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Fed Prepares to End Balance-Sheet Runoff Later This Year

Minutes from the meeting show a split over whether officials believed any interest-rate increases would be necessary this year

By Nick Timiraos

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Most Federal Reserve officials last month expected the central bank could stop shrinking its $4 trillion asset portfolio later this year and believed a plan to do so should be released soon.

Officials agreed "such an announcement would provide more certainty about the process for completing the normalization of the size of the Federal Reserve's balance sheet," according to the minutes of the Jan. 29-30 meeting, released Wednesday.

Officials also agreed to signal a pause in interest-rate increases until they could better judge the outcome of rising risks to U.S. economic growth that had materialized since they raised their benchmark short-term rate in December. "Many participants suggested that it was not yet clear what adjustments to the target range for the federal funds rate may be appropriate later this year," the minutes said.

The written account of the meeting showed a split over whether officials believed any interest-rate increases would be necessary this year because of diverging views over the economy's likely trajectory.

Several officials "argued that rate increases might prove necessary only if inflation outcomes were higher than in their baseline outlook," the minutes said. Others indicated, however, that they expected another interest rate increase could be justified given their outlook for solid growth later this year.

Officials have used the word "patient" to describe their current stance of putting rate increases on hold, and some form of the word appeared 14 times in Wednesday's minutes. Officials didn't see significant risks to signaling they would move to the sidelines after raising rates in quarterly intervals last year, the minutes said.

But they also discussed contingency plans should they need to return to raising interest rates. "Many participants observed that if uncertainty abated, the committee would need to reassess the characterization of monetary policy as 'patient' and might then use different statement language," the minutes said.

In December, officials raised their benchmark rate by a quarter-percentage point and signaled two more rate rises were likely this year. At last month's meeting, officials delivered an about-face from their policy stance six weeks earlier because the economic outlook had turned cloudier.
Financial-market volatility had increased due to concerns over slowing global growth, trade tensions between the U.S. and China, and the Fed's plans to continue lifting rates. In addition, the expiration of funding for parts of the federal government resulted in a 35-day shutdown.
Tighter financial conditions and the prospect of muted inflation convinced officials they no longer needed to raise rates with the same urgency they had in 2018.

Several Fed officials at the January meeting said they had slightly lowered their outlook for economic growth this year since the December meeting, pointing to softer consumer and business sentiment, downgrades in foreign economies' growth outlooks and tighter financial conditions stemming from the year-end market swoon, the minutes said.
While many of the crosscurrents officials cited last month for justifying their policy pause had been building last fall, the minutes provide a fuller account of why officials changed course more convincingly after the December meeting.
Market volatility, for example, increased in the two weeks following the December meeting. In addition, officials expressed concern with the narrowing in spreads between short- and long-term interest rates. Recessions tend to follow, by roughly one or two years, after the spread turns negative.
Some officials also signaled worry that increases in corporate borrowing costs could ultimately restrain economic growth.

The shift in the Fed's rate outlook reflects a broader stepping back from the framework that has guided policy decisions in

recent years. The Fed operates under a framework that expects diminishing slack in the labor market to ultimately fuel rising price pressures across the economy, requiring pre-emptive rate increases to keep inflation under control.
Even though unemployment has fallen to levels expected to generate wage and price pressures, inflation has run below the central bank's 2% target during most of the past three years in which the Fed has raised interest rates.
The unemployment rate ticked up to a still-low 4% in January from 3.7% last fall.
Inflation has been running near the Fed's 2% target since last year, though measures of inflation that exclude volatile energy and food prices have been running slightly below 2%.
At the January meeting, "several participants judged that risks that could lead to higher-than-expected inflation had diminished relative to downside risks," the minutes said.
Some officials said recent declines in oil prices, weaker growth abroad, and a stronger dollar could continue to hold down inflation this year.
Fed officials have signaled recently they see much less urgency to pre-emptively tighten policy because interest rates have moved closer to a neutral range expected to neither spur nor slow growth.
Wednesday's minutes also spell out in greater detail how discussions have unfolded around the Fed's asset portfolio. The central bank began to shrink its balance sheet in 2017 by allowing limited amounts of Treasury and mortgage securities to mature without replacing them. The portfolio has fallen to $4 trillion from around $4.5 trillion at its peak.

The Fed never said how long that runoff process would run. Fed Chairman Jerome Powell declined to give any updated time frame after last month's meeting.
While the Fed expanded its holdings from 2008 to 2014 to provide more support to the economy, Mr. Powell said the central bank was preparing to end the runoff for reasons unrelated to providing more or less stimulus. Instead, the decision is being driven primarily by a technical debate about the demand for reserves, or money banks hold at the Fed.
Bank reserves have declined to around $1.6 trillion last month from a peak of $2.8 trillion in 2014.
A staff briefing at the meeting last month suggested the decline in reserves might reach an appropriate endpoint later this year, and the Fed's staff presented options for slowing the process by ending the asset runoff "at some point over the latter half of this year."
After that, the Fed would hold its asset portfolio steady for some time, before later allowing it to rise again as warranted by demand for the Fed's liabilities, including currency and reserves. At that point, the Fed would return to the market to buy Treasurys.
Officials plan to continue shrinking their mortgage holdings over time to return to a portfolio of primarily Treasurys. Currently, the Fed is allowing up to $20 billion of its mortgage bonds to mature every month, though the actual amounts have been less than that because low refinancing activity has reduced mortgage payoffs. Officials debated last month whether to maintain the cap in mortgage-bond redemptions after the Fed stops shrinking its Treasury holdings.
Officials haven't decided what types of Treasury securities they will purchase when they are done running down the portfolio, and Wednesday's minutes didn't yield new clues.
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