

The Bloated Fed Balance Sheet That Isn't

BY BIAGIO BOSSONE AND MASSIMO COSTA

*It's all an
accounting
illusion.*

Kevin Warsh arrives at the Federal Reserve with a mandate, a metaphor, and a problem. The mandate came on May 13, when the Senate confirmed him as chair. The metaphor is his own: the Fed's "bloated" balance sheet, in his words, "designed to support the biggest firms in a bygone crisis era," must be reduced significantly. The problem is that every time the Fed has tried to slim down, the financial system has seemed to panic—the 2019 repo spike, the 2020 dash for cash, the 2023 failure of Silicon Valley Bank.

In the Winter issue of *TIE*, Peter Coy laid out the dilemma with characteristic clarity ("Exploding Fed Balance Sheets Forever?"). The Fed has gone "from lean to elephantine"—from roughly \$900 billion in assets in 2008 to \$6.6 trillion today, with bank reserves above \$3 trillion. U.S. Treasury Secretary Scott Bessent calls the balance sheet "swollen." Jerome Powell, on his way out as Fed chair, defended the "ample reserves regime" as "highly effective." Fed Governor Christopher Waller went further, arguing that reserves are a public good the private sector cannot reliably supply—if the government could provide clean drinking water for free, why ration it? Critics counter that abundant reserves breed risk-taking, liquidity dependence, and a balance sheet that ratchets ever upward.

It is a vigorous debate. It is also, in one crucial respect, a confused one. Hawks and doves, shrinkers and expanders, Warsh and Waller—all of them argue from a shared premise that happens to be wrong: that the \$3 trillion in reserves sitting at the Fed is debt the Fed owes, and that the central bank's losses are erosions of its capital. Neither proposition survives scrutiny. And the proof comes not from heterodox theory but from the Fed's own books.

Biagio Bossone is an adviser to international financial institutions and national central banks. Massimo Costa is Professor of Accounting at the University of Palermo. Together they developed the Accounting View of Money.

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editor@international-economy.com

THE TELL: A \$240 BILLION “DEFERRED ASSET”

When the Fed began recording losses in 2022—losses that accumulated to over \$240 billion before beginning to recede—it reached for an accounting device with no real parallel in the private sector: the deferred asset. Rather than charging the losses against capital, the Fed recorded a claim on its own future earnings, suspending remittances to the Treasury until the claim is extinguished. Markets were puzzled. Critics called it an accounting fiction. Some economists questioned whether the world’s most powerful central bank was, in some meaningful sense, insolvent.

It was none of those things. The mechanics are straightforward: when the Fed’s interest payments on reserves—the carrying cost of its post-quantitative easing balance sheet—exceed the income from its assets, net losses arise. Under normal accounting these would reduce equity. The Fed instead books a notional entry representing future net earnings to be retained before transfers to the Treasury resume. Operations continue without interruption. The European Central Bank has handled its own recent losses similarly, carrying them forward against future profits. The Bank of England and the Swiss National Bank have faced comparable pressures. In every case, the institutional answer has been the same: these are not solvency events; remittances may be deferred; recapitalization is a political question, not an operational necessity.

That is the right answer. But central bank accounting has arrived at it without a theory explaining why it is right. The frameworks remain anchored in the convention that treats central bank money—banknotes, reserves, and prospectively central bank digital currency—as liabilities. And if money is a liability, then losses against it look, at least superficially, like any other debtor’s problem. The deferred asset is an accounting intuition in search of a theory.

THE LIABILITY ILLUSION

Here is the theory. Under international accounting standards, a financial liability is a contractual obligation to transfer an economic resource to another party. Central bank reserves do not satisfy that definition. Reserves are created when the central bank credits the account of a commercial bank against securities, through lending, or in other monetary operations. They are not funds that banks have lent to the central bank. When reserves move through the payment system, the central bank does not hand over a resource it previously borrowed; it debits one account and credits another. The receiving bank holds a monetary record maintained and administered by the central bank within the architecture of the payment system, not a repaid debt.

The decisive point is irredeemability. Unlike conventional debt, reserves cannot be converted into gold,

foreign exchange, or any superior monetary instrument. At most they can be exchanged for banknotes, which are themselves central bank money and share the same sovereign origin. In a fiat system there is no redemption chain above central bank money but only conversion among its forms. There is no creditor who can demand repayment in something other than the money itself. The instrument

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is not a claim on an underlying asset. It is the asset: the foundational monetary unit on which the entire payment and banking system rests.

Why, then, do reserves still appear as liabilities? The answer is not analytical necessity but historical inertia. Under metallic and convertible regimes, central bank money really was redeemable into specie or foreign assets, and the liability classification made sense. Once convertibility disappeared, the old form survived even though its conceptual foundation had vanished. Accounting language outlived the monetary regime that justified it.

MONEY AS THE ISSUER’S EQUITY

The Accounting View of Money, which we have developed over the past several years, draws the conclusion that follows. For its issuer, sovereign money is not debt but a form of equity—not equity in the corporate sense of shareholder ownership, but sovereign monetary value created by the state and reflected in the income and net worth that issuance generates. For its holders, central bank money is a custodial asset: reserve holders own their balances, while the central bank safeguards and administers them within the sovereign monetary system.

Under this view, the issuance of central bank money generates seigniorage income that conventional accounting suppresses, treating what is in substance an equity-creating transaction as a mere liability incurred. Seigniorage is the economic benefit accruing to the issuer of an instrument that others must hold to participate in the monetary system. Unlike interest on debt, it is structural and self-replenishing, tied to the continued demand for the currency rather than to any contractual obligation to service or redeem it.

If this is right, central bank losses are not erosions of capital in the corporate sense. They are reductions in

the flow of monetary income, that is, changes in the distribution of seigniorage across time, between the central bank, the treasury, the commercial banks holding reserves, and ultimately the public. They may matter for the size of future remittances to government, but they

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do not threaten the institution's ability to operate or to honor its obligations, since they are not obligations in the first place.

And this is precisely what the deferred asset implicitly recognizes. By recording losses as a claim on future earnings rather than a capital adjustment, the Fed treats itself as an institution with a structural, indefinite earning capacity. It is an institution that can defer distributions today and recover them tomorrow, because the source of its income is not an asset portfolio that can be exhausted but a monetary function that endures as long as the dollar remains a currency in use. The deferred asset makes no sense in a framework where central bank money is ordinary debt. It only makes sense if the central bank's income is constitutive, that is, generated by its very power of issuing money. The Fed stumbled upon the right instrument for the wrong theoretical reasons.

REREADING THE BALANCE SHEET DEBATE

Now replay the arguments Coy surveyed through this lens, and the debate sorts itself into real concerns and spurious ones. Powell's claim that the ample reserves regime "has proven highly effective" is, like the deferred asset, a right answer without a theory. Waller's clean-water analogy is better than he may know: the Accounting View supplies its foundation.

Reserves are not what the Fed owes the banks; they are the settlement asset that anchors the convertibility and credibility of commercial bank money: public monetary infrastructure, not corporate borrowing. A government does not "owe" the highway system to its drivers.

Warsh's "bloated" metaphor, by contrast, smuggles in the false premise. Bloat implies indebtedness, fragility, a burden to be worked off. Once reserves are understood as

sovereign equity, the size question does not disappear—but it changes character. The issue is not how much the Fed "owes" but how large a footprint the central bank should have in the financial system, and how the seigniorage from money issuance should be distributed. Those are legitimate, indeed important, policy questions. Insolvency is not among them.

The same goes for the political economy. Randal Quarles, who has served as both Fed governor and undersecretary for domestic finance of the U.S. Treasury, called the big balance sheet an "attractive nuisance," and Coy noted that the Fed becomes vulnerable to political pressure when it is "losing money." The vulnerability is real but it flows directly from the misrepresentation. A balance sheet framework designed for borrowers, applied to an institution that does not borrow in any meaningful sense, manufactures the very appearance of fragility that politicians then exploit.

In several jurisdictions, the confusion between central bank losses and corporate insolvency has generated entirely unnecessary pressure for recapitalization. Fix the representation, and that line of attack loses its grip. What protects a central bank is not the appearance of a pristine

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corporate-style balance sheet; it is the credibility of its mandate, the legal clarity of its powers, and the institutional trust that supports its actions.

WHAT THE RECLASSIFICATION DOES NOT DISSOLVE

Honesty requires also saying what the Accounting View does not change. Interest on reserves is a genuine outflow. Paying upwards of 4 percent on \$3 trillion of reserves is real money—and it is exactly where the Fed's losses came from. Under the Accounting View this payment is seen for what it is: not debt service, but a transfer of seigniorage from the public to the banking system; a distributional policy choice that current accounting conveniently buries

inside “net income.” Making it visible would sharpen, not soften, the scrutiny it deserves.

Nor does reclassification dissolve the incentive problems Coy highlighted. The finding by former Reserve Bank

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of India governor Raghuram Rajan and his co-authors, whereby abundant reserves tempt banks into dependence on runnable liabilities, leaving a system liquid on paper and fragile in practice, concerns the quantity of reserves and the behavior it induces, not their accounting nature. The ratchet dynamic, the stigma of the discount window, the design choices among term deposits, standing facilities, and collateral rules: all of that survives, and all of it deserves the debate Warsh wants to have. The contribution of the Accounting View is to clear the ground and separate the questions worth fighting over (footprint, incentives, seigniorage distribution) from the phantoms (insolvency, capital erosion, the “burden” of monetary “debt”).

A REFORM BLUEPRINT

If central bank money is not debt, accounting frameworks should say so explicitly and systematically. Three steps follow. First, central bank statutes should explicitly recognize the power to issue irredeemable sovereign monetary assets; the reserve-creation function should no longer remain implicit in legal drafting. Second, the monetary base (reserves, banknotes, and any future CBDC) should be reclassified from liabilities to equity on the issuer’s balance sheet, while holders’ balances are recognized as custodial assets safeguarded by the central bank. Third, seigniorage should be recognized explicitly rather than suppressed within the liability structure, with losses reported as claims on future seigniorage, thus making the Fed’s deferred asset not an improvised exception but the standard treatment.

None of this would change operations. Interest could still be paid on reserves; open market operations would work as before; settlement procedures would be untouched. What would change is the public and political narrative—and, in the digital era, the legal architecture. If

retail CBDC is treated as a liability of the central bank in the way conventional debt is, citizens are implicitly cast as creditors who have “lent” the state its own money. That is a legal fiction. The fiction was harmless when money was just notes and coins. In a world of tokenized claims and programmable payments, it is not: it leaves ownership, insolvency remoteness, and access rights unsettled at the very foundation of tomorrow’s monetary system. Emerging economies, whose institutional credibility is most exposed to narratives of balance sheet deterioration and quasi-insolvency, may have the most to gain from getting the categories right.

THE QUESTION BEFORE THE WARSH FED

Coy concluded that the current trajectory—crisis, expansion, partial shrinkage, renewed stress, re-expansion—is not sustainable, and that a new equilibrium will require rethinking not just the size of the balance sheet but the role the Fed plays in the financial system. We agree, and would push one step further back. Before deciding how big the Fed’s balance sheet should be, decide what the balance sheet means. The institution that now holds \$6.6 trillion in assets against \$3 trillion in reserves is not a leveraged borrower one bad year from distress. It is the issuer and custodian of the monetary unit itself—and its own deferred asset has been quietly saying so since 2022.

The new chair inherits a balance sheet debate conducted in the wrong language. Translating it would be the

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most consequential reform of all, and the cheapest: it requires no act of Congress to begin, only the willingness to make the accounts say what central banks already know to be true. Money is not the state’s debt to society. It is the state’s equity in circulation. ♦