Shrinking the Fed's Balance Sheet and Then What?

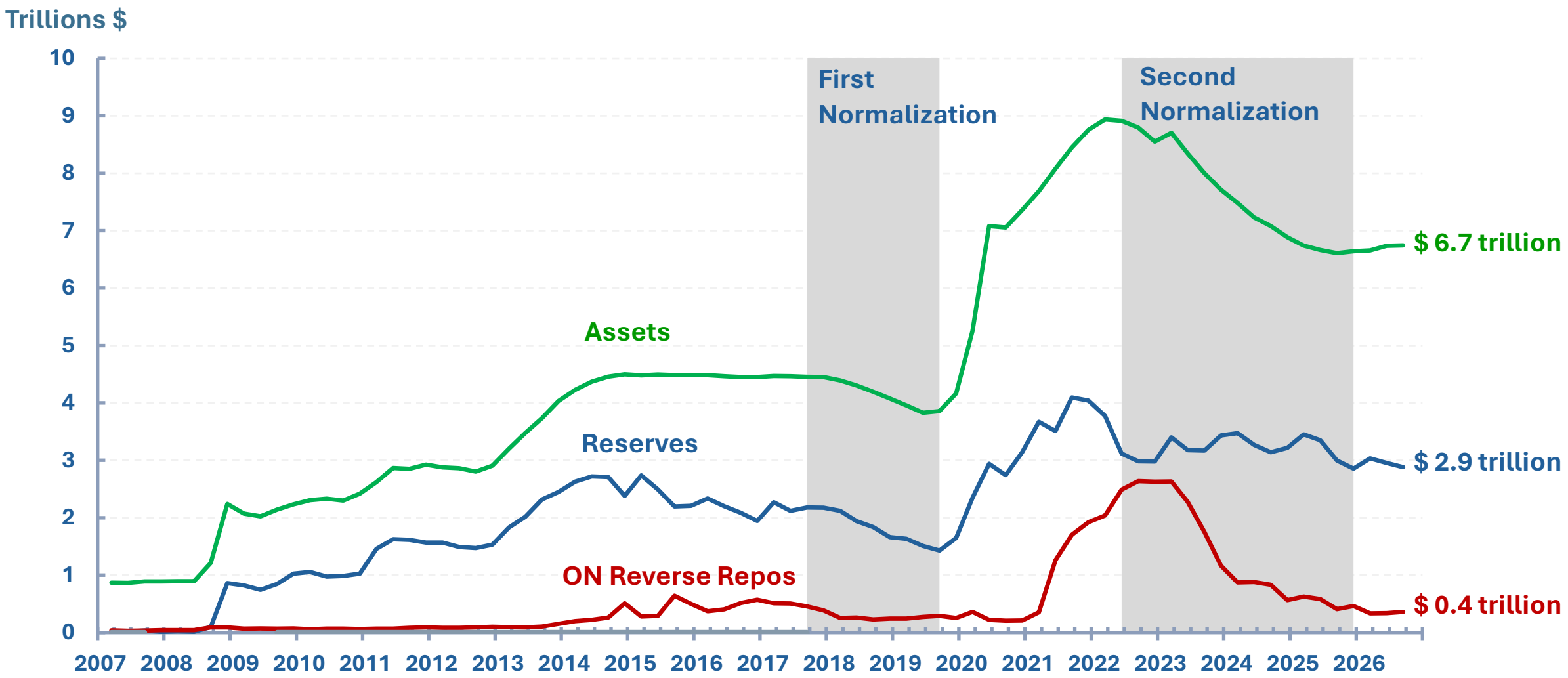
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Presentation for Session 4:
How to Prudently Reduce the Size of the Fed's Balance Sheet
Shadow Open Market Committee Fall Meeting:
The Fed's Next Chapter: Inflation, Financial Stability, and the Balance Sheet

New York, NY
October 30, 2026

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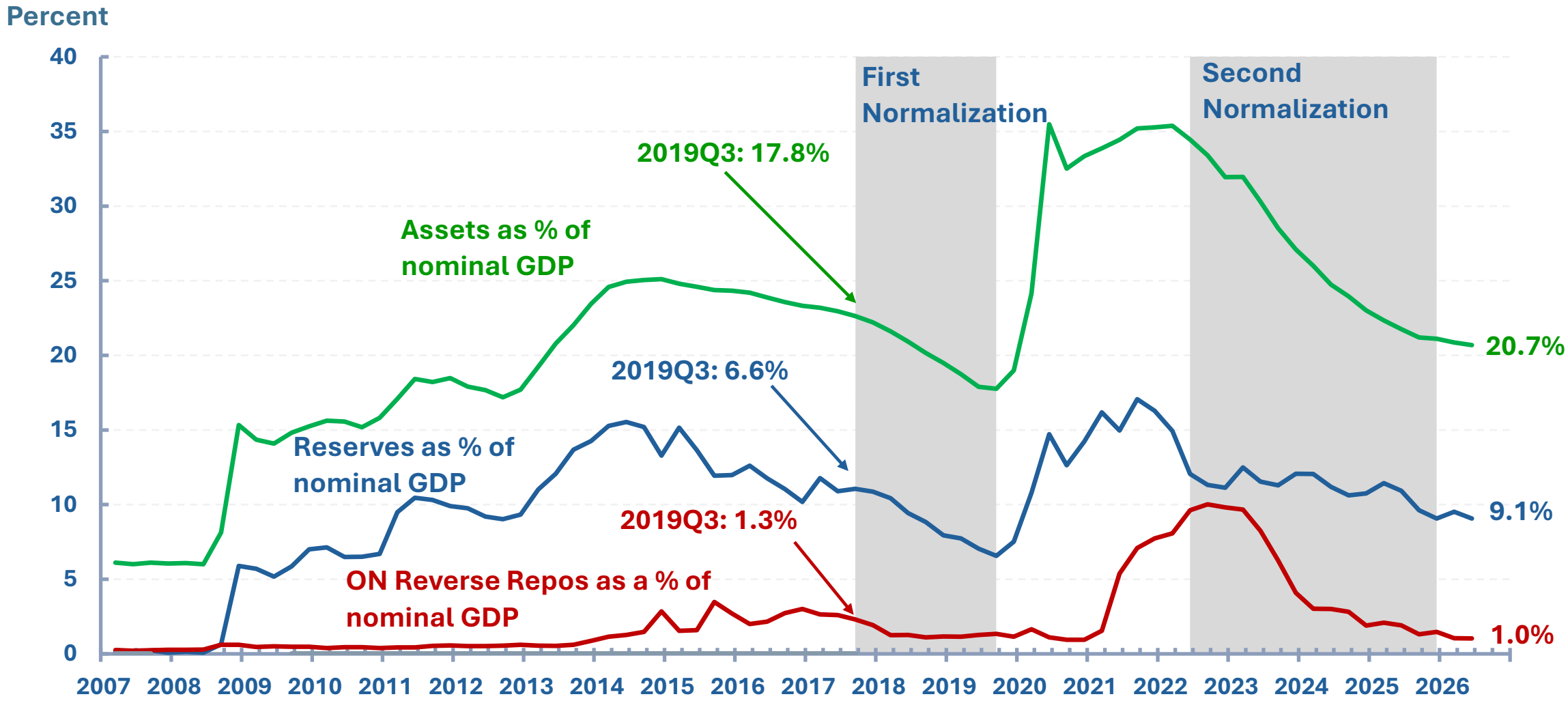
Figure 1. The Fed's balance sheet assets grew with each round of asset purchases



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

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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

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Figure 3. The level of ample reserves is endogenous

Reserve as a % of Nominal GDP

GFC Peak (2014Q2)	Sept 2019 Rate Spike (2019Q3)	Pandemic Peak (2021Q3)	Current (2026Q2)
15.5%	6.6%	17.1%	9.1%

- Level of ample reserves depends on Fed policies, banks' reactions to them, and market conditions
- This gives Fed an opportunity to influence the ample level by lowering banks' demand for reserves

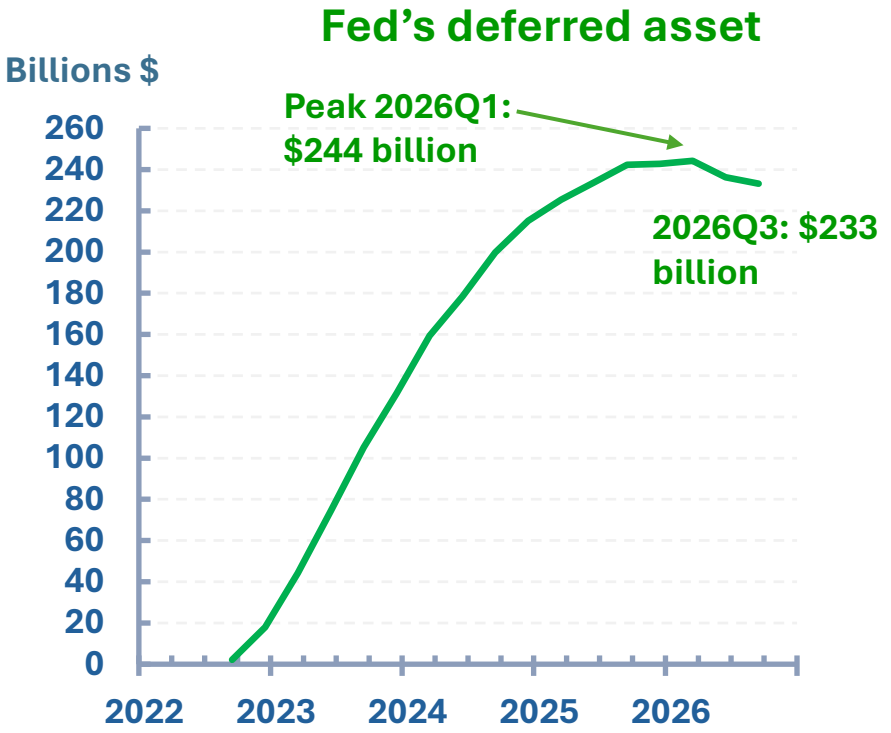
Source: Federal Reserve Board and Bureau of Economic Analysis via Haver Analytics
Quarterly data: Last obs. 2026Q2

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Figure 4. Ample reserve system has benefits but also hard-to-measure costs

- **Benefits**
  - Effective control of the policy rate
  - Somewhat simpler than scarce reserves system
  - Lower liquidity risk
- Christopher Waller (2025): ***"If governments could provide clean, safe drinking water for citizens at zero cost, why would they make it scarce?"***
- **Costs:** hard to quantify but increasingly recognized
  - **Banks rely more on the central bank** for liquidity in stress and less on their own liquidity management ("ratchet effect")
  - **Central bank's larger role in interbank markets:** banks are less active in overnight markets, so reserves may not circulate in stress situations
  - **Political economy risks:** no operational limit on balance sheet size invites fiscal use; Fed net income losses create reputational risk

Interest rate risk on Fed's balance sheet has led to cumulative losses



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

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Figure 5. Options for lowering banks' demand for reserves and reducing assets

- Add a **liquidity savings mechanism** to Fedwire
  - More netting of Fedwire payments lowers the reserves banks need to settle them
  - Would take several years to build, test, and implement
- Adjust **liquidity regulations** to lower banks' precautionary reserve holdings
  - Financial stability considerations limit how far this should go
- Make banks more willing to use the **discount window**
  - Operational readiness helps, but **stigma** persists and rises in stress conditions when we want banks to use the window
  - **Establish separate operating principles for stress and non-stress periods; e.g., different rules** for valuing collateral and setting margins in extended stress periods; Fed announces activation of stress period principles
    - Recognizes the trade-off between creating moral hazard and maintaining financial stability
- **Tiering** of remuneration of reserves
- **Demand-driven** supply of reserves
- **Selling MBS and agency debt** on the Fed's balance sheet

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Figure 6. Tiering of remuneration of reserves

- Used by Norges Bank (since 2011) and Swiss National Bank (since Sept 2022)
- Thresholds based on each bank's liquidity needs (size or payment flows)
- Bank earns IORB rate on reserves up to a threshold and a lower rate on reserves above it
  - Sum of thresholds set below the reserves supplied, so marginal reserve earns less and banks with surplus reserves lend them
- Benefits:
  - Smaller balance sheet
  - More active interbank market
  - Lower interest expense for the Fed
  - Answers critics in Congress who want to eliminate paying interest on reserves
- Issues:
  - Thresholds need periodic review: they will change with market conditions
    - Reserve Bank of New Zealand abandoned thresholds during the pandemic and opted not to bring them back afterward
  - Fed funds rate likely trades nearer the bottom of the range, with more day-to-day volatility
    - Fed should be willing to accept more volatility: it has shown it can raise rates with a large balance sheet and the standing repo facility (SRF) is a backstop

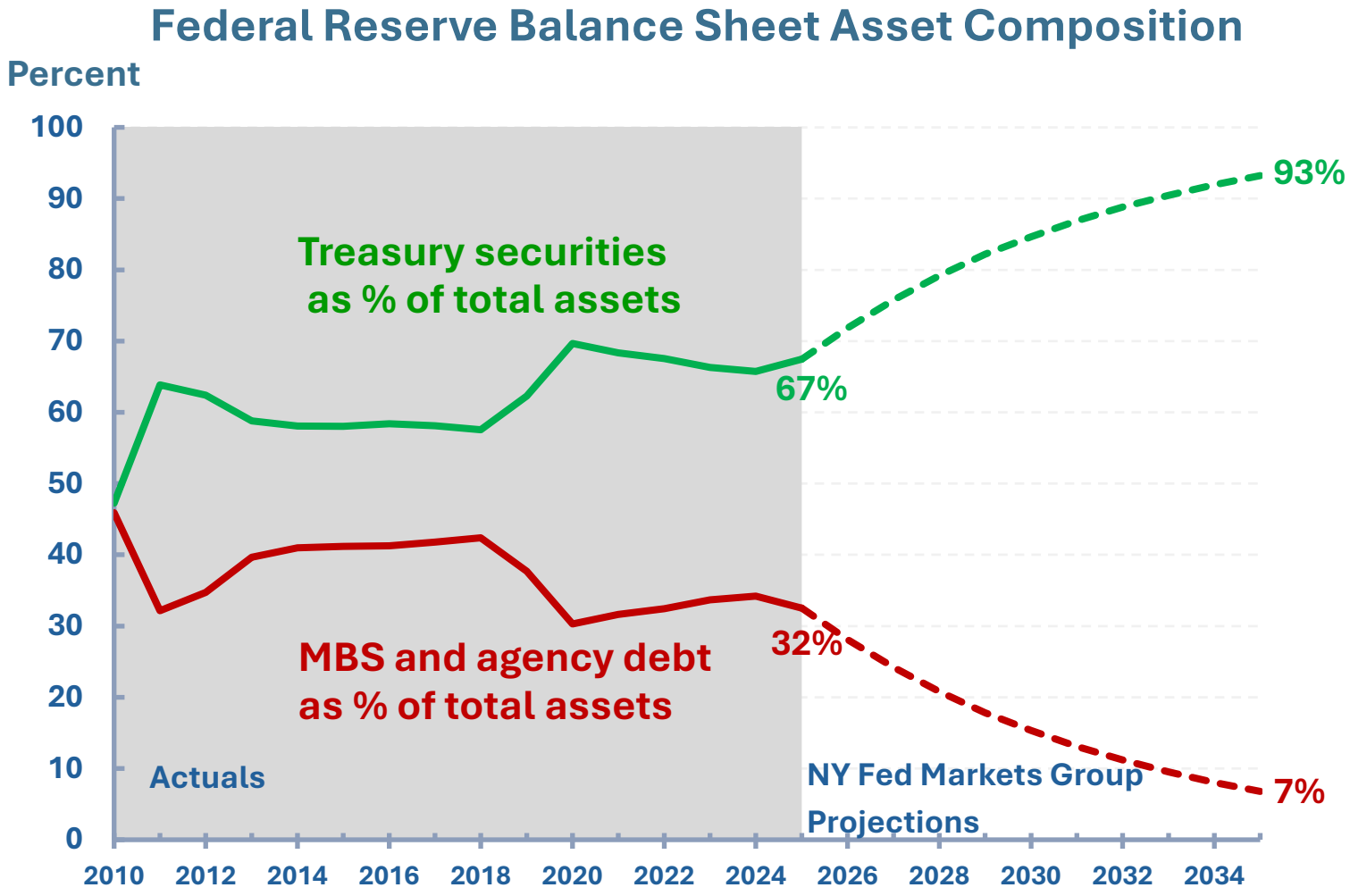
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Figure 7. ECB's demand-driven system: hybrid of a corridor and a floor system

- Adopted in **2024**
- Unlike scarce reserves: the ECB supplies **as many reserves as banks demand**, at full allotment against broad collateral
- Unlike ample reserves: the **marginal reserve is borrowed** in regular operations, not supplied by maintaining a large securities portfolio
  - Since September 2024: weekly and three-month operations at **15 basis points** above the deposit facility rate
- Average level of reserves can be **smaller** than under a floor system

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Figure 8. 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

Benefits of sales

- Shorter portfolio duration and less interest rate risk
- Lower expected future losses
- Faster return to primarily Treasuries, the Fed's stated aim since 2014

How to manage sales

- Pre-announced schedule, with a cap on combined prepayments and sales if deemed necessary
- US Treasury and Fed accord acknowledging that sales entail further losses and delay remittances, and agree the benefits of a smaller, shorter-duration Fed portfolio of Treasuries are worth it

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Figure 9. Establish a principle-based framework for large-scale asset purchase (LSAPs)

- Balance sheet grew large after successive rounds of LSAPs that were not fully unwound
  - Learning by doing
- FOMC should establish a principle-based framework to guide the use of balance sheet tools
  - Similar to the Reserve Bank of Australia's 2026 framework for additional monetary policy tools
  - More expansive than the FOMC's Statement on Longer-Run Goals and Monetary Policy Strategy
- Recognize **costs and benefits**, clarify **why**, **when**, and **how** purchase programs would be used, **exit strategies**, **effective communications**

Figure 10. Principles

(1) Asset purchases entail benefits and costs

- Benefits: add accommodation; address market dysfunction
- Costs: blur line between fiscal and monetary policy; reduce remittances to the Treasury, posing risks to the public sector balance sheet, the Fed's reputation, and its monetary policy independence; impair interbank markets and weaken banks' incentive to self-insure against liquidity risk.

(2) Targeted and temporary

(3) Clearly communicate purpose of a program at the start; monitor program to determine whether it is having the intended effect

(4) Exit strategy planned and communicated from the start

(5) Exit accomplished by allowing principal payments from maturing assets to roll off and asset sales. Particular plan of exit communicated in advance of execution

(6) Balance sheet will return in a timely way to size in line with reserves at a target size relative to nominal GDP, consistent with the ample-reserves operating framework. (Target size would be specified in the principle.)

(7) Balance sheet composition will return to being primarily Treasury securities within a reasonable time period. (Desirable duration of Treasury holdings would be specified in the principle)

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Figure 11. Summary

- The ample-reserves framework delivers effective rate control, but has **costs**
  - Reliance on central bank liquidity, a less active interbank market, and political economy/reputational risks
- The Fed can **lower banks' demand for reserves** without giving up rate control or financial stability
  - Tiered remuneration of reserves
  - A demand-driven supply of reserves
  - Discount window principles that differ in normal and stress times: balance moral hazard against financial stability
  - MBS sales
- The FOMC should willing to accept **some volatility** in short-term rates
- Once the balance sheet is smaller, it is important for the FOMC to manage it
  - FOMC should adopt a **principle-based framework for asset purchases** to guide their use so that the balance sheet can return to a normal size and composition in a timely way

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