



Economic Review

The Evolving Role of the Fed's Balance Sheet: Effects and Challenges

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November 17, 2022

Reducing the Federal Reserve's expanded balance sheet, which has provided substantial policy accommodation in recent years, may take time.

The Federal Reserve's balance sheet more than doubled in the wake of the COVID-19 pandemic, primarily due to large-scale asset purchases. In 2022, with inflation surging and the labor market tight, the FOMC has started to withdraw policy accommodation and has set in motion a plan to significantly reduce the balance sheet. However, it may be difficult for policymakers to judge how fast and how far to unwind asset purchases, especially as it is unclear exactly how much accommodation the pandemic-era asset purchases have put in place.

In this article, Chaitri Gulati and A. Lee Smith present evidence that the Federal Reserve's expanded balance sheet, with a large portfolio of long-duration assets, has provided a significant amount of policy accommodation in recent years, depressing long-term interest rates by about 1.6 percentage points as of early 2022. They also argue that the FOMC's plan to remove this accommodation through the passive runoff of maturing securities may prove challenging. They project that the downward pressure the balance sheet is currently placing on longer-term interest rates will only gradually reverse.

Publication information: Vol. 107, no. 4

DOI: 10.18651/ER/v107n4GulatiSmith

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