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Communicating a Plan for Ceasing or Phasing Out Reinvestment

Steve Meyer (Board of Governors)

This note is intended to facilitate the Committee's discussion of what additional information to provide the public about its plans for ceasing or phasing out reinvestment and shrinking the balance sheet, and of when and how to release that information.

The Policy Normalization Principles and Plans that the Committee released in September 2014 give the public some information but few details about the approach the Committee will take to ending reinvestment and shrinking the SOMA portfolio. Specifically, the Policy Normalization Principles and Plans contain the following points:

- The Committee intends to reduce the Federal Reserve's securities holdings in a gradual and predictable manner primarily by ceasing to reinvest repayments of principal on securities held in the SOMA.
    - The Committee expects to cease or commence phasing out reinvestments after it begins increasing the target range for the federal funds rate; the timing will depend on how economic and financial conditions and the economic outlook evolve.
    - The Committee currently does not anticipate selling agency mortgage-backed securities as part of the normalization process, although limited sales might be warranted in the longer run to reduce or eliminate residual holdings. The timing and pace of any sales would be communicated to the public in advance.
- The Committee intends that the Federal Reserve will, in the longer run, hold no more securities than necessary to implement monetary policy efficiently and effectively, and that it will hold primarily Treasury securities, thereby minimizing the effect of Federal Reserve holdings on the allocation of credit across sectors of the economy.

With respect to how and when to give the public additional information about its plans for reinvestment and the balance sheet, the Committee could follow the precedent it set in March 2015 when it released additional details of the operational approach that it intended to use to raise the federal funds rate once economic conditions made it appropriate to begin doing so. At that time, the Committee released several new bullet points that augmented the 2014 Policy Normalization Principles and Plans; the new bullets summarized operational plans for raising and controlling the federal funds rate. The Committee did not release a revised version of the 2014 document. Similarly, the Committee could augment the four bullet points that appear above by releasing additional bullets that summarize operational plans for ceasing or phasing out reinvestment and shrinking the balance sheet. If the Committee wants to set the stage for changing reinvestment policy later this year, it might choose to release such bullets with the June postmeeting statement. The Chair could then comment on reinvestment issues during her press conference; the minutes of the June meeting would provide additional details of participants' thinking. Subsequently, the Desk could issue a more detailed explanation of how it intends to implement the Committee's operational plan. That more detailed explanation could wait until the Committee announces, in a postmeeting statement and accompanying Directive to the Desk, that it has decided to change reinvestment policy; alternatively, the more-detailed Desk statement could be released shortly after the Committee lays out a high-level plan.

With respect to what additional information to communicate, key aspects include: (1) whether the Committee intends to phase out or just end reinvestment of principal from MBS and from maturing Treasury securities and agency debt; (2) whether the Committee intends to follow essentially the same approach for MBS and for other securities; (3) if the Committee intends to phase out reinvestment, how quickly or slowly it plans to do so; and, (4) when, or under what conditions, the Committee anticipates implementing a change in reinvestment policy.

The next two pages show draft bullet points that the Committee might issue to communicate its intentions; the bullets are preceded by a preamble similar to that used to introduce the March 2015 bullet points. The preamble and bullets are intended as a starting point for discussion; staff will revise them in light of views participants express during the upcoming FOMC meeting.

During the March 2017 FOMC meeting, most participants noted that they were leaning toward, or could accept, phasing out reinvestment rather than ceasing it all at once. Many expressed a preference for a simple, easy-to-explain, approach that, once implemented, would proceed "on autopilot" without further action by the Committee, so long as the economy evolved about as anticipated. The first bullet on the next page communicates, in general terms, a plan for reducing, in approximately equal steps, the fraction of principal that will be reinvested. The plan, which applies the same phase-out schedule to principal from agency MBS, agency debt, and Treasury securities, corresponds to the main approach described in the memo titled "Reinvestment Proposal." If discussion at the upcoming FOMC meeting indicates that participants prefer a different approach or a different timeline for phasing out reinvestment, staff will revise the language of this bullet. Of course, participants might prefer to end reinvestment all at once; draft bullets for that option appear on the page after those for phasing out.

When participants discussed longer-run policy implementation frameworks last November, many indicated that they saw advantages to using a floor system to implement policy in the longer run, albeit with an appreciably smaller level of excess reserves than at present. The second bullet on the next page indicates that the FOMC anticipates relying on a floor system in the longer run. (The reference to "autonomous factors that affect the supply of reserve balances" is meant to cover currency in circulation, the Treasury's cash balance, and other autonomous factors.) If participants consider it premature to make or communicate a judgment about the longer-run policy implementation framework, they might prefer the third bullet over the second.

The draft bullets on the next two pages say nothing about the likely timing of a change in reinvestment. That information might be contained in paragraph 5 of the future FOMC statement that announces the Committee's intention to begin phasing out reinvestments; information about timing could also be conveyed in the minutes and other communications. An illustrative draft of a sequence of revisions that could be made to paragraph 5 of the FOMC statement (the reinvestment paragraph) appears on the final two pages of this note.

Draft "Refresh" of the Committee's communications about reinvestment (for a phase-out)

At the conclusion of their discussion of reinvestment, **[** all **]** participants agreed to augment the Committee's Policy Normalization Principles and Plans by providing the following additional details regarding the approach the FOMC intends to use when it becomes appropriate to begin reducing the Federal Reserve's securities holdings.

- The Committee intends to reduce the Federal Reserve's securities holdings in a gradual and predictable manner by phasing out reinvestment of repayments of principal on securities held in the System Open Market Account. More specifically, the Committee anticipates that, if the economy evolves about as expected, the fraction of repayments of principal on agency mortgage-backed securities as well as maturing Treasury securities and agency debt that is reinvested will decline to zero [in approximately equal quarterly steps] over 1½ years.

- The Committee intends to reduce the Federal Reserve's securities holdings and the supply of reserve balances, over time, to levels no larger than necessary to implement monetary policy efficiently and effectively. The Committee **[** currently **]** anticipates reducing the supply of reserve balances to a level appreciably below that seen in recent years but large enough to enable routine fluctuations in the demand for reserves, or in autonomous factors that affect the supply of reserve balances, to be absorbed without significant fluctuations in the effective federal funds rate and without frequent open market operations to adjust the level of reserves.

OR

- The Committee intends to reduce the Federal Reserve's securities holdings and the supply of reserve balances, over time, to levels no larger than necessary to implement monetary policy efficiently and effectively. The Committee anticipates reducing the supply of reserve balances to a level that is appreciably smaller than in recent years but larger than in the years prior to the financial crisis.

- The Committee is prepared to adjust details of its approach to phasing out reinvestments in light of economic and financial developments. Moreover, the Committee is prepared to resume reinvestments if a future deterioration in the economic outlook warrants a [sizable] reduction in the Committee's target for the federal funds rate.

[All **]** participants also agreed that the Committee will use changes in the target range for the federal funds rate as its primary means for adjusting the stance of monetary policy. However, the Committee is prepared to use its full range of tools, including adjusting the size and composition of its balance sheet, if future economic conditions warrant a more accommodative stance of monetary policy than can be achieved solely by reducing the federal funds rate.

If participants prefer to cease reinvestment all at once rather than phasing it out, the preamble and bullets shown above could be replaced with:

Draft "Refresh" of the Committee's communications about reinvestment (for "just stop")

At the conclusion of their discussion of reinvestment, **[** all **]** participants agreed to augment the Committee's Policy Normalization Principles and Plans by providing the following additional details regarding the operational approach the FOMC intends to use when it becomes appropriate to begin reducing the Federal Reserve's securities holdings.

- The Committee intends to reduce the Federal Reserve's securities holdings in a gradual and predictable manner by ceasing reinvestment of repayments of principal on agency mortgage backed securities as well as maturing Treasury securities and agency debt held in the System Open Market Account.

- The Committee intends to reduce the Federal Reserve's securities holdings and the supply of reserve balances, over time, to levels no larger than necessary to implement monetary policy efficiently and effectively. The Committee **[** currently **]** anticipates reducing the supply of reserve balances to a level appreciably below that seen in recent years but large enough to enable routine fluctuations in the demand for reserves, or in autonomous factors that affect the supply of reserve balances, to be absorbed without significant fluctuations in the effective federal funds rate and without frequent open market operations to adjust the level of reserves.

OR

- The Committee intends to reduce the Federal Reserve's securities holdings and the supply of reserve balances, over time, to levels no larger than necessary to implement monetary policy efficiently and effectively. The Committee anticipates reducing the supply of reserve balances to a level that is appreciably smaller than in recent years but larger than in the years prior to the financial crisis.

- The Committee is prepared to resume reinvestments if a future deterioration in the economic outlook warrants a [sizable] reduction in the Committee's target for the federal funds rate.

[All **]** participants also agreed that the Committee will use changes in the target range for the federal funds rate as its primary means for adjusting the stance of monetary policy. However, the Committee is prepared to use its full range of tools, including adjusting the size and composition of its balance sheet, if future economic conditions warrant a more accommodative stance of monetary policy than can be achieved solely by reducing the federal funds rate.

As noted earlier, the draft bullets shown above say nothing about the likely timing of a change in reinvestment policy. That information could be incorporated in paragraph 5 of the FOMC's postmeeting statement (the reinvestment paragraph). An illustrative draft of a possible sequence of revisions to that paragraph appears below.

Current paragraph 5 of the post-meeting FOMC statement:

The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction, and it anticipates doing so until normalization of the level of the federal funds rate is well under way. This policy, by keeping the Committee's holdings of longer-term securities at sizable levels, should help maintain accommodative financial conditions.

A potential revision that could be used when the Committee first releases additional details (new bullets) about its plans for phasing out or ending reinvestment:

> For the time being, the Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. If evolving economic conditions warrant **[** further steps to reduce **|** a further reduction in **]** policy accommodation later this year, as the Committee expects, the Committee likely will **[** begin phasing out **|** cease **]** reinvestment of principal payments from all such securities before year end.

Market participants might interpret the plural "steps" (in "further steps to reduce") as indicating that the Committee will change reinvestment policy only after it has again raised the target range for the federal funds rate, or perhaps in conjunction with the next increase in the federal funds rate. In contrast, market participants might read the singular "a further reduction" as a signal that the next step in removing policy accommodation will be a change in reinvestment policy rather than a rate hike. In combination with "before year end," language such as that shown above—if released in June—likely would lead market participants to expect a change in reinvestment policy in September or December.

The Committee might prefer, instead, to condition a change in reinvestment on reaching a specific level of the target range for the federal funds rate. If so, it might prefer a version of paragraph 5 like the one that appears below rather than the one that appears above.

An alternative version of paragraph 5 that would explicitly link the start of phasing out to the target range for the federal funds rate:

> For the time being, the Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. The Committee will **[** begin phasing out **|** cease **]** reinvestment **[** when the target range for the federal funds rate reaches X to Y percent **|** when, after the target range for the federal funds rate has been set at X to

> Y percent, the Committee next judges it appropriate to further reduce policy accommodation **]**.

The first of the bracketed choices at the end of this possible version of paragraph 5 suggests a trigger: The Committee will change reinvestment policy at the same time that it raises the target range for the federal funds rate to "X to Y percent." The second of the bracketed choices suggests a threshold: The Committee will first raise the target range to "X to Y percent" and change reinvestment policy later, when it next judges it appropriate to take another step to reduce policy accommodation.

Finally, though it may well be premature to consider exactly what the Committee will say when it decides to cease or begin phasing out reinvestment, participants may nonetheless want to see potential language. Examples are shown below. These examples assume that the change in reinvestment will become effective no sooner than the beginning of the month that follows the FOMC meeting at which the Committee decides to begin phasing out (or to cease) reinvestment of principal.

Versions of paragraph 5 that could be used when the Committee begins to taper, or ceases, reinvestment:

> The Committee decided today to begin phasing out reinvestment of repayments of principal from its holdings of Treasury securities, agency debt, and agency mortgage-backed securities, effective at the beginning of **[** MONTH **]**. If the economy evolves about as currently expected, the fraction of repayments of principal from all such securities that is reinvested will decline to zero **[** in approximately equal quarterly steps over 1½ years **]**. This action will result in a gradual and predictable reduction in the Federal Reserve's securities holdings that will contribute to normalizing monetary policy over time.
>
> **OR**
>
> The Committee decided today to cease reinvestment of repayments of principal from its holdings of Treasury securities, agency debt, and agency mortgage-backed securities at the beginning of **[** MONTH **]**. This action will result in a gradual and predictable reduction in the Federal Reserve's securities holdings that will contribute to normalizing monetary policy over time.