



The Daily Dish

# All Eyes on the Fed

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## *Eakinomics: All Eyes on the Fed*

Financial market participants will be focused on the Federal Reserve today; specifically, the announcements coming out of the meeting of the Federal Open Market Committee (FOMC). The policy-making arm of the Fed is expected to announce that the Fed will begin to shrink its massive portfolio of Treasury securities and mortgage-backed securities (MBS). Recall that the Fed purchased large quantities of both assets as part of its Large Scale Asset Purchases (LSAP) program. This served to keep interest rates low and drive capital market dollars into riskier investments with higher yield. The goal was to avoid deflation — mission accomplished — and spur more rapid economic growth — not yet in sight. The balance sheet reduction is a welcome development eight years after the crisis ended.

Shrinking the balance sheet does not mean that Fed policy is tight by any means. The real federal funds rate — the overnight borrowing rate adjusted for inflation — remains in negative territory, so it is hard to argue that interest rates are too high. Indeed, the interesting thing to watch is the degree to which the portfolio reduction awakens quiescent financial markets. The private sector will now have to absorb a lot larger debt issuance. While this has not triggered an upward movement in interest rates yet, one could easily imagine a bit of a spike if inflation suddenly picks up or the economy accelerates from the 2.0 percent growth trend it has settled into during the recovery.

Of course, the Fed can also alter its interest rate policy, so a second key part of today's announcement is to examine the pace at which FOMC participants expect rates to rise. Will there be another hike in December 2017 and three more raises in 2018? Or, will soft data and concern about portfolio reduction move the Fed to a more dovish pace?

The Fed is setting the basic policy for 2018 and giving markets a peek. But everything could change with a dramatic tax reform, sudden inflation, or shocks from abroad.