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Kevin Warsh wants to reduce the balance sheet. Congress could help by creating a resolution fund.

How to Ease the Fed off Quantitative Easing

By Matt Seikerke And Steve H. Hanke

Kevin Warsh thinks the expansion of the Federal Reserve's balance sheet from \$900 billion in 2008 to almost \$9 trillion in 2022 was a mistake. Mr. Warsh, President Trump's nominee for Fed chairman, wants to take a knife to the central bank's \$6.7 trillion balance. He thinks three-plus years of quantitative tightening hasn't gone far enough.

Shrinking the Fed's balance sheet requires a sober look at the unrealized losses looming in the Fed's portfolio and the potential market impact from unwinding that portfolio. Provided these are acknowledged and budgeted for, a dedicated institution can manage the wind-down, allowing the Fed to operate a more conventional monetary policy. Here's some history to clarify what is at stake.

The Fed's balance sheet grew to an unprecedented size through three waves of quantitative easing that started after the financial crisis of 2008. The Fed began to purchase Treasury bonds and agency mortgage-backed securities aggressively. It also began to pay interest on reserves and used reverse repurchase, or repo, transactions to keep interest rates on target.

Quantitative easing drove the 10-year Treasury rate lower by more than 90 basis points. Buying agency mortgage-backed securities reduced their yields by more than a percentage point, indirectly contributing to lower mortgage rates. With safe investments yielding very little, the equity risk premium—the amount investors demand to compensate for the additional risk of stocks—also came down.

During the Covid pandemic, the Fed prescribed more of the same, doubling the size of its balance sheet and sending the 10-year rate, mortgage rates and the equity risk premium to historic lows.

Quantitative easing has pumped up asset markets from the beginning. Treasuries extended their bull run as interest rates fell further. Home prices went from unaffordable to ludicrous. Equity valuations show investors paying higher multiples for the same earnings, as well as placing healthy valuations on companies that are years from any earnings at all. The effects have been so strong that the Fed, in a heroic feat of ex post facto rationalization, has begun to think of asset prices as another transmission mechanism for its balance-sheet policy instrument.

Easing also transformed the liquidity of the monetary system as the Fed's asset purchases flooded the banking system with reserve money. Banks are now so inundated with reserves that they barely borrow from each other in the interbank market.

Unwinding quantitative easing would reverse the Fed's impact on asset and interbank markets, restoring the determination of interbank rates, long-term interest rates, mortgage spreads and equity prices to market forces. While the Fed embraces these goals for the most part, it has moved slowly, letting its asset portfolio run down naturally. At this pace, quantitative tightening will take a decade or so.

The Fed's reluctance to move quickly stems from its unwillingness to burst asset-price bubbles, even those of its own making. It also fears crystallizing financial losses on its portfolio by selling bonds, preferring to realize losses slowly by paying more interest on reserves than it earns on bonds. Whether fast or slow, such losses eat away at the Fed's capital and are ultimately charged to the government.

Congress can accelerate the process of unwinding quantitative easing by establishing a "QE resolution fund," capitalized and chartered as an independent agency. Its purpose would be to acquire and liquidate the Fed's portfolio as rapidly as market conditions allow. Choosing the right level of initial capital for the fund would be important because it

would set a bound for realizing losses on the Fed's portfolio, and the charter would set a time limit for liquidation. Allowance should also be made for potential operating losses. The resolution fund would auction short-term notes in exchange for reserve money and tender reserves with the Fed to purchase Treasuries and agency mortgagebacked securities at cost. The notes would pay interest at the interbank rate. This would make banks indifferent between holding notes and reserves. The size of the Fed's balance- sheet reduction and the runoff rate of the resolution fund would be controlled by banks' willingness to swap reserves for notes. Accordingly, the banking system itself would determine how much of aggregate reserves are "excess reserves," tightening the interbank market and allowing a market-clearing interbank interest rate to emerge that is consistent with the demand for reserves.

With market-determined interbank rates, the Fed could stop paying interest on reserves and reduce its footprint in repo markets. The Fed would be free to use its balance sheet in more-conventional ways, like using open-market operations to influence the interbank rate. It would take the unwinding of quantitative easing as an external constraint on its policy, rather than as an instrument of its policy.

Shrinking the Fed's balance sheet is desirable, as it will enhance the Fed's independence and remove the market distortions created by quantitative easing. It is also feasible. The primary obstacle is a possible lack of political will. Should we keep error-prone Fed "balance sheet policy" in the mix for the convenience of a flatter yield curve and lower mortgage rates, or should we declare the era of quantitative easing over?

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