

The central bank is the largest holder of U.S. debt, giving it undue influence on the federal budget.

How the Federal Reserve Fuels Fiscal Profligacy

By Judy Shelton

If Republicans are serious about reducing federal deficit spending, it is important to consider the effect the Federal Reserve has on the nation's budgetary outlook. If the numerical models imposed by the Congressional Budget Office drive fiscal policy, lawmakers also need to understand what they portend for monetary policy.

The Fed once was committed to "normalizing" its balance sheet—shrinking its footprint in credit markets by reducing the size of its portfolio of Treasury debt and mortgage-backed securities. Chairman Jerome Powell noted in a 2019 speech that large-scale asset purchases by the Fed over the previous 10 years had been viewed from the outset as "extraordinary measures to be unwound, or 'normalized,' when conditions ultimately warranted."

But according to CBO estimates, the Fed won't be reducing its holdings of Treasury securities over the next decade. Instead, it will increase them significantly. The Fed owns \$4.2 trillion in U.S. government debt in the form of Treasury bills, notes and bonds. The CBO projects the Fed's holdings of Treasuries will climb to \$9.9 trillion in 2035—more than double today's amount.

NOTE For perspective, the central bank owned less than \$500 billion in Treasuries before the 2008 global financial crisis. The CBO predicts that the Fed's share as a percentage of federal debt held by the public will rise to 20% in 2035 from 16% in 2025. Through multiple rounds of quantitative easing, including vast new purchases of Treasuries during the 2020 pandemic, the Fed has become the largest single holder of U.S. national debt.

The blowout of the Fed's balance sheet has enlarged its powers and prominence. Aside from the Fed's ability to influence interest rates that directly affect the cost of financing government debt—now 16% of total federal spending—the ramifications of the nation's compromised debt funding raise disturbing questions about the com-mingling of government functions.

To what extent do the consequences of past actions by the central bank now impinge on the fiscal options facing lawmakers? The Fed's complicity in fueling the inflation that was largely driven by excessive government spending in recent years appears to have rendered monetary officials leery of economic activity—to the point of leaning toward restrictive interest rates at the expense of productive economic growth.

All of which leads to the fundamental challenge of defining the appropriate role of a central bank in a free-market economy. The Fed's portfolio of government-backed financial assets generates huge earnings from interest-rate payments. By law, after covering its own expenses, the Fed must remit these earnings to the Treasury. Therein lies an inherent conflict of interest: Federal Reserve remittances have been a significant source of revenue to the federal budget, providing more than \$835 billion from 2013-22.

While Fed officials portray this fiscal bonanza as an incidental consequence of monetary policy, at least one member of Congress has expressed open appreciation. In July 2020, during Mr. Powell's semiannual testimony before the House Financial Services Committee, Rep. Brad Sherman (D., Calif.) applauded

the Fed for consistently remitting its "profit" to the Treasury, adding: "I think you should focus on it because it is very important."

The Fed's main tool for conducting monetary policy is to pay interest on the cash balances of commercial banks and money-market funds kept on deposit at the Fed. Since September 2022, interest payments from the Fed totaling \$607 billion have exceeded its own interest income—which means those earnings from the Fed's portfolio have been going to private banks and mutual funds rather than the Treasury. Legislators might be interested to know that 44% of the money the Fed is currently paying on \$3.4 trillion in reserve balances is going to foreign banks.

Congress could rescind the Fed's authority to pay interest on reserve balances, which was granted in October 2008 as part of an emergency package. The Fed would likely return to traditional open market operations as its main tool for conducting monetary policy. Banks would respond by moving their cash into Treasury securities, bringing down interest rates. Even better, banks might increase lending to the private sector.

If the Fed chooses to maintain interest rates aimed at restricting economic activity, it would mean selling a portion of its portfolio securities— thus shrinking its \$6.7 trillion balance sheet in accordance with the original plan. But there's a complication. From the CBO's perspective, this would trigger recognition of the Fed's \$927 billion in cumulative unrealized losses on its portfolio, wiping out the Fed's earnings from interest payments. No "profits" from Fed operations, no remittances to the Treasury.

The accounting conundrums of federal agencies are wearying to the soul. But to accept passively the inexorable enlargement of government would be fully demoralizing. We must confront the Fed's effect on the federal budget because robbing Peter to pay Paul leads to further government encroachment. Taxpayers will ultimately pick up the tab.

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