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Chairman Kevin Warsh will face resistance to reform from colleagues eager to protect their turf.

Why the Fed's Balance Sheet Needs to Shrink

By David Malpass

Each part of the federal government tries to grow bigger and more influential at the nation's expense. The Federal Reserve is no different. Mission creep adds power and payroll. The Fed also has unlimited spending power and a false mystique of success. The result is a multibillion-dollar building renovation, hundreds of big-government economists on the payroll, and a \$6.8 trillion balance sheet, one-third larger than second-place JPMorgan.

In recent remarks, Fed Gov. Michael Barr defended the central bank's size, arguing that a bigger Fed makes banks more resilient, helps money markets function, and improves the stability of the financial system. In reality, the Fed's massive balance sheet does the opposite. It puts a government agency in the driver seat on bond, repo and interbank markets, blocking innovation.

The Fed has lost hundreds of billions on bad bond bets while becoming entwined in fiscal policy, destroying the interbank market, condoning the debasement of the dollar, and slowing progress on stablecoins and digital payment systems.

Chairman Kevin Warsh has correctly advocated regime change, including shrinking the Fed's balance sheet to allow price signals to work and competitive markets to form. Treasury Secretary Scott Bessent has highlighted the central bank's harm to affordability and income inequality. By spending trillions of dollars in the 2010s and during the Biden administration, the Fed channeled capital to long-duration bonds at the expense of small businesses and working capital.

Additions to the Fed's powers during the 2008 financial crisis allowed it to buy bonds and pay interest to banks without limit, injecting it deeply into fiscal policy and the explosion of national debt. Its antiquated economic models have allowed wide swings in inflation and deflation while poor regulatory policy contributed to bank failures such as Silicon Valley Bank.

The pre-Warsh Fed's stated policy was to expand, not shrink, the balance sheet. As banks grow, the Fed claims it should borrow more from banks to make sure it holds "ample reserves"—trillions in interest-bearing loans from banks that the Fed keeps on deposit to avert market volatility.

The ample-reserve policy puts the Fed establishment in direct opposition to the sweeping reforms President Trump has sponsored. The Fed establishment claims that bigger is better. The opposite is the case.

Shrinking the balance sheet would lay the groundwork for lower interest rates. Banks would be able to innovate to meet liquidity requirements, whereas the current ample-reserves system locks them into dependency on the Fed and its bond portfolio. Banks have multiple options and would invent more if the Fed stopped dominating.

Extricating the Fed from fiscal policy would allow it to focus on price stability rather than the confusing promise of ample reserves. Changing direction on the balance sheet would build market confidence in the longterm value of the dollar, the critical path to price stability and lower bond yields.

By maintaining a monopoly over intraday bank liquidity, the Fed impedes growth and innovation in private-sector markets. The interbank market is gone and repo markets are stunted. Now the Fed is struggling with blockchains that allow immediate settlement and avoid slow-moving Fed systems. The rise of dollar stablecoins promises massive benefits but faces a Fed that wants to protect its turf along with competition from China's fast-moving digital payment systems.

To get to a smaller Fed that allows markets to innovate, Mr. Warsh will have to overcome entrenched anti-reformers. He has substantial credibility but faces vocal opposition in the 19-member Federal Open Market Committee, the inertia-filled governing body that is likely to oppose market innovation and deny the negatives from the Fed's massive balance sheet. Well-funded Fed partners in academia, media and Wall Street are advocating that reforms should be limited to reducing the emphasis on forward guidance.

That would fail Mr. Trump's call for deep reform and delay his administration's progress on rebuilding manufacturing jobs and supply chains. The Fed's balance-sheet expansion is particularly harmful during the current supply shock because rapid innovation in the supply chain requires working capital loans to buy equipment, hold inventory and hire new employees. Fed policy uses excessive bank loans to buy U.S. Treasuries, crowding out small businesses. *Note*

There is no way to erase completely the damage to affordability from the previous administration's inflationary and regulatory onslaught, but a Fed commitment to shrink the balance sheet would be pro-growth, pro-dollar and bondfriendly, helping on wage gains.

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