



Research Working Papers

The Financial Market Effects of Unwinding the Federal Reserve's Balance Sheet

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The gradual unwinding of the Federal Reserve's balance sheet from 2017 to 2019 tightened financial conditions, though this tightening did not simply manifest as a reversal of the effects of the original balance sheet expansion.

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For the second time in the brief 12-year period between 2008 and 2020, central banks have again turned to asset purchase programs to combat a global economic downturn. While balance sheet expansions have become familiar and been widely studied, balance sheet normalization is less well understood. This paper provides a first analysis of the financial market effects of balance sheet normalization based on the U.S. experience between 2017 and 2019. We find evidence that unwinding past asset purchases tightens financial conditions. However, we show that these effects cannot be merely characterized as quantitative easing in reverse. In particular, we find that balance sheet normalization lacked the large announcement effects that characterized quantitative easing. Instead, the effects of normalization manifested upon implementation and surfaced, in part, through larger liquidity effects than were evident during various phases of balance sheet expansion.

JEL Classification: E3, E4, E5

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