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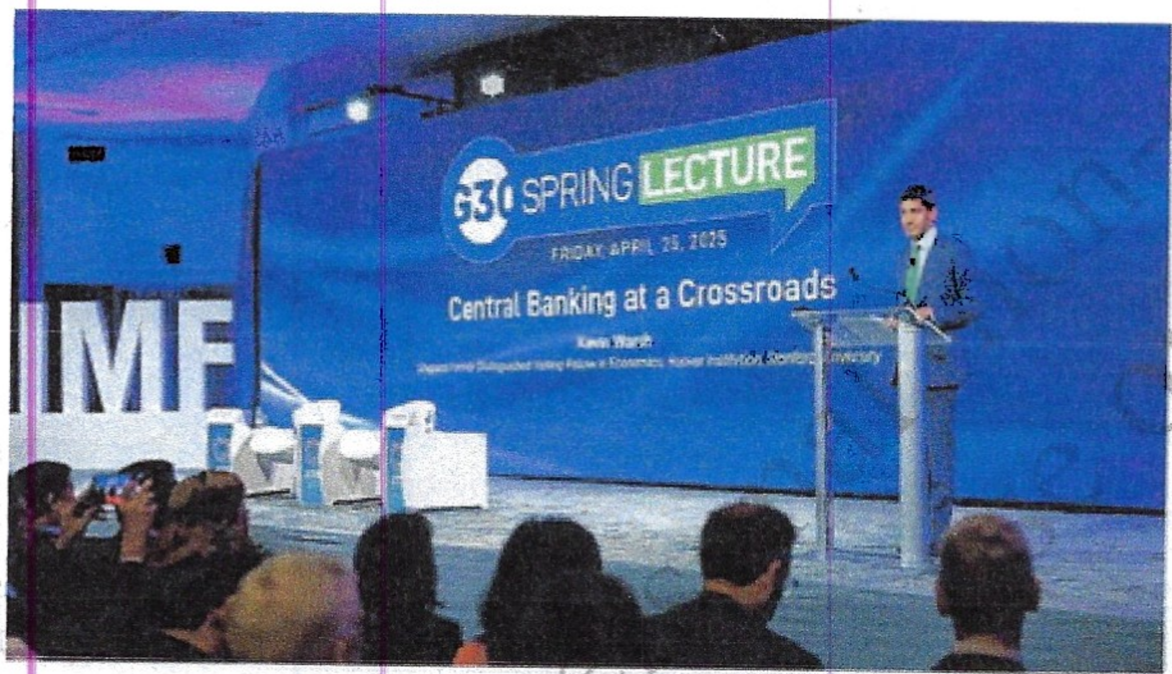

Kevin Warsh, President Trump's nominee to lead the Fed, spoke at IMF headquarters in Washington last spring.
TIERNEY L. CROSS/ BLOOMBERG NEWS

Shrinking Fed Is Easier Said Than Done

Nominee Warsh's vision of 'regime change' at the central bank could mean tighter times for markets

Is Wall Street ready to have the proverbial punch bowl taken away?

Note

Wall Street and the Federal Reserve have a long history together. To fight the 2008 global financial crisis, the Fed began buying mortgage bonds and Treasurys to help lower long-term borrowing costs and further stabilize the economy. It returned to this strategy during the Covid-19 pandemic and Wall Street boomed in 2021. Today, the Fed's balance sheet stands at over $6.5 trillion. Its liabilities include about $3 trillion in the form of reserves— essentially banks' deposits at the Fed.

Note

President Trump's new choice as his nominee to lead the Fed, Kevin Warsh, was a Fed governor during the 2008 crisis. He said in a recent Hoover Institution interview that he supported the initial round of what came to be known as quantitative easing. But he warned in 2010 that continuing to expand the Fed's balance sheet was "not a free option" and came with "significant risks."

Today, that view remains a key part of his case for lower interest rates. He has written that the Fed balance sheet is "bloated" and that its expansion has been one of the main drivers of inflation. Shrinking it, he argues, could allow for lower rates. — ? Note ?

"If we would run the printing press a little quieter, we could then have lower interest rates," he said last year in the Hoover Institution interview. "Because what we're doing right now is, we have all this money that's being flooded into the system, which causes inflation to be above target."

Already the Fed has been shrinking its balance sheet, which is down from its peak size of nearly $9 trillion in 2022. But there are also far broader changes that could be considered.

Note

The Fed's present "ample reserves" regime has fundamentally changed monetary policy and banking. Since 2008, the Fed has used the interest it pays to banks on their reserves to raise or lower the so-called floor of interest rates, a shift from other tools that it used earlier to influence market rates.

Banks and markets have also grown accustomed to operating in this era of plentiful liquidity. Some economists linked the growth in banks' uninsured deposits in recent years to quantitative easing. Banks rely on the interest income generated by their reserves.

Note

Financial markets can operate with fewer reserves, and have in the past. Banks could source more liquidity from each other, or the market.

"Money on Wall Street is too easy, and credit on Main Street is too tight," Warsh recently wrote. The Fed's "largesse can be redeployed in the form of lower interest rates to support households and small and medium-size businesses."

But thus far, when the Fed has sought to allow its balance sheet to shrink, often called quantitative tightening, at some point this has caused disruptions to markets. In 2019, after a period of balancesheet shrinking, a brief spike in so-called repo funding rates spooked bankers and investors. The shrinking was resumed post-Covid. But Fed officials cited risks to money markets late last year when they moved to again halt the shrinking process.

Note

"Wanting a smaller Federal Re--serve balance sheet is very different from practically achieving one," SMBC Nikko U.S. interestrate strategists wrote in a note on Friday. They noted that when the demand for bank reserves is greater than what the Fed is supplying, it can become more expensive for investors to finance things such as purchases of Treasurys, an unwelcome ripple.

Many bankers and investors would welcome a lighter role for the Fed in the economy and markets. But getting there could have sticking points. Bankers, for example, may oppose some officials' view that the Fed should stop paying interest on reserves. The Fed could encourage banks to more regularly borrow from the central bank when they need cash, but such borrowing can carry a stigma with some bank investors. That might need to change.

Similarly, regulators at the Fed could loosen or modify banks' liquidity requirements. But banks themselves might choose to remain very highly liquid for their own internal risk management, as it is something monitored closely by some customers, investors and banks' own lenders.

So the finer details of any plan to reshape the Fed will matter hugely to how it might affect markets. Some investors are already nervous, based on the reaction to the nomination news on Friday, when stocks fell, despite the potential for lower interest rates.

"Warsh has been seen as bearish for stocks, given his hawkish view on the balance sheet," Wells Fargo equity strategists wrote in a note on Friday.

Getting unhooked from the era of easy money could bring some headaches along the way.

—Telis Demos