

The US Fed ends an era

The US Federal Reserve has announced the unwinding of the biggest experiment in the history of central banking. It will start the process of normalizing its balance sheet from October. Since the markets were largely prepared for the announcement, the reaction has been muted. The US central bank also left policy rates unchanged.

Although the Fed is moving with extreme care, which is expected to give markets enough time to adjust, the process will be keenly watched.

Quantitative easing resulted in lower yields and its unwinding would have an opposite impact—and at some point it will start influencing asset prices. However, this is not the only thing to watch out for.

The biggest puzzle at the moment is inflation. The Fed has taken this all-important decision even as inflation continues to undershoot its target of 2%. The central bank acknowledges the fact that it is not clear why inflation is low. The big question, therefore, is what will happen to prices when financial conditions begin to tighten, relatively. Will the Fed be able to move forward as planned?

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