Why America's Federal Reserve might make money disappear

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Before the financial crisis, America's Federal Reserve held assets worth around $850bn. Today, the central bank's balance-sheet is more than five times as large, at $4.5trn. It grew during and after the financial crisis as the Fed purchased vast quantities of government bonds and mortgage-backed securities using newly created money, most of it under a policy known as quantitative easing (QE). Now the Fed is preparing to sell some assets, and retire the corresponding money. Why and how will it do this?

The Fed resorted to QE to stimulate the economy after it had moved the short-term interest rate, its usual policy instrument, as low as it could go. Debate rages over how, exactly, QE worked; Ben Bernanke, the former Fed chairman, once quipped that the policy "works in practice but not in theory". But it is clear enough that QE pushed up the price of long-term bonds. This put downward pressure on long-term interest rates (which move inversely to bond prices). Today, however, the Fed, now led by Janet Yellen, is raising short-term rates, as it tries to keep a lid on inflation. So—the logic goes—it should also shrink its balance-sheet, to push up long-term rates.

There are different ways to shrink the balance-sheet. The most aggressive approach would be to sell bonds. This would please QE's critics, who claim a large balance-sheet distorts financial markets. But nobody is certain what the effects of unwinding QE will be, and the Fed wants its policies to be predictable. So it is more likely to let the balance sheet gradually "run off", by ceasing to reinvest, in new securities, the money it receives when its bonds mature. That happens constantly. For example, $425bn of its Treasuries come due in 2018 and another $350bn in 2019. The Fed could stop reinvesting some proportion of this money. Or it could pick the simplest option, which is to halt reinvestments altogether.

How much will the balance-sheet shrink? Plentiful liquidity helps to keep the financial system stable. Some argue that this benefit is so large that the Fed shouldn't shrink its balance-sheet at all, and instead should focus on holding the right mix of assets. These arguments are not yet prevailing. In any event, the balance-sheet will remain larger than it was before the financial crisis, because the economy needs more money than it did. For example, before the crisis, there was a little over $800bn of currency in circulation; today, the figure is over $1.5trn. All that cash appears as a liability on the Fed's balance-sheet and must, therefore, be backed by assets. So, although the Fed may start to unwind QE, it will have to cling on to at least some of the securities it has bought.