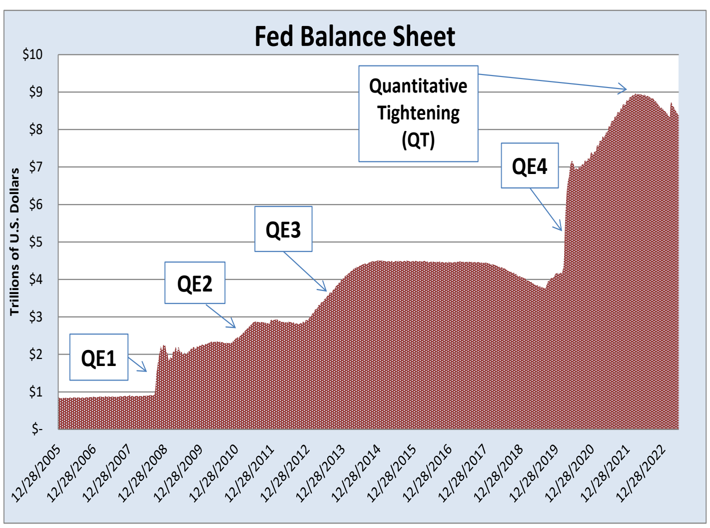
Quantitative Tightening (QT): Check the Plumbing

As market participants know, the U.S. Federal Reserve embarked on a stimulative monetary policy called Quantitative Easing, which has now been replaced with its restrictive analogue, Quantitative Tightening. The latter program is still in its early stages --- so what do we know about "QT" and what should we expect in the future from it?

Quantiative Easing: A Refresher

To start, we should revisit Quantitative Easing, or QE, which involved the Fed making large purchases of Treasury and mortgage securities, to the tune of nearly $10 trillion, or more than one third of the U.S. Gross Domestic Product.



What was the aim of doing so? The argument goes like this: when the economy is in the doldrums, as it was in the early days of the Covid Pandemic, the Fed wants to act to stimulate the economy. Ordinarily, this is done by the Fed's lowering interest rates. However, when interest rates reach 0%, as they did back then, the thinking is that the Fed cannot realistically lower them much more than that, because there is always an alternative to earning negative interest in the form of hoarding cash (literally cash, i.e. dollar bills) and storing it under one's mattress.

When faced with this constraint, one supplemental monetary policy tool is Quantitative Easing. As we have said, the idea is that the Fed goes into the market and buys up bonds and bond-like instruments. When it does this, investors' holdings of bonds are paid for by the Fed and wind up in bank deposits owned by those same investors. And the economic hope and plan is that investors are more likely to spend those extra bank deposits that are now sloshing around on things like consumer goods and services – more likely than they would have been when they instead owned a fixed investment in a Treasury bond. That substitution and the resulting spending are designed to stimulate the economy through the enhanced spending power. Alternatively, the banking system will loan those excess deposits out to fund companies' capital investments.

Reversing the Flow

Now that the Fed is embarking on QT, what should we expect? The first-order thinking starts and stops with the direct, theoretical impact: when the Fed sells its holdings of bonds and bond-like instruments, it will necessarily drain back those excess bank deposits. And it makes intuitive sense that, when we all have lower deposit levels in our bank accounts, we will be more reluctant to go out and spend. As this applies to the fight against inflation, so far so good.

However, are there possibly unforeseen consequences of QT, which we might view as "plumbing" issues? Can the system handle when the flows are reversed, that is, the unwinding of those holdings? As a threshold observation, it's clear that the Federal Reserve worries about known and unknown risks, or else they would simply be selling all their bonds and draining all the excess reserves overnight. But that is not what they are doing. They are embarking on a highly measured and slow unwinding of their bond holdings, tiptoeing forward. And, we think, with good reason.

This also makes intuitive sense: if the Fed tried to find buyers for $10 trillion of bonds overnight, that would be viewed as highly disruptive by any market participant and also by any theoretical economist as well. Still, what other risks, certain and less certain do they have to worry about?:

- **The risk that the excess deposits from QE have been invested into long-term, illiquid loans that cannot be unwound quickly.** Banks will not be able to instantaneously convert their loans back into deposits. Just like George Bailey's Building & Loan in *It's a Wonderful Life*, the moneys not there, "it's in Joe's house, and the Kennedy house..and a hundred others."

- **The risk that the excess deposits from QE have been invested into long-term liquid bonds at unattractive yields.** Similar to the previous point, banks will have to find a way to fund deposits. If they are forced to sell bonds at a loss, will we see additional situations like the one at Silicon Valley Bank?

- **The risk that the banks' capital and liquidity rules cause the system to seize up as the banks liquidate their most liquid securities in order to pay off depositors.** Banks may be unable to make new loans even to their best customers if the liquidity rules are tripped as QT proceeds and they are forced to shrink in order to comply with those rules. There is a lot of uncertainty out there about the minimum level of bank reserves needed for smooth functioning, and the Fed itself miscalculated on this only a year or so ago.

- **The risk that the Fed's own balance sheet comes under scrutiny as it sells down bonds and realizes losses.** The Fed has lost nearly $1 trillion on its bond holdings. While we are inclined to think of the Fed as impervious to such losses and while it is true that the Fed is backed by the U.S. government, we think it is underappreciated how unpleasant it could be for the Fed to report that it has, say, $5 trillion in liabilities but only $4 trillion in market value of assets backing up all our dollar bills and all our future rescue programs for the financial sector. The history books are full of central banks that became insolvent and turned to inflation, starting right here with the central bank of the Confederacy during our Civil War.

Lessons from Abroad

These risks are not limited to the United States. There is a day of reckoning coming with the Bank of Japan (BOJ), which has embarked on a QE program twice as extensive as that of the U.S. Federal Reserve. And the European Central Bank (ECB) itself owns not so much the treasury bonds of a single, strong central government, but instead the bonds of individual sovereigns: it is almost as though the Fed's balance sheet were full of municipal bonds issued by the constituent 50 states, some of which have checkered financial profiles. And, on this point, it is not implausible at all that a bad experience by the ECB or the BOJ in unwinding their holdings could cause a rethink of the whole QE/QT paradigm and cause two problems for financial markets:

1. Paradoxically, a greater imperative for the Fed to exit and reduce its QE holdings, even if that proves disruptive to financial markets,
2. A longer-term reluctance to engage in QE in the next episode of financial instability, even if a dose of QE might normally be called for.

So we at Northeast see some uncertainty as the Fed and other central banks try to unwind their QE programs through QT. Some risks are directionally visible but uncertain as to magnitude. And some risks may only become apparent when we bump up against the constraint in real time. Having said that, we are hopeful that the outcomes will be benign and that there will be a way for central banks to disengage from QE and to recharge their balance sheets by the next time they are called upon to step in -- properly -- as the tried-and-true lender of last resort for the financial system.

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