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POLICY BRIEF

# The Case for a Smaller Federal Reserve Asset Portfolio

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The current government deficit, which is generating a sustained increase in the debt-to-GDP ratio, if left uncorrected, will inevitably create a financial crisis. The huge size of the Federal Reserve System's (Fed's) portfolio of Treasury and mortgage-backed securities creates the impression that the political system can turn to the Fed to buy long-term Treasury debt to mitigate rising bond yields. However, even if the Fed were to accede, the resulting inflation would still only temporarily help in reducing the real value of government debt and, in the long run, would exacerbate the underlying problem as expected inflation rose. The Fed needs both to make clear that monetary policy cannot resolve an unsustainable fiscal deficit and to reduce the size of its asset portfolio to emphasize that limitation.

Despite the limits, the Federal Open Market Committee (FOMC) has decided to maintain a gigantic asset portfolio. Economist Bill Nelson noted that this decision was made evident by the FOMC's choice to continue to maintain the current size of its portfolio by ending quantitative tightening and offsetting maturing debt holdings with purchases of Treasury securities:

> There was a critical determination made at the December [2026] FOMC meeting. The Committee revealed by its actions that it officially concluded that the Fed needs to create at least $3 trillion in reserve balances to implement monetary policy using their current approach. That necessary quantity of reserves determines the minimum size of the Fed's securities portfolio—about $6½ trillion [given currency outstanding]. The Committee is wrong, however; it can get much smaller. It just takes a little work, time, and some appropriate changes to bank regulations.[1]

Economist David Beckworth summarized Nelson's analysis, which explained how the ratcheting up of the FOMC's asset portfolio occurred.[2] Drawing on the Swedish Riksbank's procedures for controlling reserves, Beckworth explained how the FOMC could adopt operating procedures that would cause banks to reduce their demand for reserves and thus allow the FOMC to scale back the size of its asset portfolio to an amount once again only relatively larger than the public's

demand for currency. The remainder of this policy brief develops the argument that the FOMC should reduce the size of its asset portfolio while also explaining the limitations of its ability to buy government debt in a financial crisis.

## The Costs of Quantitative Easing and Excess Reserves

When the FOMC initiated purchases of long-term assets (first mortgage-backed securities and then Treasury securities) in response to the Great Recession, the assumption was that the size of its asset portfolio would not be permanently enlarged. Why not return to the pre-2008 regime in which, during periods of financial panic, the Fed met increased liquidity demand through the purchase of short-term Treasurys, which then ran off and extinguished reserves when the unusual demand for liquidity ended? The FOMC could return to the earlier regime by persisting with gradual QT (quantitative tightening, entailing sales of securities in the Fed's portfolio as well as allowing securities to mature without replacement) and simply accept increased volatility of interest rates, albeit with rates continuing to average around a level consistent with IOR (interest on reserves). Eliminating interest-rate volatility subsidizes banks' costs of reserves management, but that is neither a necessary nor a desirable function of a central bank. Its core function is to stabilize the growth of nominal income at a level consistent with price stability.

The problem with the way QE (quantitative easing) was conducted is that it eliminated the federal funds market for banks, limiting it only to the government-sponsored enterprises, which do not have accounts at the Fed. Pursuing a committed, moderate QT would incentivize the revival of the federal funds market, thereby allowing banks to adjust to reserves inflows and outflows. A desirable side effect of the funds market was that banks assessed the health of the institutions to which they lent funds. That market discipline is now gone.

## Fiscal Unsustainability and the Coming Debt Crisis

The Fed's asset portfolio rose from 0.2 percent of GDP in early 2008 to 9.9 percent in 2025. In a future financial crisis, the vast size of the Fed's portfolio would encourage the political system to look to the Fed to monetize debt issuance, thereby creating an uncontrolled inflation. For the indefinite future, the United States will run a deficit of roughly 6 percent of GDP. The debt-to-GDP ratio, which is already 100 percent, will continue to rise. Inevitably, holders of US government debt will take notice of Congress's lack of political will to make the painful decisions required to bring the deficit under control. A doom loop will then set in.

Recent commentary underscores the scale of the problem. Nick Lichtenberg writes:

> Federal borrowing has accelerated under both parties, the Joint Economic Committee noting that the debt has risen by an average of about $8 billion per day over the past year, pushing the burden to more than $112,000 per person. Budget analysts estimate interest payments alone are on track to top $1 trillion in fiscal 2026, crowding out other priorities

> and making it harder for future Congresses to respond to emergencies. Despite bipartisan rhetoric about responsibility, Congress has struggled even to pass routine spending bills on time, forcing last-minute deals while the debt keeps climbing. Analysts say this gridlock makes comprehensive reforms—such as overhauling the tax code, adjusting entitlements programs, or adopting budget rules—politically difficult even as the math grows more unforgiving.[3]

The current large primary deficit—that is, the deficit excluding interest payments—will cause public debt to grow faster than real GDP. The result will be an ever-larger debt-to-GDP ratio. Government bond issuance competes with private issuance, and the combined demand, public and private, will over time push long-term interest rates higher. Crowding out of private investment can mitigate the rise in interest rates, but only briefly. Over time, that crowding out increases pressure on the Fed to monetize government debt. The doom loop arises because rising interest increases the cost of financing the public debt and will cause the deficit, in dollar terms, to grow faster than GDP, further exacerbating the rise in bond rates.

In this environment, once a doom loop begins, a financial crisis driven by fiscal unsustainability and the self-reinforcing rise in bond rates cannot persist indefinitely. Roughly one-third of outstanding US debt will mature in 2026.[4] An increase in market interest rates will raise the cost of financing the deficit relatively quickly. At some point, a financial crisis will occur. The dollar will depreciate as foreign investors reduce their purchases of US debt, and long-term rates will spike. The Fed will then be in the hot seat, with no easy way out, unless the political system again forms the bipartisan consensus—prevalent before the 2008 recession—that deficits should be kept relatively small. The route to bringing together the warring parties in Congress to make painful cuts in entitlements and tax increases, especially without White House leadership, is, to say the least, daunting.

## Political Pressure, Fiscal Dominance, and Inflation Risk

The political system will turn to the Fed to buy time. It will demand that the Fed purchase long-term Treasury debt to relieve the pressure in bond markets. How will the Fed respond? Outsiders—and probably the Fed itself—have no clear idea. The Fed's portfolio is already gigantic. Why not add additional long-term government debt? After all, three QE programs beginning with the Great Recession did not cause inflation.

If the Fed somehow became willing to discuss the role of the price system in the transmission of monetary policy, it would have an answer. It would acknowledge the interest rate as the price of intertemporal consumption, which moves to equilibrate contemporaneous aggregate demand with potential real output. The required interest rate is the natural rate of interest. Consider QE. When the Fed buys long-term bonds, it replaces those illiquid bonds in the public's portfolio with short-term, liquid bank deposits. To rebalance its asset portfolio away from an excessive amount

of liquidity, the public purchases illiquid assets such as equities, which stimulates expenditure. The natural rate of interest rises.

In the first part of the recovery from the Great Recession, the natural rate of interest was negative. QE, along with forward guidance, worked in a desirable way to make it positive. When the natural rate became positive—starting in a sustained way in December 2016—the Yellen FOMC raised the funds rate to track the rise in the natural rate of interest above zero. The story was very different in March 2020, when QE was initiated in response to the rise in unemployment at the start of the pandemic. The policy of flexible average inflation targeting (FAIT) committed the FOMC to maintaining QE and a zero funds rate until the unemployment rate reached or declined below its prepandemic level of 3.5 percent. As the natural rate of interest rose while the funds rate remained at zero, there was no offset to the stimulus provided by QE.

To provide the monetary control required for price stability, the FOMC must follow a rule that allows the price system to work. Otherwise, as with FAIT, the result is the macroeconomic equivalent of price fixing. With the funds rate maintained below the natural rate of interest, excess supply in bond markets results in the monetization of government to maintain the interest rate peg. The result is money creation and inflation, as in countries such as Zimbabwe and Venezuela. Fortunately, during the inflation of 2022–23, markets continued to expect price stability. With the sharp rise in the funds rate that began in March 2022, the FOMC raised the funds rate to—or somewhat above—the natural rate of interest. The resulting money creation then followed the one-time "helicopter drop" of money associated with the writings of Milton Friedman.

## Conclusion: Why Monetary Policy Cannot Solve Fiscal Problems

What will happen when a financial crisis arrives and long-term bond rates rise? To mitigate that rise, the political system will demand that the Fed buy long-term government debt without increasing the funds rate. If the Fed does so, just as under the pandemic FAIT policy, inflation will rise and bond rates will rise further as inflation expectations increase. If the Fed refuses to buy government bonds and pressures the political system to cut the deficit instead, Congress may threaten to change the Federal Reserve Act to reduce the Fed's independence. Fiscal dominance and inflation, however, cannot deal with an unsustainable deficit. Will the threat of a collapse of the value of the dollar create a renewed sense of fiscal responsibility on the part of the political system? No one knows.

## About the Author

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## Notes

1. Bill Nelson, "Forward Guidance: The Fed Needs to Be Seen to Be Working Hard to Get Smaller," LinkedIn, December 22, 2025, https://www.linkedin.com/pulse/forward-guidance-fed-needs-seen-working-hard-get-smaller-bill-nelson-jalve/.
2. See David Beckworth, "Déjà Vu at the Federal Reserve," *Macroeconomic Policy Nexus*, January 13, 2026, and Bill Nelson, "How the Federal Reserve Got So Huge, and How It Can Shrink" (Bank Policy Institute, Staff Working Paper 2024-1, February 2024), https://bpi.com/wp-content/uploads/2024/02/How-the-Federal-Reserve-Got-So-Huge-and-Why-and-How-It-Can-Shrink.pdf
3. Nick Lichtenberg, "Jamie Dimon Warns that the $38 Trillion National Debt Is Not Sustainable and It's One of Two Tectonic Plates that May Crash in the Near Future," *Fortune*, January 23, 2026.
4. Real Investment Advice, "A Third of US Debt Matures in 2026," *Daily Market Commentary*, December 12, 2025.