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Economics Group

Interest Rate Weekly

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Notes on the Fed's Exit Strategy, Part I

As the Fed continues to wind down its asset purchases, we are approaching a tipping point in monetary policy. The focus now shifts to how the Fed will begin to reverse unconventional monetary policy.

Overview of Fed Programs

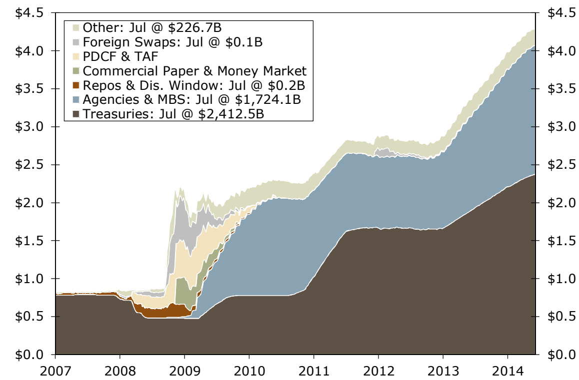
The FOMC is scheduled to end its asset purchases in October, signaling the end of the unconventional monetary policy operations by the committee which has resulted in a large number of assets on the balance sheet at the Fed (top graph). The focus now shifts to how the Fed will begin to tighten monetary policy and the use of tools other than the fed funds rate in order to conduct policy actions going forward. Given the large scale asset purchases by the Fed, the potential exists that the fed funds rate alone may not be effective in controlling interest rates. In this week's note, we review the range of options the Fed could potentially use to help move interest rates when the time comes.

The Interest Rate on Excess Reserves (IOER), which is the rate paid to banks to hold reserves at the Fed, helps to set the floor for the federal funds rate. In essence, banks are paid to hold funds at the Fed (middle graph). The problem emerges when the fed funds rate is below the IOER due to Government-Sponsored Enterprises (GSEs) selling in the Fed funds market. Should this occur, the effectiveness of the IOER to set a floor on the fed funds rate would be diminished. Thus, the Fed has introduced a Reverse Repurchase Facility (RRP) in which the Fed sells securities that are on its balance sheet to financial institutions while it agrees to repurchase those assets the next day and pay a slight return to the institutions. The key difference with the RRP and IOER is that the market is broadened to include a larger set of financial institutions to earn interest and, in turn, helping to steer short-term interest rates. However, this new RRP facility has raised some concerns about the potential effects on short-term instruments during flights to quality inside the Fed, primarily from NY Fed President Dudley. Yet another tool in the Fed's toolbox is known as the Term Deposit Facility (TDF), in which the Fed pays interest on a portion of the bank reserves held at the Fed in order to lock up some of these reserves for seven-day periods. This process would also supplement the IOER paid in order to control short term rates.

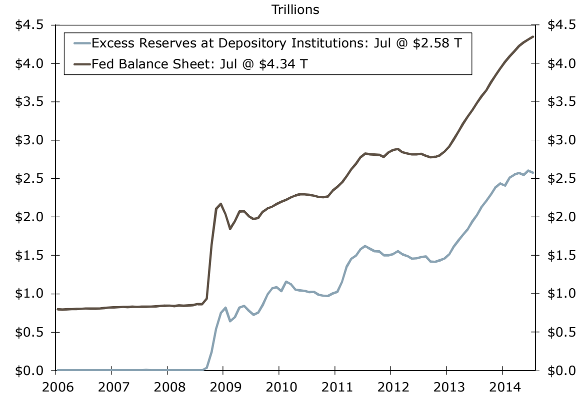
Things to Look for in the Months Ahead

We will be looking for signs from the Fed on the proposed use the RRP facility and the TDF. While we expect the Fed to reinvest the proceeds of maturing assets to maintain the level of assets on the balance sheet for some time, the question remains regarding the impact of drawing down the level of assets on the Fed's balance sheet. While we are certainly not implying a causal relationship, we do find the correlation between the level of assets on the Fed's balance sheet and equity markets (bottom graph). Now at the tipping point of monetary policy is the time to pay even closer attention to the fine details of the Fed's operations and its numerous impacts on financial markets.

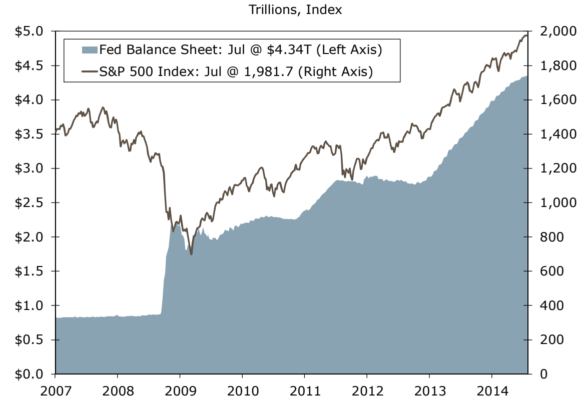
Federal Reserve Balance Sheet
Trillions



Excess Bank Reserves
Trillions



Federal Reserve Balance Sheet vs. S&P 500 Index
Trillions, Index



Source: Federal Reserve Bank, IHS Global Insight and Wells Fargo Securities, LLC

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