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INSIGHT

Federal Reserve: Tapering of Asset Purchases

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In November 2021, the Federal Reserve (Fed) announced that it would begin to "taper" its large-scale asset purchases, popularly known as "quantitative easing" (QE), by $15 billion per month (see **Table 1**). In light of the further increase in inflation, it announced in December that it would double the monthly reduction in purchases in January. In January 2022, the Fed announced that purchases would end in March, at which point its balance sheet will stop growing. Under tapering, the Fed will continue to purchase Treasury securities and agency mortgage-backed securities in a two-to-one ratio.

Table 1. Fed Monthly Asset Purchases

(billions)

2021-2022	Amount	Decline from Previous Month
Before Tapering	$120	n/a
After November Tapering Announcement:		
November	$105	$15
December	$90	$15
After December Tapering Announcement:		
January	$60	$30
February	$30	$30
March	$0	$30

Source: CRS.

Tapering is the first step in the eventual "normalization" of monetary policy from the highly stimulative policies in response to COVID-19, which included asset purchases. Tapering itself withdraws some stimulus, and its pace determined when the Fed will begin raising interest rates. The Fed could have raised the federal funds rate at any time but will wait until tapering has ended, consistent with past practices. In January, the Fed announced "it will soon be appropriate to raise" rates. The Fed also stated that it would begin to reduce the size of the balance sheet sometime after the federal funds rate had been increased, primarily by not replacing maturing securities.

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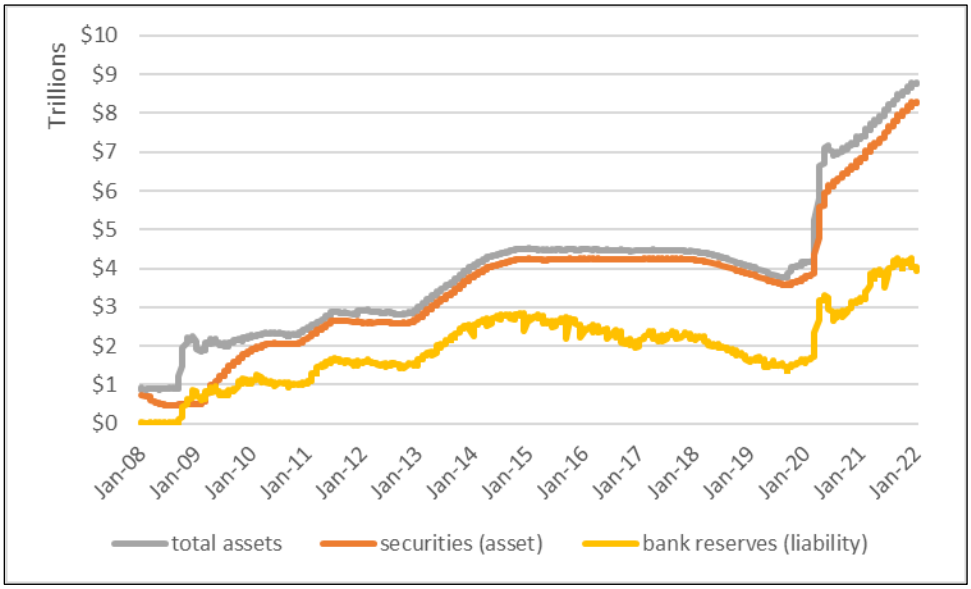
History of Asset Purchases

QE was first used in three rounds between 2008 and 2012 in response to the financial crisis when the Fed purchased Treasury securities, MBS, and agency debt. Tapering was first used in 2013 to wind down QE3, and the surprise caused Treasury yields to rise and financial volatility in emerging markets (popularly called the "taper tantrum").

The Fed holds securities it buys as assets on its balance sheet and has financed its purchases by expanding its liabilities by an equal amount. Securities held by the Fed increased from $0.8 trillion before the financial crisis to $4.2 trillion by the end of 2014, as seen in **Error! Reference source not found.**. Bank reserves held at the Fed are the primary liability that has increased over this period. While the Fed has not literally "printed money" to finance these purchases, increasing bank reserves has a similar effect, as bank reserves are part of the monetary base. Bank reserves have increased from $40 billion at the beginning of 2008 to $3.8 trillion at present.

Figure 1. Federal Reserve Balance Sheet



Source: Federal Reserve.

In the fall of 2019, a liquidity shortage caused repo market turmoil, prompting the Fed to begin purchasing Treasuries again. Asset purchases rapidly increased in response to financial unrest caused by the pandemic's onset in the spring of 2020, with securities holdings increasing by about $2 trillion in two months. MBS purchases resumed then, and for the first time the Fed purchased agency CMBS (MBS backed by commercial mortgages) in relatively small amounts. Beginning in June 2020, the Fed purchased $120 billion of securities per month—a faster rate than the rounds of QE following the financial crisis. In December 2020, it pledged to continue purchases at this rate "until substantial further progress has been made toward its maximum employment and price stability goals." When tapering was first announced, the unemployment rate had fallen from 6.7% to 4.8% and the Fed's targeted inflation measure had risen from 1.3% to 4.3%. Since March 2020, the Fed's securities holdings have doubled to $8.9 trillion.

The Fed's Rationales for QE

During every period of asset purchases except 2019 to March 2020, the federal funds rate (a short-term interest rate that is the main target of monetary policy) was near zero. QE allowed the Fed to provide additional stimulus when the economy faced deep recessions by reducing Treasury and mortgage rates when short-term rates were constrained by the "zero lower bound." A reduction in those rates would be expected to feed through to other long-term rates throughout the financial system, thus boosting interest-sensitive spending, which most studies have confirmed. In the pandemic, the Fed also emphasized the effects of QE on reviving liquidity in stressed financial markets. Boosting overall bank reserves helps ensure that individual banks maintain adequate liquidity. In addition, the financial crisis originated with a crisis in mortgage markets and featured financial distress at Fannie Mae and Freddie Mac. Purchasing agency debt and MBS helped relieve stress in mortgage markets more directly. By contrast, today housing markets are generally booming.

Policy Implications of Tapering

Now that tapering has begun, how quickly should the Fed normalize monetary policy? Although QE increases the monetary base, which can theoretically lead to higher inflation, this did not occur as some critics feared after the financial crisis. Instead, inflation was generally below target before the pandemic. However, inflation was well above the Fed's target in 2021. In the Fed's view, the rise in inflation does not require policy to be tightened more quickly, given the economy has not yet returned to full employment and the pandemic continues. Some critics would like the Fed to wait until the pandemic is over to begin tapering. Others see little justification for continuing asset purchases—a tool intended for crises—during a financial boom and high inflation and fear that the slow pace of tapering has put the Fed behind the curve in maintaining price stability.

The Fed's permanently larger balance sheet also raises broader policy issues: Is it appropriate for the Fed to hold a significant share of the federal debt and MBS outstanding? Is it appropriate for the Fed to pay banks interest on reserves and operating standing repo facilities in order to make interest rate control in the presence of a large balance sheet possible? Because of the Fed's independence, Congress does not interfere with specific monetary policy decisions, and it is difficult to devise legislative constraints on future asset purchases or the balance sheet that would not impinge on the Fed's independence. Furthermore, the Fed needs the authority to buy and hold some types of securities for normal monetary operations outside of QE. Some past bills would have revoked its authority to purchase MBS or allowed MBS purchases in crisis conditions only.

Author Information

Marc Labonte
Specialist in Macroeconomic Policy

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