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Chair Jerome Powell prepared to address reporters last month. The Fed's balance sheet has been shrinking gradually since 2022. ELIZABETH FRANTZ/ REUTERS

Fed Weighs When to Stop Shrinking Assets

BY NICK TIMIRAOS

Federal Reserve officials have a suddenly pressing decision that has nothing to do with an interest-rate cut. It is whether to stop shrinking the central bank's \$6.6 trillion asset portfolio within days or wait until the end of the year.

As recently as two weeks ago, the Fed seemed on track for a year-end decision. Chair Jerome Powell, in a rare speech devoted primarily to technical monetary plumbing dynamics, said the central bank could approach the point "in coming months" where it needed to end the three-year campaign to shrink its holdings.

But analysts say firmer-than-anticipated pressures in overnight funding markets since then could warrant stopping sooner.

The debate over when to stop portfolio runoff is separate from the one over whether to hold interest rates steady or to cut them, as is widely expected this week. These deliberations revolve around how best to ensure the Fed maintains effective control over short-term interest rates.

The Fed expanded its enormous portfolio—sometimes called a balance sheet—during the 2007-09 financial crisis and again during the pandemic when it bought colossal quantities of government debt and mortgage-backed securities to stabilize markets and stimulate the economy.

Officials have been gradually shrinking the balance sheet since 2022, when it reached nearly \$9 trillion, by letting securities mature without replacing them. When the Fed purchases securities, it creates reserves—electronic cash that banks hold at the central bank. When the securities mature, that electronic money drains out of the financial system.

Fed officials don't want the balance sheet to be so big because supplying trillions of dollars of interest-bearing reserves to the banking system carries political costs, such as paying large amounts of interest to banks. But officials also need to keep short-term interest rates under control. Let them jump unexpectedly, and the volatility could affect mortgage rates, business lending and the flow of credit to the economy.

Officials don't have much experience with the delicate process of shrinking the balance sheet. Like a driver hunting for an off-ramp on an unfamiliar highway, officials risk blowing past the exit if they wait too long. Doing so would repeat an episode Fed leaders want to avoid: In September 2019, the Fed inadvertently drained too many reserves, and overnight lending rates surged. Officials hastily executed a confusing U-turn, pumping cash back into the system.

For the past three years, most of the Fed's balance-sheet runoff drained cash not from banks but a separate deposit facility where money-market funds could park cash. That facility is nearly empty, having fallen from a peak of more than \$2.2 trillion in 2023. With that cushion gone, every dollar that rolls off the Fed's balance sheet comes straight out of bank reserves.

In the days after Powell's Oct. 14 speech, overnight rates firmed up as the government issued new debt, pulling cash out of the banking system—the government's equivalent of a big customer making a major withdrawal. Those funding pressures have nudged the central bank's benchmark federal funds rate higher within its target range of 4% to 4.25%, which suggests reserves are moving less freely in the banking system.

The pressures eased briefly but returned last week during an interval when mortgage-related cash flows typically reduce firming in money-market rates. Banks have more regularly tapped a Fed lending facility designed as a safety valve that lets them exchange securities for reserves, offering another sign of reserves becoming less ample.

Lou Crandall, chief economist at Wrightson ICAP, said the Fed's current framework was designed to spot the recent market signals that suggest they are approaching their likely destination of less ample reserve levels. "The proximity alerts are going off in the cockpit," he said.

The Fed has twice slowed the pace of the balance-sheet runoff, most recently to a glacial pace of around \$20 billion in securities every month this past April.

Continuing to shrink the balance sheet for months could signal that the central bank isn't concerned about recent volatility, said Blake Gwinn, head of U.S. rates strategy at RBC Capital Markets.

"They could let this go longer, but personally, I would have stopped this six months ago," said Gwinn.

The Fed is allowing up to \$35 billion in mortgage securities and \$5 billion in Treasurys to roll off the portfolio every month. Because officials have indicated they would like to have only Treasurys on the balance sheet once they end the runoff, they are likely to continue reducing the mortgage securities, investing the proceeds of any maturing bonds into Treasurys.

At least one Fed official has signaled a possible preference to allow the runoff to continue for longer. Michelle Bowman, vice chair for banking supervision, said in September she would prefer to target over the longer run a smaller balance sheet than outlined by the 2022 principles in order to minimize the Fed's footprint in markets and improve the ability to read signals of stress.

Fed governor Christopher Waller, who voted against the Fed's decision in March to slow the pace of Treasury runoff, defended the current operating framework during a moderated discussion this month. "We're about at that point" before which banks have to compete with each other for reserves, he said.

The current framework wisely ensures that "people don't have to, at the end of the day, go scrambling around looking for nickels and dimes in the couch to cover their reserve positions. That, to me, is idiocy," he said.

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