

That's one of several big implications of a dry 'implementation note' on its Treasury purchases.



POLITICAL ECONOMICS

The Fed Quietly Announces It's No Longer Steering the Ship

As President Trump's beauty pageant to select a new Federal Reserve chief grinds on, spare a thought for the booby prize Jerome Powell has left for his successor. Last week's Federal Open Market Committee meeting dragged the central bank back into quantitative easing.

Most attention after the meeting focused on Mr. Powell's interest-rate cut, the sixth since September 2024, totaling 1.75 percentage points. But the Fed also announced (via a dry "implementation note") that it will buy roughly \$40 billion in shortterm Treasury bills over the next month, and an indeterminate (but probably similar) monthly amount until at least April. There's reason to believe that if the Fed has started expanding its balance sheet again, it will continue indefinitely.

The Fed thinks it is merely finetuning a financial system it rewired after the 2008 financial panic. The core issue is the liability side of the central bank's balance sheet, and how that changed as a result of the quantitative-easing bond purchases that expanded the asset side of the ledger.

The Fed starting after the 2007-08 crisis increased its asset holdings by acquiring large quantities of Treasury debt and mortgage-backed securities. These had to be offset by liabilities on the central bank's balance sheet, and the easiest liability to increase was the accounts of reserve funds that commercial banks deposit at the Fed. The central bank created new money with which to buy bonds and that money flowed into reserve accounts as compensation for the bonds the Fed had bought from banks and their customers.

This practice built a new monetary circuit between the Fed and banks. Commercial banks previously had satisfied their need for liquid reserve assets in a variety of ways, including trading among themselves in an overnight-reserves lending market. Following the introduction of quantitative easing, the Fed expected banks to meet their emergency-liquidity needs by holding larger reserve balances at the central bank.

That "expected" is deliberately ambiguous. The Fed predicted banks might prefer the greater safety of reserve balances as a way to satisfy stricter capital-adequacy regulations. But officials also put greater pressure on banks to maintain larger reserve balances, via regulation and the reward of interest payments on reserve balances.

This new "ample-reserves regime" has far-reaching, sometimes hard-to-measure consequences. Because of the way post-2008 financial regulations account for reserves in calculating financial risk, high reserve balances can (counterintuitively) gum up lending to Main Street and discourage banks from trading Treasuries. Now another risk is coming into view: The Fed losing control of its own balance sheet.

This problem has emerged as the central bank has embarked on successive attempts at quantitative tightening—shrinking its balance sheet by allowing bonds to run off the asset side of the ledger.

Reductions in Fed asset holdings require its liabilities to shrink as well, and this carries the danger that commercial-bank reserve deposits may at some point fall below the level banks think they need. No one is quite sure where that line is. But if reserve deposits fall below it, interest rates could go haywire in the market for overnight lending where banks borrow from each other if they need more reserves—shooting far past the target the Fed sets for this, the federal-funds rate.

This happened in autumn 2019, and officials now seem to be worried by recent similar signs of unrest in that interbank market. Hence their move last week to expand their asset holdings—purchases of Treasuries—to avoid a risk that the reserve-balance liability might fall too low.

The Fed presents all the foregoing as a technocratic matter of little larger importance. But the central bank's resistance to calling it "quantitative easing" doesn't change the economics of it. The Fed finds itself relaunching a form of QE when it claims it's still in inflation-fighting mode—with all the potential implications for interest rates and inflation that asset purchases bring. This also is an example of how, under an ample-reserves system, the central bank's balance sheet must remain large relative to the economy. Apparently today's level of around 20% is the new minimum.

Worse, it's hard to shake the suspicion the Fed is losing control of its balance sheet policy. For most of the post-2008 period, officials decided what quantity of assets they wanted to hold and then prodded the liability side of the ledger to keep up. Now the central bank is allowing its creditors to steer the ship. Commercial banks can goad the Fed into buying Treasuries by increasing their demand for reserves. How else to interpret quantitative easing prompted by the Fed's fear of interbank-lending volatility?

Alternatives to the ample-reserves system exist, and will be a topic for another day. Among the candidates for Fed chairman, Kevin Warsh seems keenest to abandon the current regime. Doing so would be a good project for whomever Mr. Trump picks.

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