

Exploding Fed Balance Sheets Forever?

Under such a policy, will banks take dangerous forever-larger risks?

BY PETER COY



If the billions of dollars in bank reserves parked at the Federal Reserve were pounds on a bathroom scale, the Fed would have weighed 103 pounds in September 2008—and 3,014 pounds in March 2026. The central bank has gone from lean to elephantine. And every time it tries to slim down, the financial system seems to panic.

In a widely read *TIE* cover story last year, U.S. Treasury Secretary Scott Bessent called the Fed’s balance sheet “swollen.”

Kevin Warsh, Trump’s pick to succeed Jerome Powell as Fed chair, is in the same camp. “The Fed’s bloated balance sheet, designed to support the biggest firms in a bygone crisis era, can be reduced significantly,” Warsh wrote in an op-ed for the *Wall Street Journal* in November. In his April 2026 confirmation hearing, Warsh said the Fed should shrink its balance sheet but didn’t say how, except that it should be done “slowly and deliberately.” The Senate Banking Committee voted 13–11 on strict party lines on April 29 to advance his nomination to the full Senate, which voted to confirm Warsh on May 13.

Powell and other Fed insiders are sensitive to the criticism that their footprint has gotten too big. But in an October speech titled “Understanding the Fed’s Balance Sheet,” Powell said that “our ample reserves regime”—the term of art for a big balance sheet—“has proven highly effective.”

So, what’s going on here? Why did the Fed’s balance sheet get so big in the first place, why hasn’t it shrunk more, and why is the whole issue

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knocking everyone off balance? It's good to have a grasp of the issue because it's bound to come up more often now, with Warsh about to take over at the Fed and Bessent remaining at Treasury.

The Fed's balance sheet, like any company's, is simply a record of what it owns and what it owes. On the asset side are mostly U.S. Treasury securities and mortgage bonds. On the liability side are mostly cash, deposits from the Treasury Department, and bank reserves.

All of the Fed's liabilities have grown in recent years. There's more cash—much of it circulating abroad, and much of it used by criminals, who like its anonymity. The federal government's checking account at the Fed, known as the Treasury General Account, is also bigger than it used to be.

But the biggest growth has been in reserves, which are special deposits that commercial banks keep at the Fed. Banks use their reserves to pay each other—for example, when the customer of one bank makes a big payment to the customer of another.

Before the 2008 financial crisis, banks kept just enough reserves on hand to cover their daily liquidity needs and to comply with the Fed's requirements. When

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they didn't have enough reserves, they would borrow some from other banks.

The financial crisis blew up that venerable system overnight. The Fed aggressively bought Treasury and mortgage-backed securities to drive down long-term interest rates across the economy. As in the past, it paid for the assets with reserves, but far more than the banking system had ever held—and those reserves stayed in the system long after the panic passed.

Quantitative easing became a go-to tool for the Fed every time the economy softened. The Fed conducted a second round of asset purchases starting in 2010, a third

starting in 2012, and a fourth starting in 2020, after the covid pandemic hit.

The covid purchases were the biggest yet. The Fed started buying in March 2020 and kept going until May 2022, long after the recession was over. It increased its asset holdings by \$4.6 trillion over the period. "With the clarity of hindsight, we could have—and perhaps should have—stopped asset purchases sooner," Powell admitted in his speech last October.

The Fed has slimmed down somewhat since May 2022, shedding about \$2.3 trillion in assets. But it's still at \$6.6 trillion in total assets, far more than before covid.

On the liability side, bank reserves are just over \$3 trillion, also higher than at any time before Covid. That's way more than Fed officials once envisioned. As recently as December 2018, according to the transcript of a Federal Open Market Committee meeting, Powell said "I think I would have buyer's remorse" if reserves needed to be as high as \$1.5 trillion under the Fed's new operating framework.

Despite that growth, the Fed is cautious about shrinking its balance sheet much further. The problem is that banks have grown accustomed to having lots of reserves stashed at the Fed. Whenever the Fed has shrunk too much in the past, stress has erupted—in the 2019 repo spike, the 2020 "dash for cash," and the 2023 failure of Silicon Valley Bank. The message from markets has been unmistakable: Don't take the punch bowl away.

Bill Nelson, a former senior Fed official now at the Bank Policy Institute, has warned of "a self-reinforcing cycle that requires the Fed not only to be massive, but to become ever more massive."

One problematic consequence: When banks have lots of money readily available in their Fed accounts, they're tempted to take bigger risks elsewhere on their balance sheets, Raghuram Rajan of the University of Chicago, with co-authors Viral Acharya, Rahul Chauhan, and Sascha Steffen, argued in a 2023 working paper.

One risky thing banks do when reserves are plentiful, Rajan and his co-authors argued, is to depend more on "runnable" liabilities—that is, money that can be snatched away at a moment's notice, such as credit lines from other banks and uninsured deposits.

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Main Street vs. Wall Street. *Fed Chair nominee Kevin Warsh has argued that the main beneficiaries of the Fed's balance sheet expansion are big companies that can issue bonds at lower rates when long-term interest rates fall. Smaller firms that rely on short-term bank loans don't fare as well, he has said.*

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When the Fed switches from easing to tightening, banks ought to reduce their dependence on runnable liabilities, but don't, at least not enough, the authors found. The result is a mismatch: the system looks liquid on paper but is fragile in practice. Stress appears first at the periphery, as it did with Silicon Valley Bank, and then forces the Fed to intervene at the center. The balance sheet has a ratchet: Each peak and trough is higher than the ones before.

"The evidence suggests that the expansion and shrinkage of central bank balance sheets has led to liquidity dependence of banks on central banks," the authors wrote.

Another concern of critics: A large balance sheet is an "attractive nuisance," former Fed Vice Chair Randal Quarles said in 2022, after leaving the Fed. Congress and the White House have already floated ideas for directing the Fed's asset purchases toward favored causes—from green infrastructure to digital assets. Moreover, the Fed becomes vulnerable to political pressure at times such as the present when it's losing money because the interest it earns on its assets is (temporarily) lower than the interest it pays on its liabilities, such as reserves.

Warsh, for his part, has argued that the main beneficiaries of the Fed's balance sheet expansion are big companies that can issue bonds at lower rates when long-term interest rates fall. Smaller firms that rely on short-term bank loans don't fare as well, he has said.

In his op-ed for the *Wall Street Journal* this past November, Warsh wrote that the Fed should curtail its support of lower long-term rates while simultaneously cutting short-term rates "to support households and small and medium-size businesses." That would be a neat trick that would simultaneously shrink the Fed's footprint and please the man who picked him for the job, Trump, who has pounded the table for lower rates.

But Warsh's gambit might not work as designed, Jennifer McKeown, chief global economist at Capital Economics, wrote in February. Warsh assumes that the economy won't be overstimulated if a cut in short-term

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rates is counterbalanced by a rise in long-term rates through bond-selling. But McKeown pointed out that the link between the balance sheet's size and financial conditions is unpredictable. And if banks' reserves fall too much, it could disrupt short-term funding markets, she wrote: "Rather than creating policy space, aggressive quantitative tightening could reduce the Fed's control over rates and its flexibility in a crisis."

Fed officials do not deny that the balance sheet is large. They do dispute that it is a problem. Governor Christopher Waller, the most forceful defender of the current framework, argued last year that reserves are a public good that the private sector cannot reliably supply on its own. They enable the payments system to function. If the government could provide clean drinking water for free, Waller asked, why would it ration it? In his view, ample reserves allow the Fed to control short-term rates through administered tools such as the interest rate on reserve balances, without daily firefighting in money markets.

What is the way forward? Other major central banks, including the Bank of England, the European Central Bank, the Bank of Canada, and the Reserve Bank of Australia, are moving toward frameworks that give banks the liquidity they need primarily through short-term lending operations rather than by holding trillions of dollars of securities on their own balance sheets.

Mr. Fed Chair, Call Your Office!

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One option, championed by David Beckworth of George Mason University's Mercatus Center, is to revive the Fed's term deposit facility and make the rate it pays the main policy rate, in place of the federal funds rate.

Money tied up in term deposits isn't as readily available in an emergency, which could be a bad thing. But Beckworth sees it as a good thing. His idea, which ties in to Rajan's point, is that if banks don't have as much easy liquidity from the Fed, they won't dare to depend so much on runnable liabilities to fund themselves.

Another option, resembling what other countries do, is to normalize use of the discount window, which is where banks can go to borrow money directly from the Fed. The stigma attached to borrowing from the Fed remains so strong that banks avoid it even in stress, forcing the Fed to rely on broad-based interventions rather than targeted liquidity.

A third option is regulatory. If regulations allowed more forms of collateral to count toward banks' liquidity requirements, banks would not need to hold such large quantities of reserves. Nelson has proposed reviving the term auction facility, which would allow banks to pre-position collateral and borrow as needed without stigma.

The Fed's balance sheet will never return to its 2007 size. But the current trajectory—crisis, expansion, partial shrinkage, renewed stress, re-expansion—is not sustainable. The system has become conditioned to expect the Fed to be the first responder, not the last resort. A new equilibrium is possible, but it will require rethinking not just the size of the balance sheet, but the role the Fed plays in the financial system. ♦