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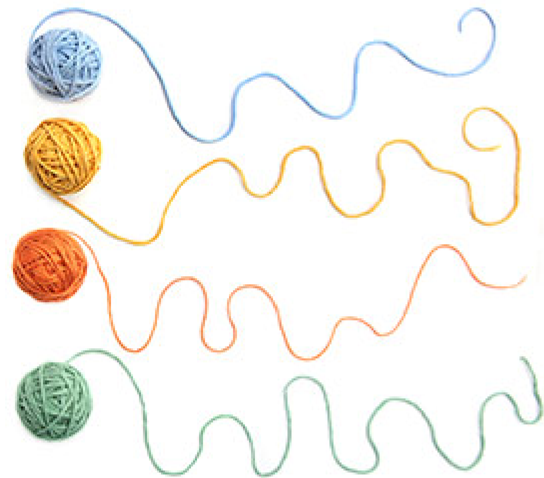
How the Fed Is Reducing Its Balance Sheet—and Why

By Laura Hopper, Public Affairs Staff

As the economy heats up, followers of Federal Reserve news may be noticing a corresponding increase in the use of some phrases that seem cryptic:

- Balance sheet reduction (or unwinding)
- Monetary policy normalization
- Liftoff

And just when you thought you had mastered interest rates.



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The phrase "unwinding" is often used because of the slow and gradual nature of reducing the Fed's balance sheet, which expanded in size after the financial crisis.

Prepare to hear those terms in the news more often. With the 2007 financial crisis in the rear-view mirror and the Fed's goals of maximum employment and price stability in sight, the Fed is now "moving toward a more neutral policy stance," St. Louis Fed Economist David Wheelock said in our Timely Topics podcast (originally released in September 2017).

The monetary policy steps that the Fed took amid and following the financial crisis are no longer needed for today's economy. Now, a process called "monetary policy normalization"—essentially, turning the clock back to pre-crisis monetary policy—is under way.

But what is a balance sheet, in Fed terms? Why does it need reducing or unwinding? And when and how do we have … liftoff? Open Vault unwinds the new-normal vocabulary in today's new economic environment.

What Is a Balance Sheet? (And What Does the Fed's Balance Sheet Include?)

You may be more familiar with a balance sheet from the perspective of a company or of your own budget. Company balance sheets, like your personal accounts, have assets and liabilities.

In the Fed's case:

- **Its principal assets** are the securities that it holds in its portfolio, which consist primarily of U.S. Treasury and mortgage-backed securities.
- **The Fed's liabilities** include U.S. currency—"Federal Reserve notes are a liability of the Federal Reserve banks," Wheelock pointed out—and the reserve deposits that banks and other depository

institutions hold with the Fed.

Sounds simple enough, but the Fed's balance sheet became much more complicated during and after the financial crisis as the Fed took action in response. To provide liquidity to the financial system during the crisis, and to encourage recovery from the recession that followed, the Fed purchased large amounts of those aforementioned U.S. Treasury and mortgage-backed securities. It paid for those purchases by adding funds to reserve deposits.

Fast-forward 10 years or so, and recovery is at hand. But post-crisis, the Fed's balance sheet had expanded in size—from about $870 billion in August 2007 to $4.5 trillion in September 2017. A portion of that growth would have happened anyway, Wheelock noted, due to a natural increase in currency supplied to the public. But the Fed has always viewed the remaining increase as temporary, with an eye toward shrinking, or "unwinding," the balance sheet once economic recovery was complete.

Why Shrink the Balance Sheet Now?

This is when another cryptic phrase, "liftoff," comes into play. The Fed's balance sheet expansion was one strategy to assist economic recovery.

Another was keeping interest rates at or near zero for almost a decade. In December 2015, the Federal Open Market Committee increased the federal funds rate target from 0 to 0.25 percent—where it had been for years—to 0.25 to 0.50 percent. The term "liftoff" refers to that increase, as well as the gradual pattern of incremental small increases that have since followed.

The term "liftoff" refers to increases in the federal funds rate target, starting in December 2015.

Both strategies were implemented to aid economic recovery, so the Fed's long-term plan was to gradually end both policies: aka, normalizing monetary policy.

How Will the Fed "Unwind" Its Balance Sheet?

Raising interest rate targets is one thing. Shrinking the balance sheet is a bit more complicated, but the Fed has started down the path of reduction.

Here's how it works: When Treasury securities reach their maturity date, they are paid off by the government; mortgage-backed securities are paid off by Fannie Mae and Freddie Mac. Wheelock explained that the Fed had "been going out in the market and replacing those securities with purchases of other securities so as to keep the balance sheet constant. And the idea of unwinding the balance sheet is simply stopping the replacement of securities that mature."

The phrase "unwinding" is often used because of the slow and gradual nature of reducing the Fed's balance sheet. St. Louis Fed Research Director Chris Waller recently compared it to slowly opening the stopper in a drain and letting water run out.

In a May 2018 Dialogue with the Fed presentation, Waller explained that the Fed is taking a capped, controlled approach to unwinding its balance sheet: letting Treasury securities "run off" at about $6 billion a month and letting mortgage-backed securities run off at about $4 billion a month. "And then it's going to increase at every three months," he said, "to where there's a maximum of $30 billion a month in Treasuries running off, and $20 billion a month in mortgage-backed securities" running off.

"So, effectively we're increasing the supply on the market of U.S. Treasuries," Waller continued. "We're letting the supply of U.S. Treasuries in the hands of the private sector grow."

Editor's note: On July 31, 2019, the FOMC announced that it would end the runoff of the Fed's balance sheet earlier than previously indicated.

Additional Resources

- What Is Quantitative Tightening?
- Essay and video featuring St. Louis Fed President James Bullard discussing A Preferred Approach to [Monetary Policy] Normalization.