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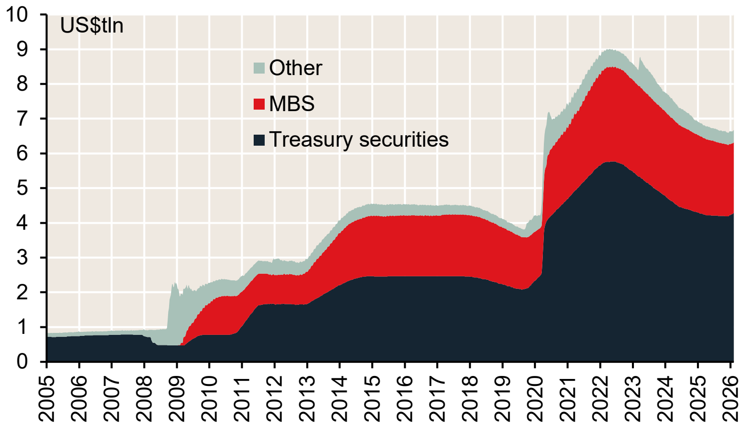
Kevin Warsh vs. the Fed's balance sheet

By Taylor Schleich & Ethan Currie

Kevin Warsh's nomination for Fed Chair last month was somewhat curious. While the ex-Fed Governor has *recently* advocated for lower rates (due to an expected AI-driven productivity boom), his reputation as a steadfast hawk runs counter to Trump's unrelenting desire for lower interest rates. And even as his hawkish policy rate stance moderated, his views on balance sheet policy haven't wavered. To him, the Fed's balance sheet is excessively large, distorting markets, incentivizing and enabling government borrowing and contributing to economic imbalances. In this *Market View*, we explore the evolution of the Fed's balance sheet and offer alternative perspective on some of Warsh's views. We also judge the practicality and likelihood of major reforms to Fed balance sheet policy.

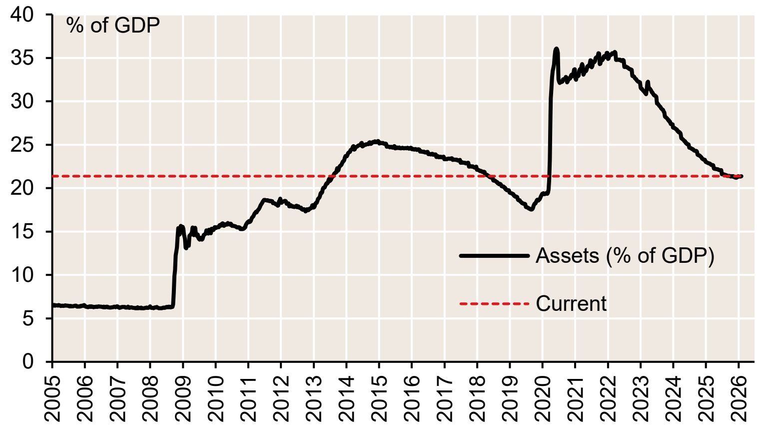
In summary, we view the scope for major further reductions to the Fed's balance sheet as limited under the current regulatory framework. Financial market deregulation—reducing the demand for reserves and allowing banks to absorb the Fed's Treasuries—would create scope to lessen the FOMC's portfolio. Still, there are risks when the most stable and predictable buyer/holder of Treasuries is replaced by riskier entities. The likely result is higher term premiums and long-term borrowing costs. This can be partially mitigated by lower policy rates but pass through to the long end is limited. Any associated upward pressure on (mortgage) rates is unlikely to sit well with the President. There's also the practical constraint that balance sheet decisions, like rate decisions, are voted on. While there are FOMC participants sympathetic to his view, it's not clear there's appetite for wholly reforming balance sheet policy. More realistic near-term changes under Warsh could involve testing a slower purchase pace (to keep reserves ample) or focusing reinvestment buying on shorter-term debt. We don't expect the central bank to restart QT.

Chart 1: At $6.6 trillion, the Fed does own a lot of assets…
Federal Reserve assets by major type



Source: NBC, FRB, BBG

Chart 2: …though it's much less striking scaled to GDP
Federal Reserve assets as a share of GDP



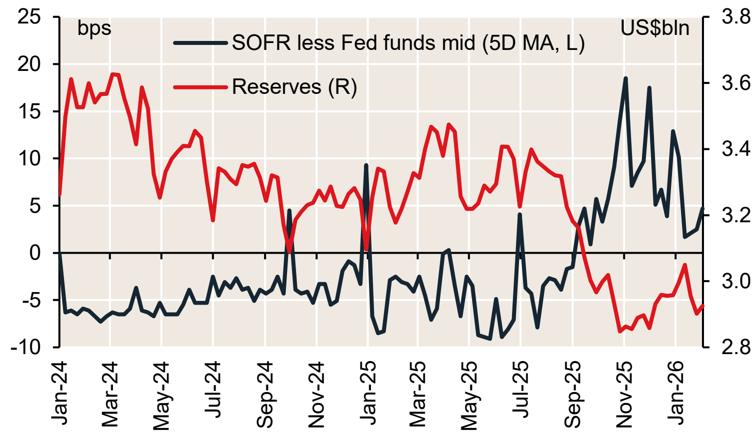
Source: NBC, FRB, BBG, BEA

There's no denying the Fed balance sheet is large at more than $6.5 trillion but that's down from an even larger $9 trillion after a material QT effort. While today's asset base is about 50% higher vs. pre-pandemic, the growth looks far less significant scaled to GDP. Compositionally, the decision to end QT last year didn't stop MBS roll-off. Even under status quo policy, MBS pullback will continue.

Chart 3: Fed assets are dictated by their liabilities…
Breakdown of Federal Reserve liabilities

Source: NBC, FRB, BBG | Note: Data as of 11-Feb.

Chart 4: …and reserve shrinkage led to funding pressures
SOFR-fed funds target (mid) basis (L) vs. reserves (R)

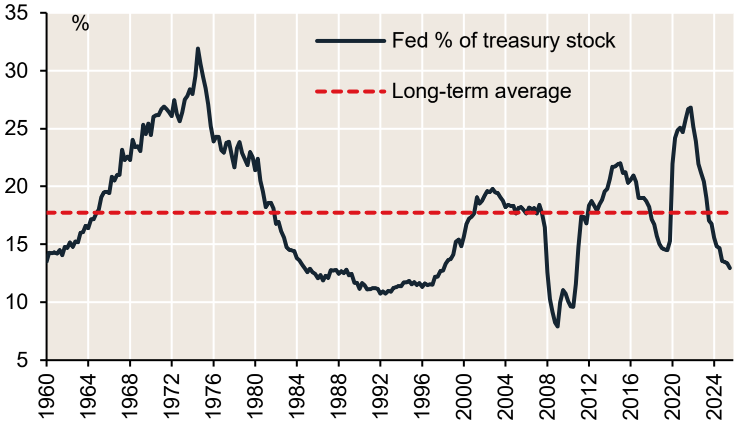


Source: NBC, FRB, BBG

Ultimately, it's the Fed's liabilities that drive their assets. Currency demand grows with the economy and the TGA is dictated by the Treasury. Together, these necessitate a Fed balance sheet of at least $3.3 tln. But it's reserves that were the guiding light for balance sheet policy in recent years. As those fell in 2025, repo market pressure accumulated (much like in 2019) prompting the Fed to stop QT. Without reducing the demand for reserves (chiefly, through regulation), scope for further asset run-off is limited unless the Fed becomes comfortable with greater volatility in funding markets.

Chart 5: Fed share of Treasury market not historically large…

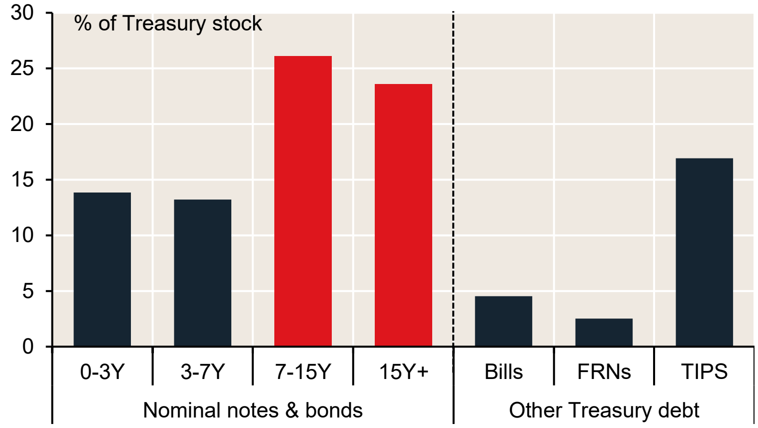
Share of Treasury market held by monetary authority (i.e., the Fed)



Source: NBC, BBG, FRB | Note: Latest data = Q3:2025

Chart 6: …though their footprint is bigger out the curve…

Share of Treasury market held by the Fed, by term to maturity and debt type

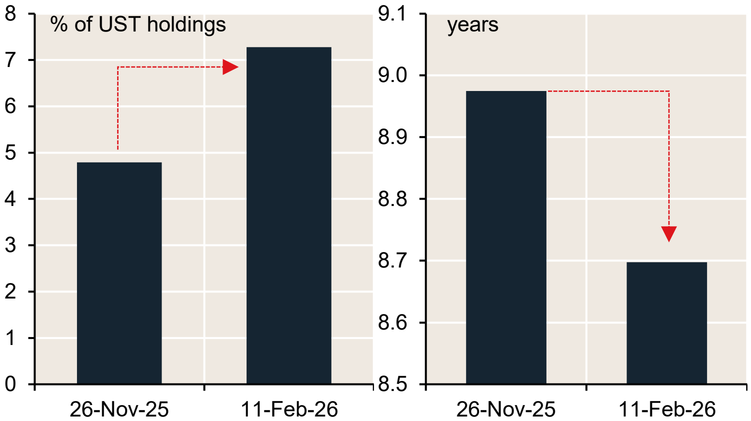


Source: NBC, BBG

The Fed's Treasury portfolio has doubled from 2019, but their share of the market has shrunk (as outstandings increased even faster). Today, the Fed owns <15% of USTs, below the long-run average. However, they do disproportionately hold longer-term debt. Warsh/other balance sheet hawks have a legitimate gripe here as in theory, this disproportionately compresses long-term yields.

Chart 7-8: …but that's started to change, albeit modestly

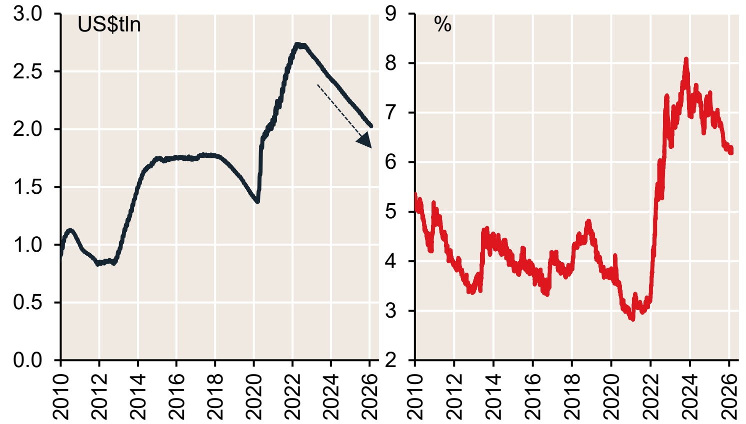
T-bill share of Fed UST holdings (L), WAT of Fed UST holdings (R)



Source: NBC, NY Fed | Note: WAT = weighted average term

Chart 9-10: The Fed's MBS portfolio will continue to shrink

Fed MBS holdings (L) and average 30-year mortgage rate (R)

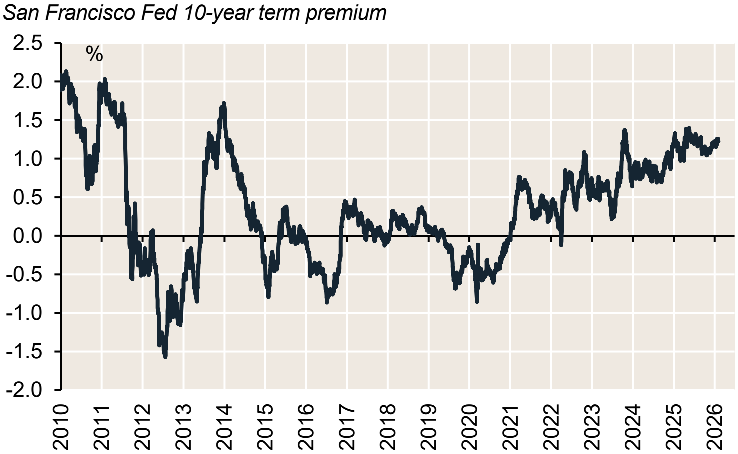


Source: NBC, BBG, FRB

Since QT ended, outright UST buying has all been in T-bills, lowering the duration of the Fed's portfolio. While we don't think Warsh will shrink the balance sheet much more, this strategy could be used more (e.g., reinvest UST proceeds in shorter-term debt vs. proportionately on the curve). Moreover, *all* proceeds from the Fed's MBS portfolio are now being invested in bills. So, the FOMC is *already* reducing its market footprint, even if gradually. A more aggressive stance/abrupt change under Warsh risks pushing yields/mortgage rates higher… a potential issue for President Turmp.

Chart 11: Term premia are already elevated

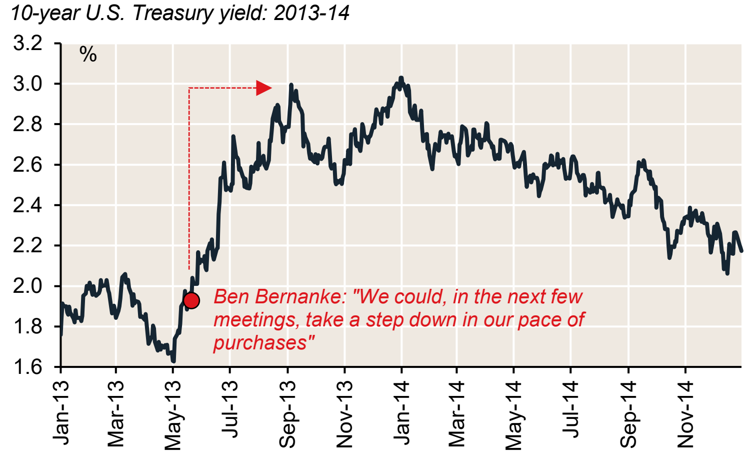
San Francisco Fed 10-year term premium



Source: NBC, BBG, SF Fed

Chart 12: History offers a warning of communication risk

10-year U.S. Treasury yield: 2013-14



Source: NBC, BBG

Warsh's balance sheet stance leaves risks to long-term yields skewed higher, even if he's more willing to ease the policy rate. And even if regulatory reform adds bank capacity to hold USTs, losing the most stable buyer/holder could add to bond market volatility. Yields/term premia are already high vs. the post-GFC period, and we assume Trump's tolerance for rising borrowing costs is low. If yields jumped on balance sheet changes, political pressure/noise would likely follow, adding further risk to the term premia. We assume Warsh prefers to avoid the 'Powell treatment'. In the past, markets have been spooked by major perceived changes to balance sheet policy (see: the taper tantrum). If Warsh were to reform balance sheet policy, markets may push back hard, at least initially.

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