

Not on the Powell-Trump dust-ups, but on the bigger economic news lurking on the bank's balance sheet.



POLITICAL ECONOMICS

The Federal Reserve Owes America an Explanation

The main news from last week's Federal Open Market Committee meeting was the escalating war of words between Federal Reserve Chairman Jerome Powell and President Trump. But while the two of them spar about blame for inflation past and future, economic growth and interest rates, pause to consider the bigger economic news lurking in the central bank's post-meeting statement: the slow, strange death of quantitative tightening. *

While holding its short-term policy interest rate steady at 4.25% to 4.5%, the FOMC announced it is slowing the pace at which bonds roll off its balance sheet. Henceforth the Fed will reduce its holdings of Treasury bonds by only \$5 billion a month; it will continue to reduce its portfolio of mortgage-backed securities by up to \$35 billion a month. This is a more languid pace than the previous Treasury runoff, which the central bank had capped at \$25 billion a month. And that pace itself, set last year, had marked a slowing of the pace from \$60 billion a month in the first phase of quantitative tightening in 2022. *

To hear Mr. Powell tell it, this is merely a technical adjustment—a matter of financial plumbing rather than monetary-policy setting. This explanation has the virtue of being partly true, although it's debatable how "partly."

When the Fed expanded its balance sheet by buying bonds in successive rounds of quantitative easing across more than a decade, new liabilities necessarily arose on its balance sheet to equal the assets it accumulated. The biggest of these liabilities was the dramatically increased quantity of reserves that commercial banks deposit at the central bank.

This phenomenon has transformed America's financial system. Whereas banks once met their needs for overnight financing via active interbank markets, they now rely on reserve deposits to satisfy regulatory requirements and managerial preferences for liquid stockpiles. The shift was driven by regulatory changes after the 2008 financial panic, and especially by the Fed's decision to start paying interest on these reserve deposits—turning them into a source of income for banks. How this change affects banks, the economy and the Fed remains an open research question among academics. Note

One thing the Fed does know about this situation, however, is that the quantity of reserves that banks choose to hold at any given moment is surprisingly hard to predict. Fed economists over the years have revised steadily upward their estimates of how much money commercial banks might want to hold in reserve deposits under the new "ample reserves" system. The Fed already has gotten this wrong once: In autumn 2019, following a couple years of quantitative tightening, banks' reserve balances suddenly dipped below what turned out to be the magic level. Overnight borrowing rates spiked, a big embarrassment for a central bank that hadn't seen the fiasco coming.

Mr. Powell says the Fed is slowing quantitative tightening now in order to avoid a repeat of the 2019 kerfuffle. He noted in his press conference after last week's FOMC meeting that blips in overnight lending rates suggested to policymakers that they should ease up on the pace at which they shrink the balance sheet.

Fair enough. But how can the Fed claim this has nothing to do with its broader monetary policy, which ostensibly is oriented toward curbing inflation still persistently above the

2% target? Officials billed the expansion of the central bank's balance sheet as a form of easing. It's called quantitative *easing*, after all. Now they seem to want to argue that the pace at which they shrink the balance sheet is mostly irrelevant to how

quickly they rein in inflation. This while the Fed's total assets hover around \$6.8 trillion, off the post-pandemic peak of nearly \$9 trillion but still far above the prepandemic level of around \$4.5 trillion (which we used to think was a historic high).

Mr. Powell and his colleagues owe the public some explanation about what they think they're doing here. I mean that literally, not glibly: What is their understanding of how the size of the Fed's balance sheet affects the financial system, and the economy? Under what circumstances might the "ample reserves" system that requires a much larger Fed balance sheet come into conflict with the inflation-control half of the Fed's mandate from Congress? And what will or should the Fed do if there is such a conflict of policy tools and aims?

The Fed instead keeps mum. FOMC participants aren't asked to include their views on the appropriate size of the balance sheet in the quarterly economic projections they prepare (the so-called dot plots), focusing solely on the short-term interest rate. More egregiously, thorny questions about the balance sheet, quantitative easing and quantitative tightening appear to be entirely off the table in the regularly scheduled "strategic review" the Fed is conducting this year.

This may not matter if Fed officials are correct that inflation will continue its gradual deceleration toward 2% and no one will notice all this confusion about quantitative tightening. But if they're wrong about that, don't assume the Fed can hide from its big balance-sheet question forever.

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