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Before the Task Force on Monetary Policy, Treasury Market Resilience, and Economic Prosperity of the House Committee on Financial Services
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On the Federal Reserve Balance Sheet and Policy Tools

Thank you Chairman Lucas and Ranking Member Vargas, for holding this hearing and inviting me to testify about the Federal Reserve's balance sheet.

Introduction

At a basic level, the Fed's balance sheet reports the values of its assets and liabilities. The two must match up, of course. The main assets of the Fed are its securities holdings – generally government securities such as Treasury securities and Agency mortgage-backed securities – and its loans to banks and others, which are generally small but can be very large in times of financial stress. The Fed's largest liabilities are currency – the Federal Reserve Notes that can be used to pay for things – the deposits of banks at the Fed – known as reserves – and the Treasury's deposits at the Fed. Banks hold reserves at the Fed because they need them to make payments for themselves and for their customers. Similarly, the Treasury holds money in its account at the Fed because the Fed is the bank for the Treasury, and the Treasury needs to make and receive payments. Finally, in recent years, the Fed has allowed nonbanks effectively to deposit money with it through reverse repurchase agreements, and these "RRPs" have been a large part of Fed liabilities at times.[1]

Currently, Fed assets total about $6.5 trillion, almost all of which are accounted for by securities holdings (Table 1, Figure 1). On the liability side of its balance sheet, currency stands at close to $2.4 trillion, bank reserves are about $3 trillion, and the Treasury account at the Fed is about $800 billion.

Factors Affecting the Balance Sheet

The size and composition of the Fed's balance sheet reflect a range of policy decisions by the Fed.

Taking loans first, in a period of financial stress, the Fed may decide to use its lending authority under the Federal Reserve Act to provide liquidity to banks and others. It extends the loans (appropriately secured to limit risk) by providing funds to the account of a bank – either the borrower, if the borrower is a bank, or to the bank of the borrower if the borrower is not a

[1] For additional information on the Federal Reserve balance sheet, see Dawsey, English, and Sack (2022).

bank. The total amount of such lending can be very large, as we have seen in recent years. For example, total Federal Reserve lending jumped to well over $1 trillion in 2008, and the level of reserves – the liability counterpart to that lending – rose by nearly as much. (Other balance sheet items were also changing during this period.)

Another policy with significant implications for the Fed's balance sheet is quantitative easing. If the economy is very weak and the Fed has cut its usual policy tool, short-term interest rates, to near zero, it can provide additional monetary accommodation by purchasing longer-term securities. Those purchases, by reducing the amount of longer-term securities held by private investors, pushes up their prices and so their yields fall. The result is lower rates on mortgages, auto loans, corporate bonds, and other types of credit, which, in turn, encourages spending and so boosts output and employment. The Fed pays for such purchases by increasing reserves, putting reserves in the account of the bank of the seller of the securities for the bank to credit to the seller's account. For example, following the financial crisis the Federal Reserve purchased about $3.5 trillion of securities to help ease credit conditions, and bank reserves at the Fed rose close to $3 trillion.

Policy Implementation

An important choice affecting the size and composition of the Fed's balance sheet is the method the Fed uses to implement its conventional interest rate policy. Policy can be implemented in a variety of ways. One possibility, employed by the Fed prior to the financial crisis, is to implement policy with a relatively small balance sheet and use securities purchases and sales to adjust the level of reserves to achieve the desired outcome for short-term interest rates. This approach is sometimes referred to as a "scarce reserves" system. This sort of implementation was no longer possible by late 2008 because the huge increase in reserves resulting from Fed emergency lending and QE meant that the required adjustments to reserves were simply not feasible. As a consequence, the Fed began implementing policy using the interest rate paid on reserves.[2] Since leaving money at the Fed is completely safe and liquid, banks should not lend out funds at rates much below the rate paid on reserves, and so that rate should set a floor for market rates. This approach is sometimes referred to as an "ample-reserves" system, since it works even with a very high level of reserve balances.

As the Fed shrank its balance sheet between 2017 and 2019, it considered whether it should return to a scarce reserves approach with a smaller balance sheet or stay with an ample reserves system and a larger balance sheet. In January 2019, the Fed announced that it would stick with the ample reserves system.[3] That decision reflected a balancing of a number of potential costs and benefits. One cost was the impact of a high level of reserves on overnight interbank funding markets. With banks holding very high levels of reserves at the Fed, they have little need to borrow and lend reserves to manage their holdings. As a result, the overnight

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[2] Congress provided the Fed with the authority to pay interest on reserves in September 2008.
[3] See the press release here: https://www.federalreserve.gov/newsevents/pressreleases/monetary20190130c.htm

interbank funding market has become much smaller and more idiosyncratic. That market can, at times, provide useful signals to banks and policymakers regarding building strains at a particular bank or set of banks.

On the other hand, the Fed viewed the high level of bank reserves under the ample reserves system as likely to contribute to financial stability. In the event of a shock to the financial system, there would be less need to add reserves as ample reserves would already be in place. Moreover, problems at large banks, the failure of which could cause systemic problems, can be managed better if those banks had a larger cushion of reserves to draw on, either to get through a difficult period or to be resolved. And community and mid-size banks have an added source of high-quality liquidity to draw on when they experience unexpected liquidity strains. In addition, by 2019 the ample reserves system had been in place for more than a decade, had been working well to allow the Fed to set its policy rate, and there were presumably risks associated with trying to transition back to a scarce reserves regime. When policymakers assessed the overall costs and benefits of the two systems in 2019, they concluded that staying with the ample reserves system was preferable.

Some criticisms of the ample reserves framework are simply not valid. In particular, some commentators have suggested that the payment of interest on reserves imposes a significant cost on the Fed, and so on the Treasury (since Fed profits are remitted to the Treasury) and provides a windfall for banks. But this is not the case. As noted earlier, the Fed's balance sheet must balance. Increases in reserves are balanced by increases in Fed securities holdings, and the interest paid on reserves is offset by the interest earned on the securities. Although those rates can differ in the short run, depending on the portfolio of securities held by the Fed, they are roughly equal over time, implying no significant cost to the Fed on average. Similarly, banks' balance sheets must balance. So the interest that banks receive on their reserves at the Fed are offset by the interest and other costs associated with the deposits or other funding that banks must raise in order to fund the reserves. The result is no significant change in bank profits.[4]

Finally, some have expressed the concern that the Fed, by operating with a larger balance sheet, may encourage the view that it will use its balance sheet to address other, non-monetary policy, concerns or be willing to ease policy to address fiscal stresses by monetizing federal debt.[5] However, such concerns can arise regardless of the size of the Fed's balance sheet. Instead, these risks point to the importance of the Fed's monetary policy independence. The Fed should implement monetary policy to foster the objectives given by Congress – maximum employment and stable prices – without regard for political or other pressures to use its tools for other aims.

Thank you. I look forward to our discussion.

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[4] These arguments are spelled out in greater detail in English and Kohn (2025), which is attached as an appendix.
[5] For example, see Nelson (2024) p. 3.

References

Dawsey, Kristopher, William B. English, and Brian Sack (2022), "The Federal Reserve Balance Sheet." in *The Research Handbook of Financial Markets*, Refet Gurkaynak and Jonathan Wright, Eds., Cheltenham: Edward Elgar, 2023.

English, William and Donald Kohn (2025), "What would happen if Congress repealed the Fed's authority to pay interest on reserves?" *Brookings Commentary*, September.

Nelson, William (2024), "How the Federal Reserve Got So Huge, and Why and How It can Shrink," *Southern Economic Journal*, v. 91(4), pp. 1287-1322.

Table 1

Federal Reserve Balance Sheet – January 7, 2026

($Billions)

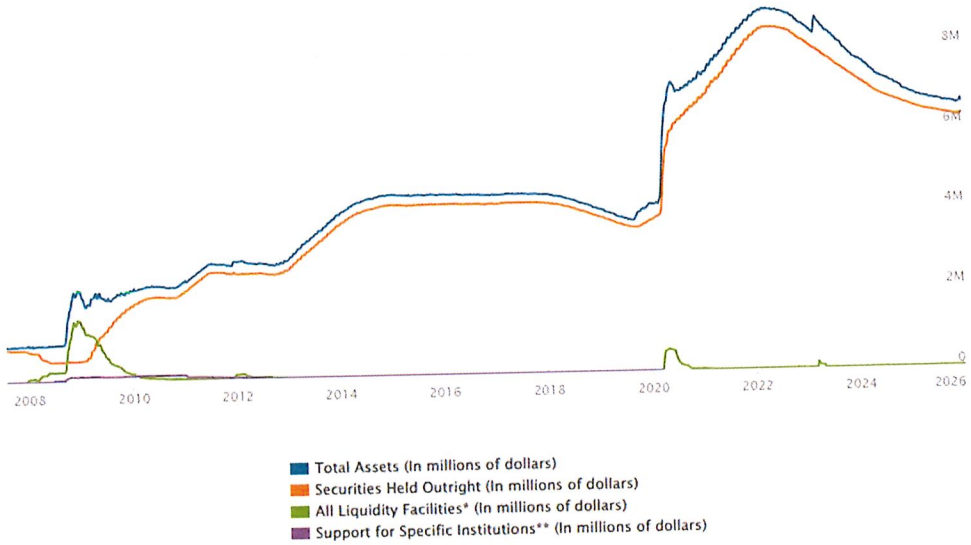
Assets		**Liabilities**	
Securities	6,478	*Currency*	2,391
Other	96	*Reserves*	3,023
		Treasury General Account	784
		Other	330
Total Assets	6,574	Total Liabilities	6,528
		Capital Account	46
		Total Liabilities and Capital	6,574

Source: Federal Reserve Statistical Release H.4.1

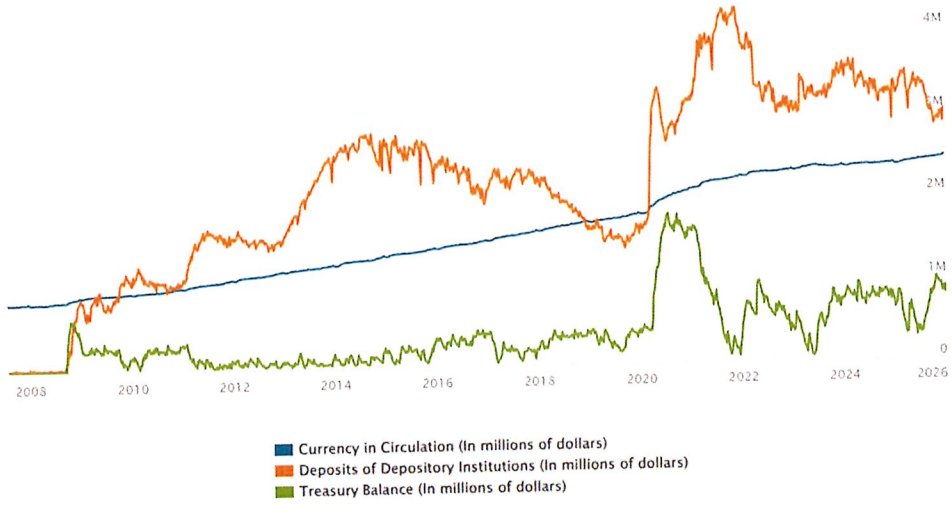
Figure 1

Assets and Liabilities of the Federal Reserve System – 2007-2025

Assets



Liabilities



Source: Federal Reserve

Appendix

English, William and Donald Kohn "What would happen if Congress repealed the Fed's authority to pay interest on reserves?" Brookings Commentary, September.

BROOKINGS

COMMENTARY OP-ED

What would happen if Congress repealed the Fed's authority to pay interest on reserves?

William B. English and Donald Kohn

September 10, 2025

Some in Congress have proposed a repeal ↗ of the Federal Reserve's authority to pay interest on bank reserves. This post explains why the Fed pays interest on reserves and why the concerns raised about such payments are wrong.

What are bank reserves?

Reserves are deposits that banks hold at the Fed. Banks hold such deposits because they need them to make payments, both for themselves—when they make loans or purchase securities—or for customers writing a check on their bank account, for instance. In addition, banks hold reserves as insurance against a sudden need for liquidity if financial markets are disrupted or the banks face unexpectedly heavy withdrawals. (Banks have not been required by regulation to hold reserves at the Fed since 2020.)

While each bank can adjust its holdings of reserves, the total amount of reserves in the system is set by the Fed through its actions. The Fed can increase the aggregate level of reserves by purchasing securities (such as U.S. government bonds) in the open market and paying for them with newly created reserves. Similarly, it can decrease reserves by selling securities.

Figure 1: Reserves of depository institutions

$ billions

Source: Federal Reserve Bank of St. Louis

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Since that time, the Fed has implemented policy largely by raising and lowering the rate it pays on reserves. That rate serves as a rough floor on short-term interest rates because banks will not lend funds to others at a rate below the one they can obtain from the Fed. (For additional information on the Fed's policy implementation since the financial crisis, see Ihrig, Meade, and Weinbach, 2015.) Many other central banks, including the European Central Bank, the Bank of England, and the Bank of Japan, also use the payment of interest on reserves as a tool to implement policy. This approach proved effective when it came time for the Fed to raise rates in late 2015 (see Anderson, Ihrig, Styczynski, and Weinbach, 2017). It allowed the Fed to buy Treasury securities to ease market crises in 2019 and 2020 without losing control of the short-term interest rate. And following the substantial additional QE undertaken in response to the COVID pandemic, interest on reserves worked well when the Fed increased interest rates in 2023 and 2024.

But the global financial and COVID crises are over, so why continue paying interest on reserves?

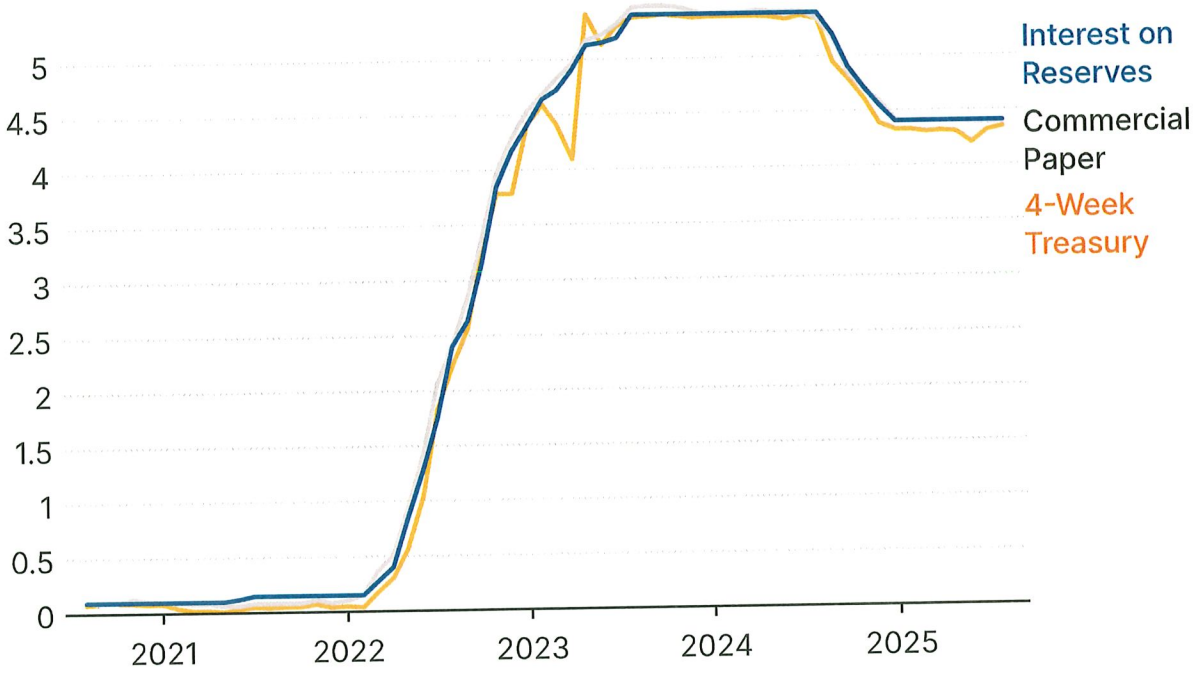
Treasury after paying the Fed's expenses)—and so, the budget deficit—depends on the *net* interest earned or paid by the Fed.

The interest rate paid on reserves is a short-term rate—reserves are held overnight—while the rate on the Fed's securities holdings is a mix of short, intermediate, and long-term rates, depending on the particular portfolio of securities the Fed is holding. Thus, Fed interest income and expense (including interest payments to banks) can differ significantly in some periods. Indeed, the Fed had large profits and made large remittances to the Treasury for a number of years following the financial crisis and again in the immediate aftermath of the pandemic, but it has had substantial losses recently, reflecting the rapid rise in short-term rates put in place to combat the post-COVID inflation (Figure 2). But this is a temporary condition. Over time, yields on long-term securities have somewhat exceeded, on average, those on short-term debt as investors arbitrage across instruments with different maturities to achieve roughly equal risk-adjusted returns. As a result, the effects of a larger Fed balance sheet on interest payments to banks and interest receipts on securities should be roughly offsetting, leaving Fed income and the federal budget deficit about unchanged. (For a discussion of the potential implications of QE for Federal Reserve income and the federal budget, see English and Kohn, 2022. (https://www.brookings.edu/articles/what-if-the-federal-reserve-books-losses-because-of-its-quantitative-easing/))

account at the Fed. Thus, if the rate paid on reserves offered banks an excessive profit, increased competition among banks for deposits would push up bank funding costs, offsetting that profit.

Figure 3: Yields on alternative assets

percent



Source: FDIC, Federal Reserve Bank of St. Louis

Note: 30-Day AA Financial Commercial Paper Interest Rate, T-Bill secondary market rate; adjusted to investment basis

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What would happen if the Fed could no longer pay interest on reserves?

If Congress repealed the Fed's authority to pay interest on reserves, the Fed would turn to other tools to implement monetary policy. In the short run, the Fed probably would make greater use of reverse repurchase agreements to provide a floor for short-term interest rates. In a reverse repurchase agreement, the Fed essentially borrows short-term in financial markets; counterparties will not lend to anyone else at a rate lower than the Fed is offering. Reverse repurchase agreements have effects—and costs—similar to those of the payment of interest on reserves. Thus, ending interest on reserves would leave Fed interest payments little changed, and so would have little effect on Fed profits and so on the federal budget.

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