



Impact of Fed's Plan to Do a "QE Unwind"

What makes tomorrow's meeting at the Federal Reserve so interesting to market watchers and bond investors is the likelihood that Fed Chair Janet Yellen will provide more details on her plans to [begin unwinding](#) the Fed's balance sheet: how much, how fast, how soon, and what does it all mean? In addition, she is hoping to placate conservatives in Congress who remain unhappy over the Fed's intervention in the markets in the aftermath of the real estate collapse that triggered the Great Recession.

In June, Yellen outlined some possible scenarios, which included letting some of the bonds on the central bank's enormous \$4.2 trillion balance sheet simply mature without reinvesting the funds in new issues. She suggested the Fed would also start selling off some \$10 billion a month of existing securities, and then raise that amount every quarter until it reaches \$50 billion a month. This way, by expanding on her plans, and by slowly — very slowly — shrinking the Fed massive balance sheet, she hopes to avoid another "taper tantrum" that bond investors experienced back in 2013 when then-chairman Ben Bernanke first said the Fed should start reducing some of its holdings of U.S. Treasuries and mortgage-backed securities.

If she provides sufficient clarity, and sufficient caution, Yellen might not only start the process without disrupting the market, but also avoid further criticism from congressional critics who think the Fed stepped way out of bounds in starting the whole "quantitative easing" (QE) program in the first place. In that way — again, if she is successful — she will not only cement into place the Fed as a necessary element in the American economy, but show that further "QE" expansions to meet future recessions are a legitimate tool.

Whether she can pull it off is an open question. Keynesian economist Austan Goolsbee, who headed Obama's Council of Economic Advisors in 2010 and 2011, said, "The final exam, with the grade yet to be determined, is: can the Fed actually get out of this stuff?"

The Fed has been essentially flying blind for years, moving outside not only its mandate (to maximize labor force participation while keeping inflation under control) but its past experience. Said David Blanchflower, a Dartmouth College economist (read: Keynesian) who was on the monetary policy committee of the Bank of England from 2006 to 2009, expressed it perfectly: "We had no idea what we should buy, how much, for how long ... [and] there is no idea on the way going out."

It was all a grand experiment: expand the money supply to keep interest rates so far below market rates that people seeking income would take higher risks — i.e., dividend-paying stocks, real estate ventures, etc. — and home owners would find it easier to buy houses. This was the Keynesian antidote to the economic collapse. Rather than let the economy right itself by itself (see America's recession and recovery in 1920-1921), Keynesians suffer the hubris to think they know better than the market, and intervened, resulting in the longest, slowest recovery from a recession in American history.



Written by [Bob Adelman](#) on September 19, 2017

Once the Fed began to embark on its plan to bail out banks and other financial institutions in the wake of the real estate collapse, there was no going back. When the federal government took over Fannie Mae and Freddie Mac — mortgage insurers that were approaching bankruptcy — it found that it needed to buy up billions of their failing mortgages. That explains why \$1.7 billion of the Fed's balance sheet consists of mortgages and mortgage-backed securities.

But when that didn't work the Fed adopted the strategy of "quantitative easing" (QE) — creating money to spur spending across the economy — which some observers thought would never end.

But it did end, in 2014, and the Fed has been sitting on its massive pile of government and mortgage debt, waiting for the economy to revive enough so it could be offloaded without major economic disruptions.

The Fed won't be unwinding its entire portfolio. Instead it expects to reduce it by between \$800 billion and \$1 trillion over the next few years, leaving in place a balance sheet of between \$2.5 and \$3.2 trillion. This means that the Fed will never again see days when its balance sheet shrinks all the way back to the \$900 billion it had prior to the Great Recession.

Its plan should have little impact on short-term rates. Using the 10-year Treasury as the standard, when Yellen's plan (assuming it begins in October) kicks in, it might boost its yield by perhaps a quarter of a percentage point. This would be the natural result of increasing supply in a market with a fixed demand. When more is supplied, prices will go down. In the bond market that translates into a mini-interest rate hike.

But demand from abroad for U.S. bonds continues to be strong. Yields on 10-year bonds issued by foreign governments such as Japan's and Germany's remain far below U.S. 10-year bonds and so any increase in rates here will only make them more attractive to foreign buyers.

In fact, once Yellen has filled in the details, as she is expected to do on Wednesday, investors and market watchers are likely to express a sigh of relief, and continue the Fed-fueled rally in stocks that began in 2009 and that shows little sign of stopping. Diane Swonk, chief economist at DS Economics, agrees: "The start to reducing the Fed's balance sheet is an action the markets are ready for. The Fed has laid out a roadmap and there is really a sense of relief to finally get it started."

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