ECONOMIC RESEARCH

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Normalization of balance sheet begins

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The reduction in the central bank's balance sheet starting in October is an appropriate step on the path to normalization and comes as no surprise to the markets. In recent months the Fed had presented and discussed its plans sufficiently clearly. There has been no fundamental change in the central bank's outlook for the economy. Against this backdrop the Fed is still signaling one further rate hike this year and a continuation of the gradual normalization of the key rate level over the next three years. This is also to be welcomed.

The reduction in the balance sheet is in line with the principles of monetary policy normalization already outlined by the Fed a while back. Accordingly, the reduction in the bond portfolio is to occur in a gradual and predictable manner. The central bank will not sell the bonds it accumulated as part of its asset-purchase program directly, but gradually reduce the reinvestment volume emanating from maturing bonds. The Open Market Committee envisages an interruption of the reduction process only in the event of a material deterioration in the outlook for the economy.

However, with regard to the economic outlook, the Fed remains upbeat. In particular, it sees no lasting impact on economic activity from the hurricanes in recent weeks. Rather, it seems to assume that, after an initial knock, the economy will already firm up substantially at the end of the year. This removes any doubts that pronounced swings in the economic indicators in the wake of the natural catastrophes might derail a further rate hike in December.

The Fed is correctly sticking to its line with regard to adjustment in the key rate level deemed appropriate over the next three years (towards 3%). With gradual rate hikes it avoids the risk of getting behind the curve. If it waits too long it would then possibly have to tighten rates sharply. This would heighten the risk of choking off the economy and triggering turmoil on the financial markets.

The Open Market Committee's clear line is evidently having an impact on the markets which have now clearly upped the probability of a December rate hike. Ultimately this should mean that the weakness of the dollar seen in recent months will come to an end.

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