When Will the Easing End?

How will the Fed taper off its bond buying program?

Provided by *Benedict A. Mitchell Jr.*

In its May 1 policy announcement, the Federal Reserve reaffirmed its commitment to its current stimulus campaign, or QE3 – its monthly purchase of $85 billion in bonds.[1]

QE3 has undeniably boosted the stock market and assisted the real estate recovery. Yet at some point, the Fed will decide to let the economy stand on its own and stop its aggressive easing of monetary policy. Wall Street is beginning to wonder how and when that will occur.

Will the Fed wind down QE3 in early 2014? Quite possibly – but it could happen sooner. Bloomberg recently polled 47 economists for their opinions, and 61% of them felt that the Fed would wrap up QE3 in the first half of 2014. Another 11% thought the central bank would halt its bond purchases in the fourth quarter.[2]

What will the Fed's first step be? Abruptly ending QE3 could be foolhardy. The median estimate in Bloomberg's poll was for an initial cut to $50 billion in purchases per month, evenly split between mortgage-linked securities and Treasuries.[2]

Does anyone think the Fed might *increase* its bond buying? That possibility is on the table. On May 1, the Fed said that it "is prepared to increase or reduce the pace of its purchases" depending on how "the outlook for the labor market or inflation changes."[1]

As the *New York Times* notes, Fed officials don't see a whole lot of merit in increasing bond purchases. In the first quarter, the central bank already bought an amount of securities roughly equivalent to the volume of new mortgage bond issuance.[1]

The latest indicators haven't been great by any means: the jobless rate is still closer to 8% than 6.5% (the point at which the Fed would consider raising interest rates), the pace of manufacturing seems to have slowed this spring (the Institute for Supply Management's factory index came in at 50.7 for March), and Q1 GDP was estimated at 2.5%. Is all this just another spring swoon, or should the Fed buy more assets in response to these indicators?[2]

If the sequester truly damages the recovery and the Fed elects to buy more bonds instead of less, it certainly has the leeway to pull it off. The annual core inflation rate, as measured by the Commerce Department's personal consumption expenditures (PCE) index, was just 1.1% in March. The central bank has an inflation target of 2.0%.[1]

The status quo may prevail into winter. The Fed has no compelling reason to stop buying securities in the near term. By gradually reducing its asset purchases, it could try to engineer a soft landing for the stock and real estate markets – and considering that the Dow pulled back about 2,000 points shortly after the end of both QE1 and QE2, there is every reason to strive for that outcome.[3]

As JPMorgan Chase's chief U.S. economist Michael Feroli noted last week, "In effect, the Fed signaled that the pace of asset purchases would be data-dependent in both directions, but that right now the data gives them little reason to change in either direction."[1]

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