TOP of MIND

# INTERVIEW WITH BRIAN SACK

Brian Sack is Director of Global Economics at the D. E. Shaw group. Prior to joining the D. E. Shaw group in 2013, he was an Executive Vice President at the Federal Reserve Bank of New York (FRBNY), where he served as head of the FRBNY's Markets Group and managed the Federal Reserve's System Open Market Account portfolio from 2009 to 2012. Below, he reflects on the experience with the Fed's asset purchase programs and argues that the Fed should maintain a relatively large balance sheet and be willing to deploy it as a policy tool during future downturns.

*The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.*

**Allison Nathan: You were involved in both establishing quantitative easing (QE) as a policy concept and implementing it after the financial crisis. Looking back, how important was QE to the economic recovery?**

**Brian Sack:** QE proved to be a critical policy tool. Without it, the economic recovery would have been slower, and there would have been a greater risk of the economy getting stuck in a deflationary trap. Given that the Fed's traditional policy instrument, the federal funds rate, was constrained by the zero bound, it was very important for the Fed to convey that it still had an instrument that it would actively use to pursue its economic objectives. I think that message had very meaningful effects on expectations for the economy and on financial conditions in a way that ultimately supported the recovery.

**Allison Nathan: Can we really call QE a success, given that inflation remains below the Fed's target?**

**Brian Sack:** It's true that inflation has been disappointing. That being said, the low level of inflation today, if anything, highlights how important it was for the Fed to have been responsive with this policy instrument. If the Fed had sat on its hands and allowed a much more sluggish recovery, I think the problem of low inflation would have been more severe.

**Allison Nathan: Through what channel did QE impact the economy most?**

**Brian Sack:** In my view, QE worked primarily through the portfolio balance channel. By reducing the amount of duration risk that would have otherwise been in the market, QE pushed down the term premium for longer-term securities, thereby reducing those interest rates. As investors sought to substitute into other securities, there were positive knock-on effects to broader financial conditions. There may have also been some effect through the signals that QE provided about the path of the federal funds rate, but my intuition is that it was less important than the portfolio balance channel, especially considering that the Fed was separately providing explicit guidance on its policy rate over much of this period.

**Allison Nathan: In retrospect, is there anything that the Fed should have done differently?**

**Brian Sack:** The Fed could have perhaps defined its policy reaction function for the balance sheet more clearly. Over the earlier QE programs, the Fed's purchases moved in very large, discrete steps. In retrospect, it might have been better to move in more moderate steps with more frequent adjustments to economic conditions, as that could have helped markets and the public better understand how the Fed intended to set this policy instrument. When market participants are able to understand and anticipate central bank actions, monetary policy tends to be more effective. The Fed ended up moving in that direction during QE3, but it arguably could have done so sooner. That said, I would note that the Fed was launching a new policy instrument and that this innovation was taking place under challenging circumstances. So, in my view, debating whether the exact implementation of the tool was optimal is much less important than the Fed's overall decision to actively use the tool.

**Allison Nathan: What will it mean for the economy and for markets to put balance sheet expansion into reverse? Are you concerned that normalization could prove disruptive?**

**Brian Sack:** We should expect the portfolio balance effects that I discussed earlier to reverse, which means that the term premium should face some upward pressure. However, there are several reasons to think that the adjustment will not be sizable or disruptive. First, QE effects tend to occur when expectations shift, not when the actual portfolio flows happen. In this case, the Fed has already communicated the plan for shrinking its balance sheet, so a decent share of the impact should be behind us. Second, the decline in asset holdings is set to take place in a gradual and predictable manner, so the Fed has successfully made this adjustment relatively "boring."

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And third, even once the Fed shrinks the balance sheet, the market will know that QE is an ongoing, viable tool. The prospect that the balance sheet is likely to increase again if needed could act to hold down the term premium today.

Finally, I'd note that many fundamental factors are also holding down the term premium, including low inflation expectations and the beneficial correlation that Treasury securities have with risky assets. If these factors were to shift in a manner that amplified upward pressure on the term premium, the market outcome could be more disruptive. But that would involve a fairly meaningful shift—such as sharply higher inflation expectations—which seems unlikely at the moment.

**Allison Nathan: Could there be any unintended spillovers from the interaction between Fed normalization and the ECB's eventual tapering of asset purchases?**

**Brian Sack:** I do think there are important spillovers across global markets and that the global policy environment has helped keep longer-term US interest rates low. If other central banks adjust their balance sheets in the same direction, the increase in supply and the associated effect on the term premium could end up being larger than expected. That doesn't mean we'll necessarily have an abrupt or disruptive market outcome; it just means that whatever supply effect we were anticipating would be turned up to some degree. Of course, at this point, the ECB is only considering stopping the expansion of its asset holdings, not shrinking them, and the market is already anticipating these policy shifts. So I don't see a great risk of a disruptive outcome in the short run.

**Allison Nathan: You are in favor of the Fed maintaining a fairly large balance sheet in the longer run. What advantages do you see to that approach?**

**Brian Sack:** I published a proposal in 2014 with Joe Gagnon saying that the Fed should operate a floor system with a meaningful role for the reverse repo facility, while maintaining a large balance sheet. The idea was that this framework would keep overnight market interest rates near the interest rate that the Fed pays to financial institutions. We argued that such a system would give the Fed effective control of interest rates and would be operationally simpler than the prior framework. It would also make the financial system more robust by helping satiate the private sector's substantial demand for short-term, risk-free assets. To date, our experience with the floor system has been very positive, reflecting all of these advantages. I expect the Fed to decide to maintain this type of system in the longer run, and hence I doubt its balance sheet will ever fall below $3tn in assets.

**Allison Nathan: Some market observers take the opposite view, arguing that the Fed should shrink its balance sheet to pre-crisis levels based on concerns that the floor system leaves the Fed with too large a footprint on the markets, or that having a large balance sheet could compromise the Fed's independence, among other arguments. Is there merit to any of these concerns?**

**Brian Sack:** I generally disagree with these views. I think the footprint argument is exaggerated, since the balance sheet simply transforms one type of government asset—a long-term Treasury security—into another type of government asset—bank reserves or reverse repos. Many of the other arguments in favor of a smaller balance sheet seem to be driven by nostalgia for the way things used to be or by concerns about political pressure from having a larger balance sheet. To me, it would be a shame to allow any of those considerations to stand in the way of arriving at the most effective, efficient, and robust operating framework for the Fed.

**Allison Nathan: You mentioned that the balance sheet—once considered an unconventional policy option—should now be considered a viable tool...?**

**Brian Sack:** Yes. The Fed initially proceeded with asset purchases in a very careful manner, which made sense given that we were in uncharted territory. But I think we've learned that many of the potential costs associated with QE ended up being more benign than initially feared by some observers. What's more, the Fed has now demonstrated control over the policy rate even with a large balance sheet.

Based on that experience, I think that the Fed should be more comfortable using the balance sheet when it is unable to achieve adequate policy accommodation by lowering the federal funds rate. In my view, there is a strong chance that the Fed will have to turn to asset purchases again when the next substantial economic downturn occurs, considering that the neutral level of the federal funds rate has fallen notably.

**Allison Nathan: Would it make sense for the Fed to purchase a broader range of assets in the event of a future downturn, as Fed Chair Janet Yellen suggested in a speech last year?**

**Brian Sack:** Purchases of Treasuries and agency-backed securities—the primary assets that Congress has so far authorized the Fed to buy—have the advantage of allowing the Fed to affect the market price of interest rate risk without taking on any credit risk. Purchasing a wider set of assets—as do some other central banks—might enable the Fed to have a larger effect on financial conditions and promote faster recoveries. But it would also involve putting more taxpayer money at risk and having an imprint on a wider set of risk premiums in the market. So there is a tradeoff involved that Congress would ultimately have to consider.

**Allison Nathan: Economists like Larry Summers have argued that Fed purchases of long-term government debt would have been more effective at holding down the term premium if the Treasury had not increased the maturity of its debt issuance at the same time. Should there be more communication or coordination between the Fed and the Treasury? Or would that damage Fed independence?**

**Brian Sack:** Debt management decisions can affect financial conditions in the same way as QE; they both change the supply of duration in the market. And decisions by debt managers can at times work at cross-purposes to QE decisions by the central bank. We at the Fed were certainly aware of that throughout the post-crisis period. However, I don't see a need for policy coordination in most circumstances. The Treasury makes debt management decisions with a set of goals that differ from those of the Fed; and the Fed can take those decisions as given and set an appropriate path of QE around them.

However, there is clearly a need for communication. For example, the market effects of Fed balance sheet runoff will depend on what maturities the Treasury intends to issue to replace those holdings. And the Treasury needs to have a sense of the Fed's runoff plan as it decides how to fund the government. So certainly that type of communication should take place, and I have a hard time believing that those communications somehow impair the independence of the Fed, given that the Fed's mandate is clear.

**Allison Nathan: What has been the most important lesson from the Fed's experience with QE? Is it applicable to other central banks still conducting asset purchases?**

**Brian Sack:** We learned that asset purchases have clear benefits and limited costs. I think a key lesson for all central banks is that if they see QE as a viable policy instrument, it's important to communicate that it will be used when the circumstances call for it. That will allow markets to price central bank actions further in advance and with greater accuracy, which would only make the policy more effective.

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