

Trump Is Right – the Fed Is Still Tightening.

Sure, the size of the balance sheet is holding steady, but leaving riskier assets in the market will slow growth.

By Donald L. Luskin

It must be annoying for Federal Reserve Chairman Jerome Powell when President Trump berates him on Twitter —especially when Mr. Trump insists he take policy steps he’s already taken. This seemed to happen last week when the president tweeted that the Fed must “stop their ridiculous quantitative tightening NOW!” Huh? At the Federal Open Market Committee’s meeting two weeks ago, Mr. Powell and his colleagues announced the immediate halt of the shrinking of its asset portfolio, two months earlier than expected. It has now stabilized at about \$3.6 trillion.

It sure sounds as if Mr. Trump is asking the Fed to stop its quantitative tightening twice.

Yet as annoying as Mr. Powell may find the tweets, the president is actually on to something in this case. Though the size of the balance sheet has stopped shrinking, quantitative tightening continues.

Indeed, it is set to continue for a generation, “on automatic pilot,” as it were, to borrow the infelicitous phrase Mr. Powell used to talk about the Fed’s asset portfolio last December.

The key thing to understand about the Fed’s balance sheet is that, yes, size matters—but it isn’t the only thing that matters. The composition of the Fed’s holdings matters a great deal too. Going forward, the Fed’s plans for portfolio composition mean that quantitative tightening will effectively continue, even at a stable size of \$3.6 trillion.

Composition matters because whichever types of security the Fed chooses to hold become scarcer in the market, along with their risk. For example, when the Fed buys mortgage-backed securities, it relieves the market of having to take the credit risk, the duration risk and the prepayment risk of those securities. During the mortgage crisis of 2008-09, those risks—especially credit risks—were enormous, and the Fed did a great service to terrified markets by assuming them. That allowed the markets to unfreeze, and once lenders were relieved of the risks of mortgage-backed securities, they could take other risks instead, such as new loans to start businesses and create desperately needed jobs. It seems to have worked.

That, and only that, is how quantitative easing works. It is not, and never was, a helicopter drop of money. By giving excessively risk-averse investors a timeout from much of their risk, the Fed prevents the vicious circle of fire-sale selling. In that way it supports asset prices without necessarily inflating them.

Now, even though the size of the balance sheet will no longer shrink, the Fed has announced that any time a mortgage-backed security in its portfolio prepays or matures, the proceeds won’t be

invested in more such securities, but rather in Treasury notes with an average maturity of about six years. At the same time, when the Fed's Treasury securities mature, they will no longer be reinvested in long-term notes or bonds, but rather bills and notes with much shorter maturities (the exact plan hasn't been revealed yet). All this will take decades to play out—on automatic pilot—and it is certain to send a great deal of credit risk, prepayment risk and duration risk back to the market.

If markets are reasonably risk-tolerant over those many years, they will be able to absorb those risks. But having to absorb them at all will mean, at the margin, there will be other risks—such as job creation—that markets will have to do less of. This is quantitative tightening, precisely as President Trump said, and it will drag on for decades until the last mortgage-backed security matures, about 26 years from now.

Reasonable people may differ markedly on balance-sheet policy. Mr. Trump differs diametrically on it from his own nominee-designate to the Fed board, Judy Shelton, who is on record preferring the balance sheet to keep shrinking. Where Mr. Trump sees stimulus in a large balance sheet full of relatively risky securities, Ms. Shelton sees a potentially dangerous distortion to the natural operation of markets. They are both right in their own ways, and it's worth hoping that Mr. Trump and Ms. Shelton will discuss their differences, lest someday she finds herself the target of his tweets.

It isn't clear where Mr. Powell stands. Neither last month's FOMC statement nor his prepared remarks in the postmeeting press conference explained why the shrinkage of the asset portfolio was abruptly and unexpectedly ended two months earlier than previously announced. When asked about it in the question-and-answer session, Mr. Powell was evasive, saying only, "that was really just a matter of simplicity and consistency. Really nothing more to it than that."

There is much more to it than that. Mr. Trump's irksome tweets are focusing markets on an issue that needs a full explanation from Mr. Powell: Why, when the Fed is cutting rates on the one hand, is it embarking on a generation-long regime of quantitative tightening on the other? The best way Mr. Powell can show his political independence is simply to explain himself.

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