US Rates Strategy

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New chair, new policy?

The new Fed Chair's views on QE and the size of the Fed's balance sheet have been well-telegraphed. But what can be changed?

- **The new Chair is critical of QE which has become part of the central bank's unhealthy fast-food fix**. As the Fed has only partially reversed its emergency actions, its balance sheet is several times larger than it was in 2006.

- **We think the new Chair might find FOMC support for modifying QE to better outline its intended objective and exit strategy**. But eliminating it as a policy instrument is impractical unless the Fed is willing to take rates below zero in a crisis.

- While there are valid criticisms about the consequences of a large balance sheet, **there may not be much the Chair can do to shrink its size in the near-term without creating distortions in funding markets and reducing Treasury market liquidity**.

- The behavior of market rates last fall suggests that the Fed's current $6.6trn balance sheet is consistent with bank demand for reserves. **If the Fed is more willing to accept higher funding rates, it *might* be able to reduce the size by an additional couple hundred billion dollars**.

- Higher funding rates could restore activity in the fed funds market. The Fed could retain the rate as its policy target. But a viable fed funds market is not a policy objective.

- The Fed might accelerate its shift to a Treasury-only portfolio by selling its MBS holdings. However, this would likely need to be done slowly and with some Treasury coordination.

- **Our sense is that the Fed will not be able to shrink its balance sheet. Instead, the new chair is likely to push to slow its growth by reducing banks' ever-increasing appetite for bank reserves.**

QE "happy meal"

The new Fed Chair's criticism of QE and the size of the Fed's balance sheet has been well-telegraphed in the years since he left the organization. Warsh argues that the Fed's asset purchases have become a "go to" policy standard since the financial crisis. In 2016, he argued that QE worked more by creating a wealth effect than by crowding out the supply of safe assets.[1] Since 2016, the consensus around QE's

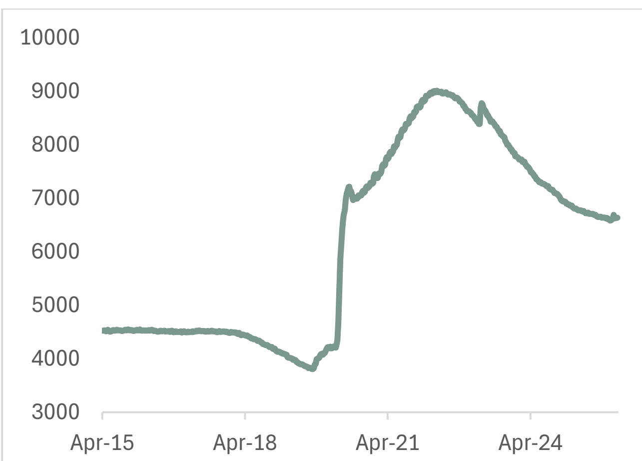
[1] See "Challenging the Groupthink of the Guild", K. Warsh, NABE Policy Conference, March 8, 2016.

macroeconomic effect has shifted from the portfolio balance channel to its role in forward guidance. This shift in purpose is another aspect of Warsh's policy criticism. Not only has this become *ex post* justification, but it reflects the "guild's" over-reliance on "central bank fast food" with its emphasis on data and near-term forecasts.[2]

QE has expanded from a program to buy a fixed amount of Treasuries and MBS to a open-ended program that includes purchasing ETFs and supporting loans to small businesses. Even if these emergency purchases were justified during COVID, the Fed was "duty bound to retrace its steps" once the emergency ended. That is, it should have returned to its pre-crisis balance sheet – in size and composition. Instead, the Fed only partially reversed its QE balance sheet expansion and its balance sheet is about $2.5trn larger than it was in 2019 (Figure 1).[3]

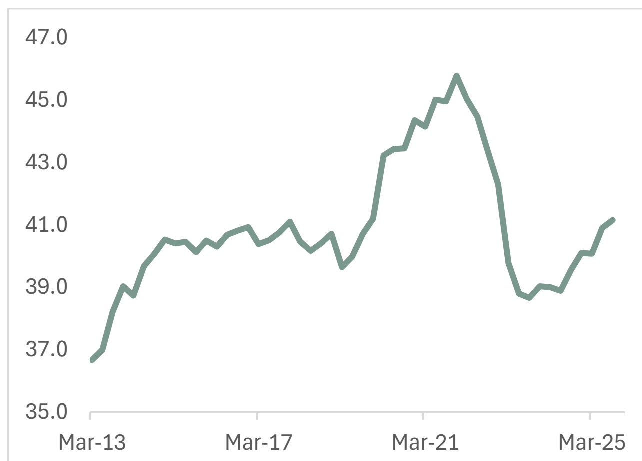
However, since March 2023, criticism of QE has increased. Open-ended purchases are not as costless as policymakers assumed in early 2020. QE swelled bank balance sheets and left them with flight-prone non-core, uninsured deposits (Figure 2). When the Fed began raising rates sharply to address inflation, banks suffered losses on their Treasury holdings and experienced deposit flight. Mostly, the criticism is with the implementation of QE. The Fed's purchases were originally intended to support Treasury market liquidity and to accommodate the demand for cash caused by the economy-wide shut down. But the Fed never clearly articulated a set of conditions for the end of these purchases. Instead, they simply morphed into open-ended forward guidance.

Figure 1: Federal Reserve assets ($bn)



Source: Federal Reserve, SMBC Nikko

Figure 2: Uninsured deposits (% dom. Deposits)



Source: FDIC, SMBC Nikko

We think the new Chair may find some support from FOMC members for *changing* QE but *eliminating* it as a policy instrument is impractical. There is probably broad support for establishing a "rules-based" approach to asset purchases with a clearly defined and transparent exit strategy set up in advance. However, once the Fed has lowered interest rates to the zero lower band, it must choose between restarting QE or adopting negative interest rates. Negative interest rates would be disruptive

[2] See, "Commanding Heights: Central Banks at a Crossroads", K. Warsh, IMF Lecture hosted by G30, April 25, 2025.

[3] As a share of GDP, it about the same size (18.5%).

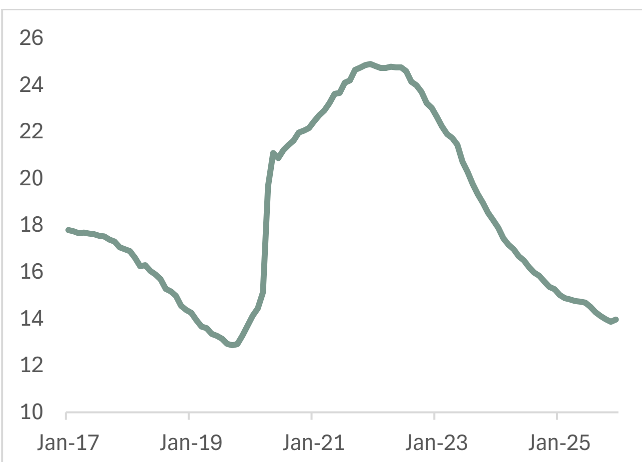
because regulations limit the ability of money funds to pass along sub-zero rates. Instead, the shift to floating NAVs might push $7trn in balances into bank deposits or other assets further disrupting markets.

Instead, the Fed might consider relying more heavily on temporary liquidity injections during a crisis. This would allow it to expand its balance sheet without permanently increasing the size. The bank term funding program (BTFP) was such a facility. Rather than permanently expanding the balance sheet through Treasury purchases in March 2023, the Fed lent cash against Treasury collateral at par for an attractive 1y term. Once the program expired, the Fed's balance sheet fell by the same amount.

Shrinking the balance sheet

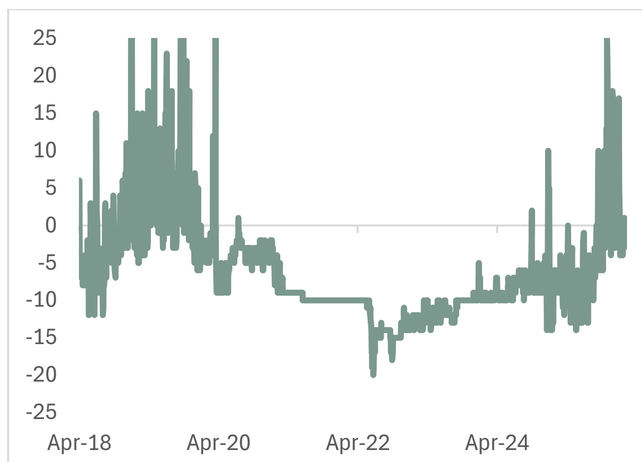
Chair Warsh argues that the Fed's large balance sheet distorts market prices and continues to suppress long-term interest rates once the emergency has passed. This encourages expansionary policy as the Fed is assumed to continuously roll over its maturing debt. The Fed holds 14% of outstanding Treasury debt down from a peak of 25% in early 2022 before QT began (Figure 3). As the Fed's market footprint has grown over time, the resulting market distortion may have encouraged more risk taking as the sense is that the Fed will step in to provide liquidity as it did after repo rates spiked in September 2019.

Figure 3: Fed Treasuries (% debt outstanding)



Source: Federal Reserve, US Treasury, SMBC Nikko

Figure 4: Tri-party less IORB (bp)



Note: The y-axis is capped at 25bp for clarity. Source: Federal Reserve, SMBC Nikko

While these may be valid criticisms, as a practical matter there may not be much the new Chair can do about the *size* of the balance sheet. Indeed, it is unlikely that the new Chair will be able to shrink the balance sheet – either by selling assets or relaunching QT – without significant market disruption or regulatory changes.

The size of the balance sheet is determined by the demand for currency, bank reserves, and the Treasury's precautionary liquidity buffer. Indeed, even if the Fed decided to return to its pre-crisis operating regime with some degree of reserve scarcity, our sense is that its balance sheet might only be a *couple hundred billion dollars smaller* than it is now.

Ultimately, the *growth* of the balance sheet may depend on how much persistent pressure in overnight interest rates the Fed is willing to accept. **We think this is bounded by its unwillingness for liquidity**

demand to distort the rate policy signal. As a result, it might tolerate overnight repo rates trading at the top of the fed funds target band – that is, 10bp above IORB. But it might not want these rates trading 25bp above the top of the target band.

Permanent reserve scarcity would change the nature of trading in the fed funds market. Currently, trading reflects the fact that the FHLBs cannot earn IORB and non-US banks arb the difference between the (lower) fed funds rate and IORB. If rates are above IORB, then all banks would be borrowers rather than arb'ers. The domestic bank share of the market would increase as banks tapped the market to top up their reserves. Trading volumes would increase and the Fed *might* be able to sustain its fed funds policy target. But restoring activity in the fed funds market is not a policy goal. **Moreover, permanently higher repo rates would increase financing costs to trade Treasuries**. We think this would reduce their liquidity as intermediaries faced higher costs to make markets and hold inventories.

Of course, the Fed could counter some of this pressure by accepting a larger role in overnight markets and regularly injecting additional liquidity through open market operations or programs like the SRP. But as a practical matter, temporarily expanding the balance sheet through SRPs *everyday* is little different than permanently increasing them through bill purchases.

Alternatively, it could simply lower the target rate to accommodate the wider financing spreads from a smaller balance sheet. However, this raises an important distinction – does the economy need lower interest rates if the source of the pressure is non-macroeconomic and could be removed by a larger balance sheet or changes to bank regulation that reduce the demand for reserves? Moreover, depending on how much rate pressure the Fed was willing to tolerate, its target rate would normally be closer to the zero lower bound making it more likely that in a future recession it would have to choose between QE and negative interest rates.

The Fed is currently letting its $2trn in MBS holdings roll off passively. But, in theory, it could decide to accelerate its return to a Treasury-only balance sheet by selling these assets off. The Fed needs to tread carefully to avoid pushing mortgage rates higher as we expect the FHFA will instruct the GSEs to increase their MBS holdings. That said, it might be possible slowly sell off its MBS and simultaneously replace these holdings with Treasuries. Something along these lines might be what Warsh has in mind for a new Treasury/Federal Reserve accord.

Our sense is that the Fed will not be able to shrink its balance sheet – either by selling off assets or resuming QT. **But it may be able to slow its growth by reducing banks' ever-increasing appetite for bank reserves.** Liquidity regulations created since the financial crisis such the LCR, NSFR, and banks' internal liquidity stress tests have made banks safer by expanding their capacity to survive a deposit run. We doubt the Fed would want to return to a pre-Basel III world with thinner bank liquidity buffers. **Instead, to slow balance sheet expansion, the Fed would need to encourage banks to hold more Treasuries in their liquidity buffers.** However, banks prefer reserves because these are always available while their Treasury holdings need to be monetized in a crisis. Monetizing their holdings can be done through repo – with the private sector or through the SRP and discount window. However, banks are reluctant to use either facility.

The Fed has considered several strategies to make borrowing from its programs a normal part of banks' regular liquidity operations. **But these have done little to reduce bank reserve demand**. Indeed, in 2019, interest pressure emerged when bank reserves fell below 10% of bank assets, but last fall, rate pressure emerged when balances fell below 12%, prompting the Fed to restart reserve management purchases (RMPs) in December. Removing the disclosure requirements on liquidity programs like the discount window and SRP *might* increase the willingness of banks to use them more regularly. But this would require an act of Congress. Separately, the Fed could apply moral suasion from its bank supervisors to push banks to shift the composition of their HQLA and to slow the growth of reserve demand.

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