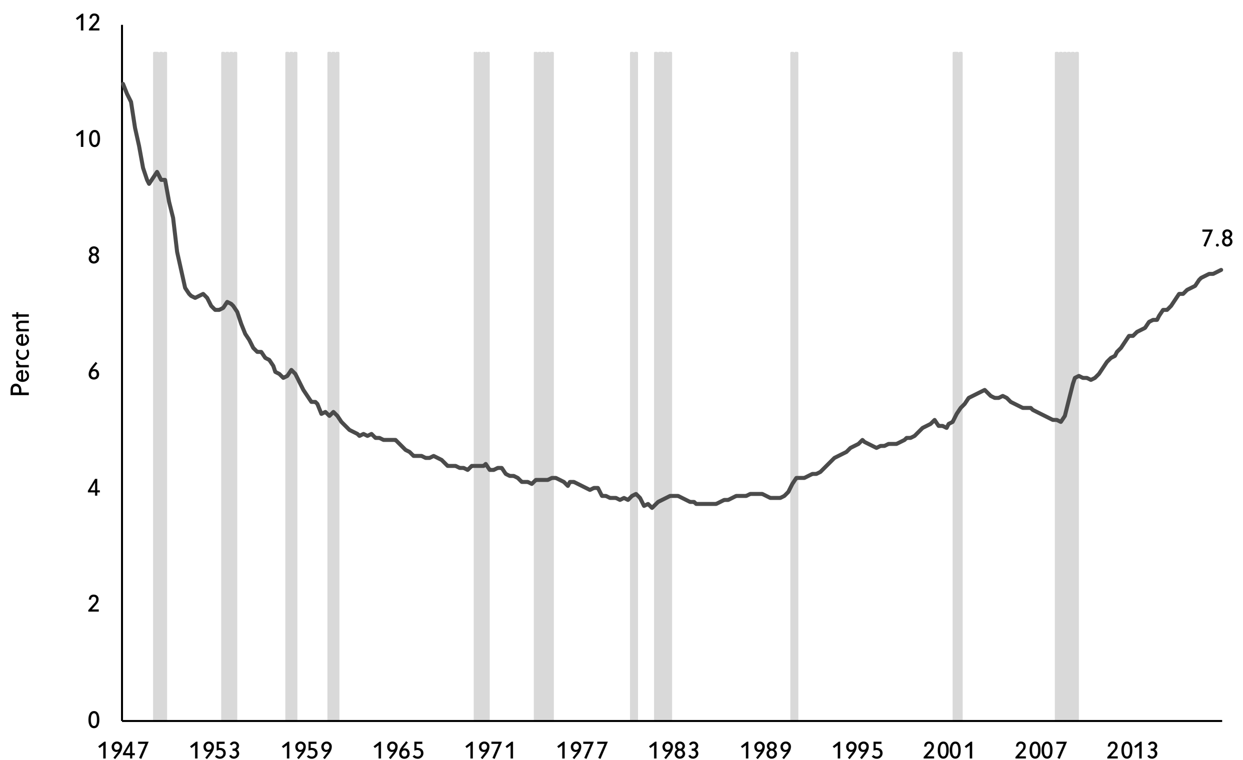
Source: Federal Reserve H4.1, accessed 3/7/19.

Three developments likely made them comfortable with an earlier stop.

First, currency (the largest liability item over time) continues to grow rapidly, at a pace exceeding that of nominal GDP by about 5 percentage points from 2007 to 2008. This extends the secular decline in the currency-to-GDP ratio and means that the same amount of assets on the Fed balance sheet is associated with fewer excess reserves. The $1.6 trillion of currency currently outstanding translates into per capita holdings of about $5,000, which does not take much personal introspection to come across as implausibly large. The best clue for explaining both the high-level and rapid growth rate is in the composition of bank notes by denomination.

The banking system supplies the notes people want on demand, and the demand is for big bills. This tends to be about stores of value or illicit exchange. As for the former, the world remains a risky place and foreign demand probably pulls up the total. It does not hurt, either, that nominal interest rates have been low, holding down the cost of storing cash. As for the latter, some of those who left or never entered during the deep recession and initially hesitant recovery may remain in the "informal" economy, which is more cash intensive.

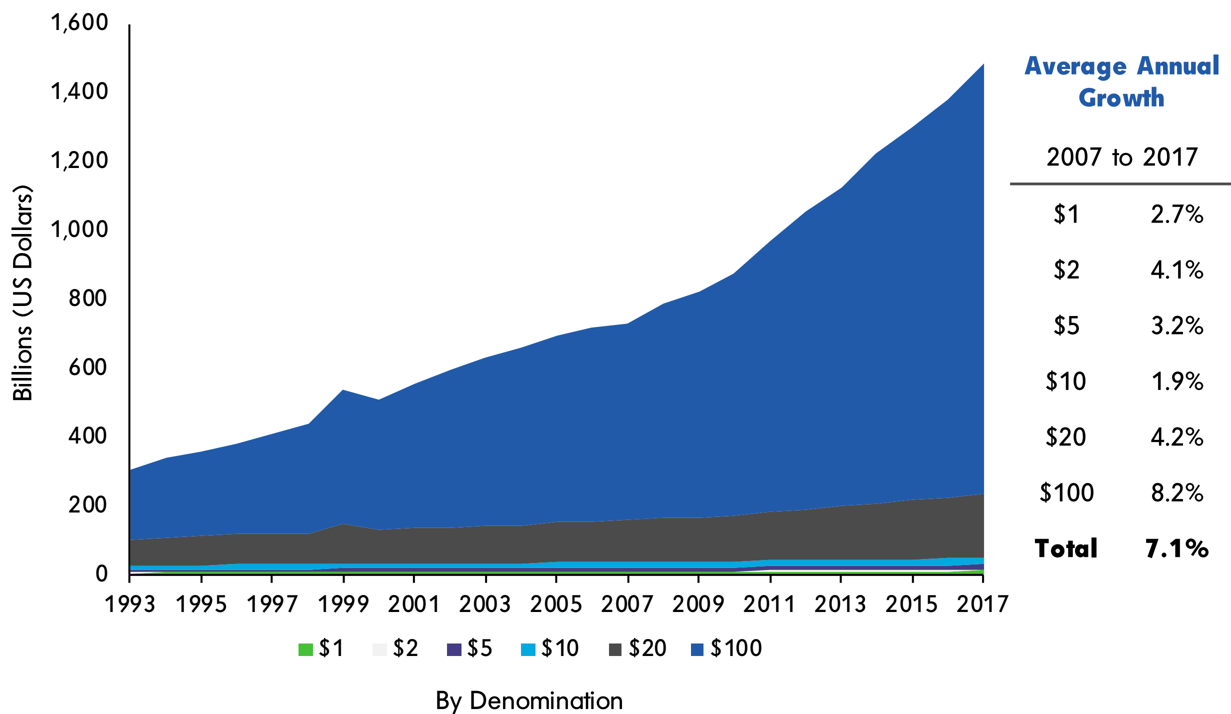
Currency Relative to Nominal GDP



Note: Shaded area represents recession as dated by the NBER. Source: BEA, Federal Reserve, and NBER, accessed via FRED, as of 10/1/18.

Second, Fed officials may be more comfortable that banks will be willing to hold an elevated level of excess reserves. Of course, some of that private-sector willingness owes to the public-sector regulation and supervision of the Fed and the other banking agencies. Reserves are high-quality assets and serve well as a liquidity buffer at a time of stress. Indeed, staff of the Federal Reserve Bank of New York published a note on the day the January FOMC minutes were released showing that the eight largest banks would need from $500 to $875 billion of liquidity, in the aggregate, if they were completely shut out of the funding market (at least as could be determined from public documents).[1]

Value of US Currency in Circulation



Source: Federal Reserve, accessed via FRED.

Third, while FOMC participants may not agree on the overall size of the balance sheet, they almost unanimously prefer to hold only Treasuries on the asset side. Purchasing housing agency and mortgage backed securities (MBS) was an unconventional policy that, after that party ended, leaves them vulnerable to accusations of manipulating spreads. Running off assets generally was a means to shrink MBS holdings specifically. The FOMC minutes indicate that they are now comfortable in reinvesting the maturing and prepaying proceeds of MBS into Treasuries, allowing them to stop the overall portfolio shrinkage sooner and continue to scale back its MBS share over time.

This is an earlier stop in balance-sheet shrinkage but not a sudden stop. The Fed will blind us with details of reserve market mechanics and staff reports on potential glide paths for asset holdings. After all, in the view of many Fed officials, monetary policy is a science.

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Vincent is Mellon's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

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Endnotes

[1] Ryan Bush, Adam Kirk, Antoine Martin, Phil Weed, and Patricia Zobel, "Stressed Outflows and the Supply of Central Bank Reserves," February 20, 2019. Accessed at https://libertystreeteconomics.newyorkfed.org/ 2019/02/stressed-outflows-and-the-supply-of-central-bank-reserves.html.

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