Shrinking the Fed's Balance Sheet and Then What?

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Introduction

I thank the Shadow Open Market Committee (SOMC) and the Center for Financial Stability for the opportunity to participate in this Fall meeting. In my remarks, I will offer my perspective on the Fed's balance sheet and on two crucial next steps: first, shrinking the balance sheet and, second, keeping it manageable once it is smaller.

The Ample-Reserves Monetary Policy Operating Framework

Since January 2019, the Fed has used an ample-reserves operating framework to implement monetary policy.[1] In this framework, the Fed keeps reserves in the banking system high enough that it does not need to actively manage their supply based on daily estimates of banks' demand for reserves to achieve the target for its policy rate.[2] The Fed communicates its policy choice by setting a target range for the federal funds rate, a market-driven rate at which banks lend reserves held in their Fed master accounts to one another overnight.

In the ample-reserves framework, the Fed supplies more reserves than banks need for liquidity management and payments. The Fed, then, achieves its fed funds rate target mainly by setting four administered interest rates: the interest rate on reserve balances (IORB) held by banks at the Fed; the interest rate on overnight reverse repurchase agreements (ON RRP); the primary credit rate, which banks pay to borrow at the Fed's discount window against eligible collateral; and the interest rate on repurchase agreements the Fed offers at its Standing Repo Facility (SRF).[3] Many entities, including money market funds and the housing government-sponsored enterprises (GSEs), are active in the overnight funding

[1] See Federal Open Market Committee (2019).

[2] I discuss this framework in more detail, and why it is not as simple as theory suggests, in Mester (2025a).

[3] In an overnight RRP, the Fed sells a security in its portfolio to an eligible counterparty and agrees to repurchase the security the next day, repaying the cash the counterparty originally paid plus interest at the ON RRP offering rate. The counterparties are a broad set of money market entities, including banks, government-sponsored enterprises (such as Fannie Mae, Freddie Mac, and the Federal Home Loan Banks), and money market mutual funds. See Federal Open Market Committee (updated May 12, 2026).

market but cannot earn interest on reserves. So, setting the ON RRP rate, in addition to the IORB rate, lets the Fed put a firmer floor under overnight interest rates.

The ceiling on overnight interest rates is determined by the Fed's primary credit rate (also known as the discount rate) and by the rate the Fed charges on overnight repurchase agreements at the SRF.[4] However, the discount window has become stigmatized and banks are reluctant to use it. The SRF helps ensure that the fed funds rate does not rise above the top of the target range set by the FOMC.

Under the ample-reserves system, the FOMC no longer needs to estimate reserve demand each day to control interest rates because at high levels of reserves, the reserve demand curve flattens out, so small changes in the supply of reserves do not affect the fed funds rate. But the Fed does need to estimate the point at which banks' demand for reserves is satiated so that it keeps reserves on the flat, ample portion of the reserves demand curve and does not allow reserves to become scarce.

How the Balance Sheet Got So Large

The Fed effectively had no choice but to adopt this operating system after it began purchasing longer-term assets during the Global Financial Crisis (GFC) and Great Recession to add monetary accommodation once the fed funds rate had been reduced to its effective lower bound. The level of reserves had risen so much that small changes in the supply of reserves had little effect on the fed funds rate, so the Fed needed to switch to a floor system to keep the fed funds rate within its target range. Assets peaked at over $4.5 trillion, or 25 percent of nominal GDP, and reserves at $2.8 trillion, or 16 percent of nominal GDP. (See Figures 1 and 2.)

[4] In an overnight repo, the Fed buys a security from an eligible counterparty and agrees to resell the security to the counterparty the next day for the amount the Fed originally paid plus interest at the SRF rate, which is set at the top of the fed funds target range. See Mester (2025a) and Afonso, et al. (2022) for further discussion of the Standing Repo Facility.

The Fed began reducing the size of the balance sheet in October 2017 by allowing assets to run off. The runoff ended in August 2019, and the Fed resumed buying assets after repo and other short-term money market rates spiked in September 2019, which the Fed took as evidence that reserves, then about $1.4 trillion, or about 6.5 percent of nominal GDP, had fallen below the ample level.

When the COVID-19 pandemic hit in March 2020, the Fed began new rounds of longer-term asset purchases. By June 2022, assets had grown to nearly $9 trillion (about 35 percent of nominal GDP), with reserves of over $3 trillion (about 12 percent of nominal GDP) and ON RRPs near $2.5 trillion (about 10 percent of nominal GDP).

The second period of balance sheet normalization began in June 2022 and ended in December 2025 when the Fed announced that reserves had reached an ample level and that it would purchase shorter-term Treasuries as needed to keep reserves ample. Currently, assets are about $6.7 trillion (about 21 percent of nominal GDP); reserves are about $3 trillion (about 9 percent of nominal GDP); and ON RRPs are very low.[5]

These episodes indicate that the level of reserves the Fed considers ample today is higher than it was in 2019, both in dollars and as a share of nominal GDP: about 9 percent now versus about 6.5 percent then. One reason is that the ample level of reserves is **endogenous**. It depends on Fed policies, banks' responses to them, and changes in overnight funding markets. But this endogeneity also gives the Fed an opportunity to influence the ample level and move it down.

The Benefits and Costs of Ample Reserves

Before addressing how the Fed could do this, we should ask why it would want to. Many at the Fed view the ample-reserves framework as simple and efficient. It allows the Fed to control the policy rate without

[5] ON RRPs are a bit over $300 billion (1 percent of nominal GDP).

having to do daily operations, and it is resilient to swings in reserve demand. Because reserves earn roughly the market rate of interest, banks face little opportunity cost in holding them and have little incentive to economize on them. Banks' willingness to hold more reserves is viewed as reducing liquidity risk in the financial system and fostering financial stability.[6] Indeed, Fed Governor Chris Waller recently likened the provision of ample reserves to clean water, saying, "If governments could provide clean, safe drinking water for citizens at zero cost, why would they make it scarce?"[7]

But are ample reserves really costless? If not, a cost-benefit analysis is needed to determine whether ample reserves is the optimal system, or whether the Fed should act to reduce the ample level of reserves, or even return to a scarce-reserves system. Such an analysis is challenging because the costs are difficult to quantify, but three have gained increasing recognition.

The **first** cost is that banks have come to rely more on the central bank to provide liquidity in periods of market stress and less on their own liquidity management.

As Acharya, et al. (2022, 2024) and Acharya and Rajan (2023) discuss, an increase in reserves may not increase liquidity because banks with surplus reserves may hoard those reserves in stressed market conditions.[8] Banks may have made commitments against their surplus reserves and so are reluctant to part with those reserves. The authors' empirical work indicates that across episodes of quantitative easing and quantitative tightening, the banking system becomes more vulnerable to liquidity shocks and more dependent on liquidity injections from the Fed. This "ratchet effect" means that a higher supply of reserves induces greater demand for them and, contrary to what is cited as a benefit of ample reserves, a greater risk of financial instability.[9]

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[6] See Nelson (2018), Zobel (2022), and Logan (2023) for more extensive discussions of the benefits of the ample-reserves operating framework.

[7] Waller (2025).

[8] See also Lopez-Salido and Vissing-Jorgensen (2025).

[9] See Borio (2023) for further discussion.

A **second** cost is the Fed's expanding role in interbank funding markets. With ample reserves, banks are much less active in overnight funding markets: Anbil, Anderson, and Eyal (2026) estimate that traditional bank-to-bank trading in the fed funds market has fallen sharply to a range of $2 billion to $6 billion of daily volume.[10] So in times of market stress, reserves are less likely to circulate from banks with excess reserves to those that need them, making it more likely that the central bank will have to inject liquidity to calm markets.

A **third** cost involves the political economy issues stemming from both the size and the composition of the Fed's balance sheet.[11] Under ample reserves, monetary policy operations place no limit on the size to which the balance sheet can grow. This creates the risk that Congress or the administration will try to use the Fed's balance sheet to fund fiscal policy initiatives, which blurs the boundary between fiscal and monetary policy and puts the Fed's monetary policy independence at risk.[12]

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[10] According to Afonso, et al. (2023), the FHLBs represent about 90 percent of the total daily lending volume in the fed funds market and U.S. branches and agencies of foreign banks represent between 65 and 95 percent of the total daily borrowing volume in the fed funds market.

[11] Plosser (2017) discusses a number of the political economy costs of a large balance sheet.

[12] For example, during December 2008, as Congress debated a bailout for American automakers, several members of Congress asked then-Chair Ben Bernanke to have the Fed lend directly to auto companies. Needless to say, the Fed was reluctant to go down this path, which would have put it squarely in the midst of industrial policy, a responsibility of Congress. See Bernanke (2015).

Congress has also used funds from the Fed's surplus account to pay for highways and other budget initiatives by putting limits on the size of the surplus. Section 32202 of the FAST Act of 2015 capped the combined Federal Reserve Bank surplus at $10 billion; any surplus amounts above that were remitted to the Treasury and then reallocated to offset general fund transfers to the Highway Trust Fund. Section 30205 of the Bipartisan Budget Act of 2018 lowered the cap on the Fed surplus to $7.5 billion; any surplus amounts above that were remitted to the Treasury and then used as a budgetary offset to fund federal spending authorized by the bill. See Fixing America's Surface Transportation (FAST) Act (2015) and Bipartisan Budget Act (2018).

In October 2024, in light of the two major hurricanes that had hit Florida in the preceding weeks, Tankus (2024) recommended that the Federal Reserve set up a 13(3) emergency facility to lend directly to municipalities that have been declared in a state of emergency due to natural disasters, such as hurricanes. This disaster relief facility would be similar to the Municipal Liquidity Facility, which the Fed established in April 2020 to help state and local governments address the cash flow problems they were facing during the pandemic. Tankus argued that the new facility would alleviate the potential funding problems caused by the Federal Emergency Management Agency's (FEMA) funding being subject to the federal appropriations process.

Another political economy issue is the Fed's negative remittances to the Treasury. Quantitative easing lengthened the duration of the Fed's assets, while its liabilities, including reserves, are short term. This maturity mismatch exposes the Fed to interest rate risk. When interest rates rose, the Fed's interest expense came to exceed its interest income, and it began booking the losses as a deferred asset on its balance sheet. The Reserve Banks' consolidated remittances due to the Treasury have been negative since September 2022, and the deferred asset's current level is about $235 billion, or 0.7 percent of nominal GDP.[13] (See Figure 3.)

These losses do not affect the Fed's ability to conduct monetary policy; the deferred asset is a claim against the Fed's future earnings. Under the Fed's accounting rules, the losses do not require the U.S. Treasury to recapitalize the Fed; the deferred asset is a negative liability that is paid down as the Fed's interest income begins to exceed its interest expense.[14] Still, the losses pose some reputational risk to the Fed by raising questions about how it is managing its finances. This could lead to renewed calls for the Fed to be brought under the government appropriations process to fund its operations, an arrangement that would undermine its monetary policy independence.

These costs of maintaining large reserve balances are hard to quantify, but they have led Fed Chair Kevin Warsh and others to examine ways to shrink the Fed's balance sheet within an ample-reserves system.

How to Shrink the Balance Sheet

Most suggestions for shrinking the balance sheet involve lowering banks' demand for reserves without jeopardizing financial stability. Some proposals focus on reducing the liquidity buffers banks hold; others

[13] The Fed's net earnings have been positive from 2025Q4 through 2026Q2, and the deferred asset began to decline this year.

[14] The European Central Bank uses similar accounting (see Bossone and Costa, 2026). Some other central banks treat these losses as a charge against equity capital. In 2024, the Riksbank petitioned the Swedish parliament (Riksdag) for a capital injection due to losses it incurred from quantitative easing that had reduced its capital. Under the Riksbank's accounting rules, bond holdings are marked to market, and losses are reflected immediately on the income statement. See Thedéen (2026).

on making it easier for healthy banks to access the Fed's liquidity facilities when they have short-term liquidity needs. But changes on the asset side of the balance sheet can complement these efforts.

1. Lowering banks' demand for reserves

a. Liquidity savings mechanism

One suggestion is for the Fed to add a liquidity savings mechanism to its large-value payments system, Fedwire. This would allow more netting of incoming against outgoing payments and reduce the reserve balances needed to settle them.[15] But as Duffie (2026) indicates, establishing a liquidity savings mechanism would involve significant software changes and would likely take several years to build, test, and implement.

b. Changes to bank regulation and supervision

Others have suggested adjusting the higher liquidity requirements put in place after the GFC and the supervisory treatment of liquidity, which could lower banks' precautionary holdings of reserves. For example, in August 2024, the Fed clarified that large bank holding companies can count their capacity to borrow at the discount window, the SRF, or the Federal Home Loan Banks as a way to monetize their highly liquid assets in their internal liquidity stress tests; previously, banks had to show they could meet extreme outflows of deposits and other funding without relying on these sources.[16] But financial stability considerations limit how far this approach of relaxing regulation and supervision should go.

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[15] Duffie (2026) describes liquidity savings mechanisms, which he points out are used by the large-value payment systems of the Eurosystem, United Kingdom, Japan, and Canada. Some central banks also have throughput rules requiring settlement of a given fraction of daily payments by a certain time of the day, which encourages balances to cycle through the system throughout the day.

[16] See Board of Governors of the Federal Reserve System (2024). Also see Lacker (2026) for a discussion of the potential financial stability problems with allowing discount window lending to become a substitute for bank liquidity management.

c. Discount window operating principles tailored to financial stability conditions

Other steps are being taken to increase the willingness of banks to use the discount window when they are short of reserves, which might also lower precautionary demand. The Fed has pressed banks to improve their operational readiness to use the window, has stood up an online portal for accessing the window, and is considering expanding the window's hours.[17]

While increasing operational readiness is useful, I remain skeptical that it will eliminate stigma or have an appreciable effect on banks' desired liquidity buffers. Stigma arises because there is uncertainty about a bank's health, and the lender of last resort cannot commit *not* to lend to an unhealthy bank. So stigma intensifies in stress conditions when banks are trying to assess the health of their counterparties, which is precisely when discount window lending is most needed. Banks have preferred to borrow elsewhere, including from the Federal Home Loan Banks, which offer cheaper funding but, as the March 2023 bank stresses showed, are not equipped to be lenders of last resort.[18,19]

A discount window reform with more potential would be to have separate operating principles, and perhaps separate governance, for normal times and for extended periods of financial stress, when the weight on stemming financial instability rises relative to the weight on mitigating moral hazard. These principles would tell those administering the window how to value collateral pledged against discount

[17] Federal Reserve System (2024). To improve operational readiness, banks are encouraged to have signed legal agreements in place, pre-positioned collateral and the ability to move it quickly, and regular tests of their access.

[18] See Mester (2025b) for further discussion. Banks have also preferred to borrow from alternative Fed facilities when they are available, even when it costs more. Research by Armantier, et al. (2015) shows that banks were much more willing to borrow at the Fed's Term Auction Facility (TAF) than at the discount window. The average interest premium per auction that banks paid for TAF funding over discount window loans was $85 million in summer 2008 and $1.1 billion in the auction after Lehman failed in September 2008.

[19] The Bank Policy Institute has proposed an alternative, the Committed Liquidity Facility (see Nelson, 2023). Under the proposal, the Fed would offer sound banks lines of credit for 30 days for a fee. The lines would be collateralized and draws would be priced at an above-market rate, like discount window loans. Supervisors and regulators would recognize the lines as a source of liquidity. The facility would not replace the discount window or SRF, but could be less stigmatized because the line would be a firm commitment to lend for at least 30 days unless the bank became insolvent. Of course, it is difficult to distinguish in real time between an illiquid bank and an insolvent one, and a refusal to lend under the line would essentially be a declaration by the Fed that the bank was insolvent, which could push the bank into insolvency if it wasn't already there.

window loans and whether margins should be adjusted. For example, pledged securities could be valued at market value during normal times but at par during extended stress periods, as was done under the 2023 Bank Term Funding Program. A public statement by the Fed that the discount window had moved to stress-period operating principles might reduce stigma and increase banks' willingness to borrow at the window.

d. Tiered reserves

Perhaps more promising would be for the Fed to adopt a tiered system for remunerating reserves, as Norges Bank and the Swiss National Bank do. Under tiering, a bank earns the policy rate on its reserves up to a threshold and a lower rate on reserves above that level. Because the marginal dollar of reserves earns less, banks have less incentive to hold excess reserves and more incentive to lend them to other banks in the overnight interbank market.[20] Norges Bank has used tiering since 2011. Reserves up to a threshold (which it calls a quota) earn the policy rate, and reserves above it earn a rate 1 percentage point lower. Different thresholds are set for banks in three groups. Norges Bank then provides reserves modestly above the sum of the thresholds, so banks with reserves over the quota have an incentive to lend to banks that are short or have reserves under their thresholds.[21] The Swiss National Bank has used a similar system of tiering since September 2022, when it returned to positive interest rates. Reserves up to the threshold earn the policy rate and reserves above the threshold earn a rate 0.5 percentage point lower. The Swiss National Bank also cites support for activity in the Swiss interbank money market as a benefit of its system.[22]

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[20] Duffie (2026) cites work in progress that suggests that tiering could have a substantial effect in lowering the demand for reserves.

[21] Norges Bank explained that the purpose of switching from the floor system to a quota-based system was to "limit bank demand for central bank reserves and to provide a stronger incentive for banks to redistribute liquidity in the interbank market." See Norges Bank (2014), p. 2.

[22] In 2015, when the Swiss National Bank (SNB) set a negative policy rate, it instituted a system of tiering to protect banks by charging them interest only on reserves above a certain level. The SNB says that a benefit of more activity in the interbank money market is that it provides a more robust basis for calculating its policy reference rate. See Maechler and Moser (2022).

A system of tiering would require some care and feeding. For example, the Reserve Bank of New Zealand (RBNZ) abandoned tiering in March 2020 during the pandemic, when reserve levels grew high enough that all banks held balances above their tier level and would have earned the lower interest rate on those balances. After the pandemic, the RBNZ reviewed its implementation framework and opted not to go back to tiering.[23]

Thresholds would need to be reviewed periodically as banks' balance sheets and payment needs change. And the fed funds rate might trade closer to the bottom of the target range and be somewhat more volatile. But the Fed's interest expense would be lower, which may help to alleviate concerns some in Congress have expressed about the Fed paying interest on reserves.[24]

e. Demand-driven operating system

The Fed might also consider moving to the system that the European Central Bank (ECB) adopted in 2024, which is something of a hybrid between a corridor system and an ample-reserves system. Unlike in a scarce-reserves system, the ECB supplies as many reserves as banks demand, but unlike in an ample-reserves system, it supplies the marginal unit of reserves through regular refinancing operations rather than by holding a large securities portfolio. This allows the average level of reserves to be smaller than under an ample-reserves system.[25]

Under these approaches, the Fed would need to be willing to tolerate more short-term rate volatility than it has to date, e.g., being less concerned if the rate is not in the center of the target range. I believe that part of the Fed's reluctance to allow any volatility in the policy rate stems from its need after the GFC to demonstrate that it retained control of that rate, and in particular, that it could raise the fed funds rate to

[23] See Silk (2022).

[24] Legislation introduced in 2025 would prohibit the Fed from paying interest on reserves, which would undermine its ability to control interest rates under any ample-reserves framework. See the Fiscal Accountability for Interest on Reserves (FAIR) Act (2025).

[25] See Schnabel (2024).

hit the target despite the large size of its balance sheet. The Fed has now demonstrated that it can control its policy rate well; in addition, the SRF serves as a backstop. So the Fed should be willing to accept some volatility in short-term rates.

2. Selling mortgage-backed securities from the Fed's balance sheet

The Fed should also consider selling some of the mortgage-backed securities (MBS) on its balance sheet. These sales would not only reduce the size of the balance sheet but also shorten the duration of the Fed's portfolio. This would reduce its interest rate risk and also speed the return to a balance sheet comprising primarily Treasury securities, an aim the Fed has had since it first published policy normalization principles in 2014.[26]

The New York Fed projects that the share of the System Open Market Account (SOMA) portfolio held in agency MBS will decline from 32 percent to about 7 percent by the end of 2035.[27] (See Figure 4.) Selling MBS would speed up that decline and bring the balance sheet back to being primarily Treasuries sooner. To make the process more predictable, the Fed could pre-announce a schedule for the sales; it could also cap the combined monthly total of MBS paydowns and sales, should it deem that necessary.[28] These sales would require the Fed to realize further losses, which would increase the deferred asset. The Fed currently holds about $2 trillion of MBS in its SOMA portfolio. These securities have a fair value of about $1.7 trillion, for a cumulative unrealized loss of about $317 billion as of 2026Q2.[29]

[26] Federal Open Market Committee (2014). The principles indicated that the FOMC did not anticipate selling its MBS as part of normalization, but it left the door open for limited sales in the longer run to "reduce or eliminate residual holdings."

[27] This projection is from the System Open Market Account's 2025 Annual Report and assumes no MBS sales and that MBS paydowns and the securities purchased to maintain ample reserve levels are reinvested in Treasuries. See Federal Reserve Bank of New York (2025), p. 37.

[28] Before it ended quantitative tightening, the Fed had capped the runoff of MBS at $35 billion per month. However, because prepayments were so low, actual redemptions ran well under the cap at around $20 billion per month. Even capping MBS sales and paydowns at $35 billion per month, a level the Fed was previously comfortable with, would result in a faster reduction in MBS.

[29] See Board of Governors of the Federal Reserve System (2026), Table 3, p. 7.

A productive step in a plan to sell MBS would be for the U.S. Treasury and the Fed to reaffirm and extend the mini Fed-Treasury Accord released on March 23, 2009.[30] This accord was intended to help protect Fed independence after the Fed had engaged in emergency interventions during the GFC. Among other points, it clarified that the Treasury would support credit market stabilization, with the Fed serving as its operator; that the Fed would avoid taking on credit risk unless absolutely necessary and the Treasury would take over long-term credit risks to protect the Fed; and that the Fed would maintain strict independence over monetary policy decisions. The reaffirmation of this accord could include an agreement with the Treasury about how losses from selling MBS would be handled and an acknowledgment that both the Fed and Treasury value moving the Fed to a smaller, shorter-duration portfolio comprising primarily Treasuries, which lowers the Fed's interest rate risk and expected future losses.

After the Reduction: A Principle-Based Framework for Asset Purchases

Suppose the Fed succeeds in reducing the size of its balance sheet. Then what?

The Fed's balance sheet grew because of successive rounds of large-scale asset purchases and a reluctance to return it to a more normal size and composition at more than a glacial pace. To keep this from happening again, the Fed should develop a principle-based framework for large-scale asset purchases (and other balance sheet policies) that clarifies why, when, and how such programs would be used; how they would be unwound; and how to effectively communicate about these policies. The framework should be more detailed than the Fed's Statement on Longer-Run Goals and Monetary Policy Strategy (2026) and similar to the framework the Reserve Bank of Australia recently released on the use of alternative monetary policy tools.[31]

[30] See Board of Governors of the Federal Reserve System (2009).

[31] I served as an external reviewer on the Reserve Bank of Australia's recently released Framework for Additional Monetary Policy Tools at Low Interest Rates. See Reserve Bank of Australia (2026) and Kent (2026).

The Fed's past asset-purchase programs were launched without a clear sense of how long they would last and how they would be reversed; their purpose was not always well communicated. There was a lot of learning by doing. A framework would codify that learning so that the lessons are not forgotten. The framework would start with principles, agreed to by the FOMC, that would guide the use of balance sheet tools, helping to ensure that costs and benefits are adequately accounted for before a program isb set up.

These principles would describe the economic and financial conditions under which asset purchases would be used, how programs would be designed, and when and how they would be exited. The principles would also stress the importance of clearly communicating the purpose of a purchase program, including whether the program is intended to support market functioning or to provide monetary policy accommodation.

For example, the principles could include the following:

(1) Asset purchases can be helpful in adding monetary accommodation once the policy rate has been reduced to its effective lower bound, and they can help stem market dysfunction in stress situations. However, asset purchases can blur the line between fiscal and monetary policy and reduce remittances to the Treasury, posing risks to the public sector balance sheet, to the Fed's reputation, and to its monetary policy independence. The accompanying increase in reserves can impair interbank markets and weaken banks' incentive to self-insure against liquidity risk. That these costs are hard to measure and take time to materialize does not mean they should be ignored.[32]

[32] These principles draw on central banks' past experience with asset purchase programs. For example, in September 2022, the Bank of England effectively handled the sharp rise in gilt yields and market turmoil that followed the government's announcement of a larger-than-expected fiscal package. The Bank set up a scheme to buy gilts to restore market functioning even though such purchases appeared to run counter to its plans to tighten monetary policy. The Bank successfully communicated that this was a temporary program and explained the difference between this financial stability action and monetary policy. Because the Bank resisted the pressure to extend the purchase scheme, U.K. pension funds, which had been relying on liability-driven investment (LDI) strategies and were vulnerable to the spike in gilt yields, built up their liquidity buffers. Bandera and Stevens (2024) show that the program addressed the dysfunction in the gilt market without spillover to monetary policy.

(2) In recognition of these costs, purchase programs, and any facilities that accompany them, will be targeted and temporary.

(3) The purpose of a program will be clearly communicated at the start, and the program will be monitored to determine whether it is having the intended effect.

(4) The exit strategy from a program will be planned and communicated from the start.

(5) Exit will be accomplished through a combination of allowing principal payments from the balance sheet's maturing assets to roll off and asset sales. The specific exit plan will be communicated in advance of its being initiated.

(6) The balance sheet will return in a timely way to a size in line with a target level of reserves relative to nominal GDP consistent with the ample-reserves operating framework. (The principle would state the target level, e.g., the current level of about 9 percent of nominal GDP.)

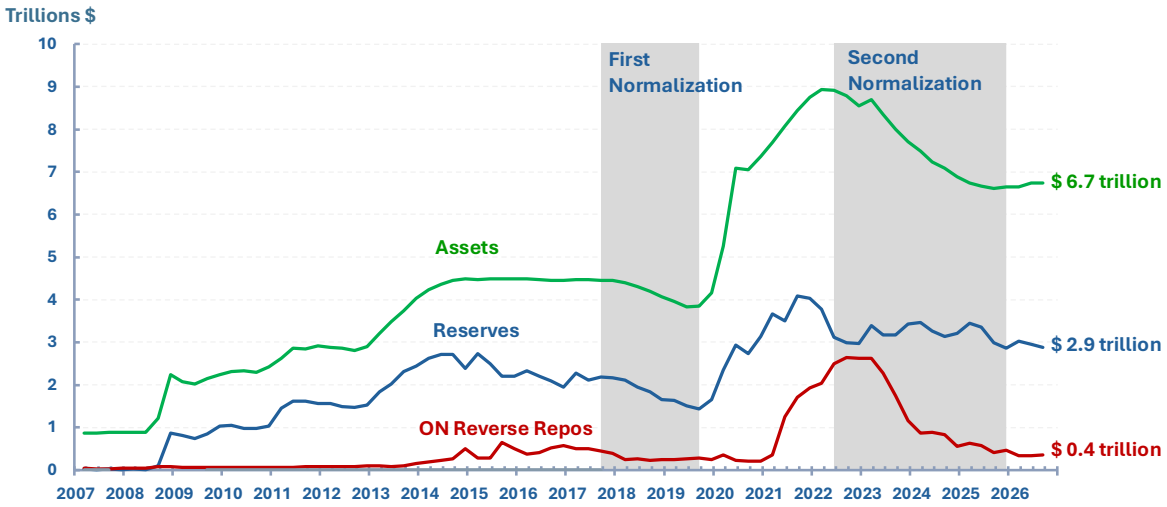
(7) The balance sheet's composition will return to being primarily Treasury securities within a reasonable time period. (This principle would also include the Committee's view on the desirable duration of the Fed's Treasury holdings, i.e., whether they should they reflect the maturity distribution of outstanding Treasury securities or skew shorter to limit the Fed's interest rate risk.)

Conclusion

The Fed's ample-reserves framework has delivered effective control of the policy rate. But it also has costs that are increasingly being recognized. These include banks' greater reliance on central bank liquidity, a less active interbank market, and political economy risks to the Fed's independence. The Fed has options for reducing the size of its balance sheet without giving up interest rate control or financial stability. These include adding a liquidity savings mechanism to the payments system, tiered remuneration of reserves, a demand-driven approach to supplying reserves, changes to discount window practices, and sales of MBS.

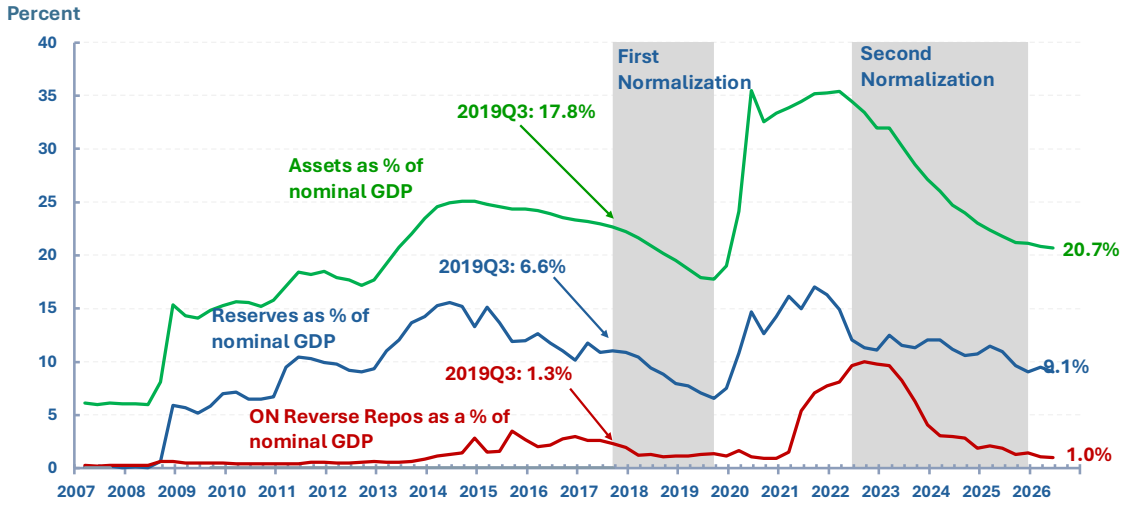
Once the balance sheet is smaller, it is important that the Fed adopt a principle-based framework for asset purchases that makes clear when and how they will be used and how they will be unwound in a timely way, so that the balance sheet does not again grow large and stay large.

Figure 1. The Fed's balance sheet assets grew with each round of asset purchases



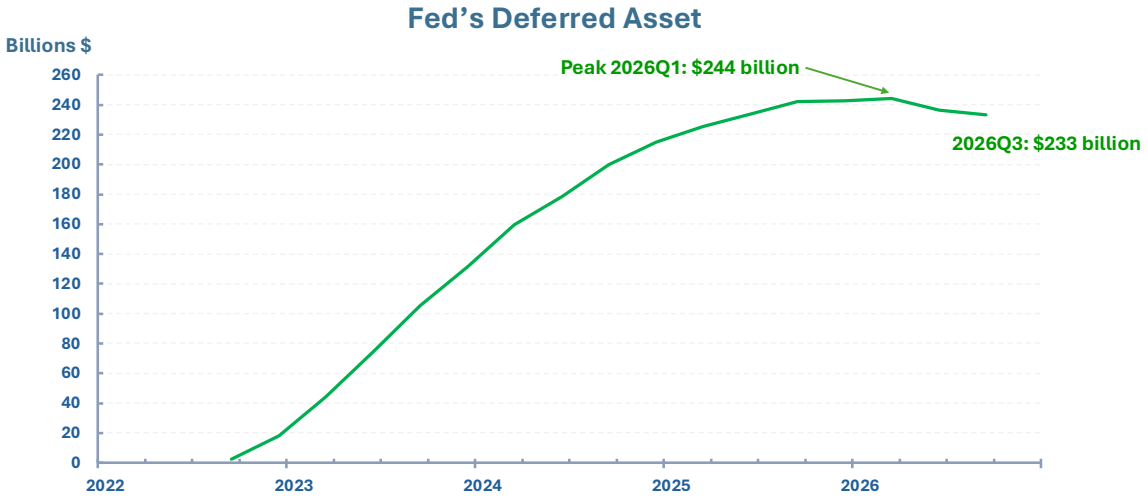
Source: Federal Reserve Board via Haver Analytics
Quarterly data: Last obs. 2026Q3

Figure 2. Reserves as a % of nominal GDP viewed as ample today are higher than in September 2019



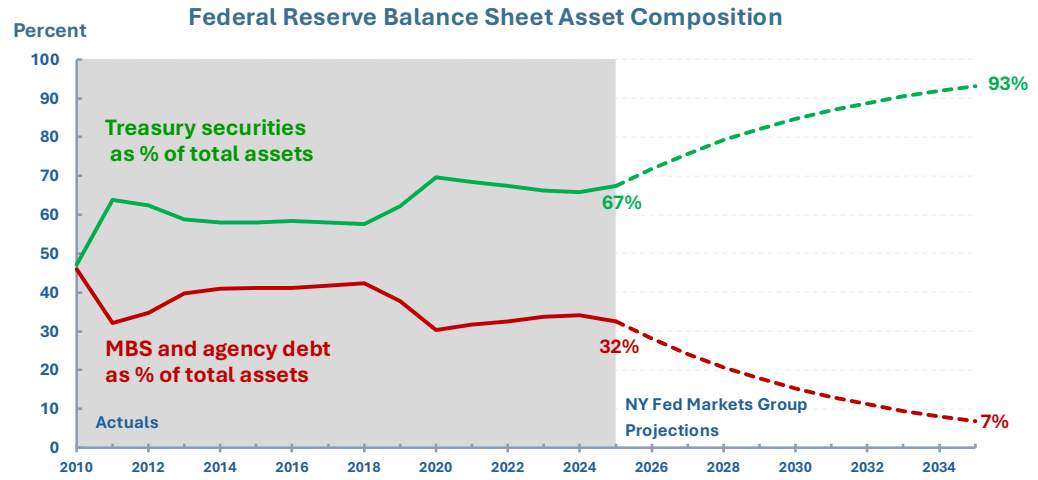
Source: Federal Reserve Board and Bureau of Economic Analysis via Haver Analytics
Quarterly data: Last obs. 2026Q2

Figure 3. Interest rate risk on the Fed's portfolio has led to cumulative losses, booked as a deferred asset



Source: Federal Reserve Board via Haver Analytics
Quarterly data: Last obs. 2026Q3

Figure 4. Selling MBS would speed the return of the Fed's portfolio to being primarily Treasury securities, a long-standing aim



Source: NY Fed Markets Group Open Market Operations 2025 Annual Report and author's calculations
Annual data: Last obs. of actual data: 2025; last obs. of projections: 2035

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