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What is Quantitative Tightening?

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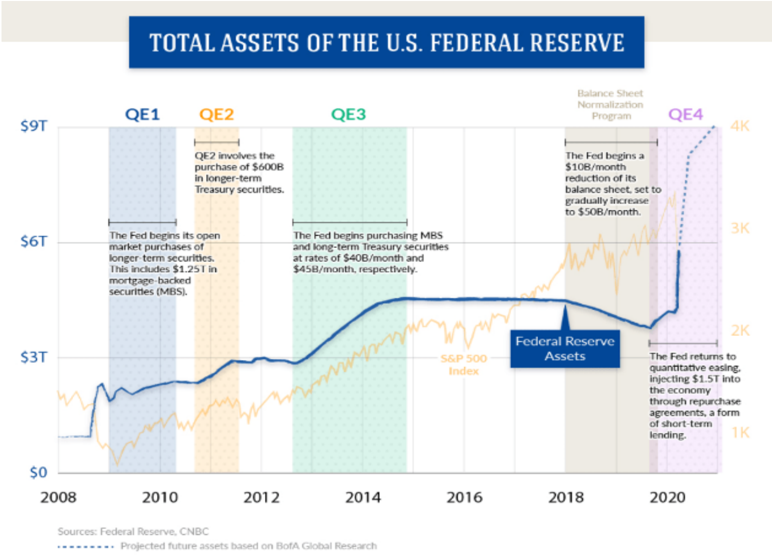

A graph of the Federal Reserve's assets throughout its history of OMOs. As of May 2022, the Fed's balance sheet is about $8.9 trillion or 37% of nominal GDP. The Fed announced in April that its second QT program ever was starting in June 2022. The current plan is a reduction of $47.5 billion per month for 3 months and then $95 billion per month until the reserves are somewhat above the level the Fed deems "ample" to prevent another liquidity crunch. These amounts are monthly caps so actual balance sheet run-off may be slower. Nonetheless, the total amount of balance sheet reduction is a record liquidity drain, double the size of the last QT cycle. Jerome Powell told Congress in March 2022 that the process would take about 3 years with $3 trillion in reductions.

As the goal of QT is to take money (i.e., financial excesses and liquidity) out of banking system and financial markets, QT will put more upward pressure on interest rates, making borrowing more expensive and tighten financial conditions which reduces economic activity. Federal Reserve governors are suggesting QT will not have much effect on the broader economy, with St. Louis Fed President Jim Bullard claiming, "one may view the effects of unwinding the balance sheet as relatively minor". But if the expansion of the balance sheet decreases long-term interest rates and enhances liquidity and growth, then the contraction of the Federal Reserve's balance sheet should have at least a reverse effect equal in magnitude, if not greater.

The implications for asset prices are significant. Higher interest rates lead to higher financing costs and tighter liquidity conditions. Almost every risk asset including equities, real estate, commodities, and venture capital is impacted by QT as valuations, cash flows and discount rates change. The scale of the QT currently planned by the Federal Reserve is unprecedented.