Testimony

Of

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United States Senate

Committee On

Homeland Security and Government Affairs

December 11, 2025

The Abundant Reserve Policy:
The Experiment That Went Awry

In 2008, the Federal Reserve ("the Fed") began experimenting with a new monetary policy regime. With Quantitative Easing (QE) the Fed shifted from a "scarce reserve policy" to an "abundant reserve policy." This new policy was a mistake on multiple levels. In no way should it continue. The Fed should return to its scarce reserve management of the banking system.

Today's hearing is focused on the fact that the Fed has paid, and is paying, "private banks," including foreign banks, hundreds of billions of dollars. As Chairman Paul and his staff have found, these numbers are a significant portion of bank earnings. This is a perversion of free market economics and it masks excessive government spending. Many Fed supporters demand Fed Independence, but the Fed itself has violated so many rules of being an independent entity it only has itself to blame for its current predicament.

Ending interest on bank reserves (IOBR) is an essential step in restoring a healthier monetary and fiscal framework. In fact, it would be like pulling the one loose thread that unravels the whole system. But to understand why, it is important to lay out how this shift in Fed policy came about. The move to paying interest on reserves represents a dramatic change. Moreover, it has not made the banking system safer, it has made it more fragile. It has raised costs for taxpayers, enabled a larger federal government than would otherwise be possible, obscured the true cost of that bigger government, encouraged mission creep at the Federal Reserve, and contributed to inequality that is reshaping the political fabric of our nation. In my opinion this experiment needs to end. A three-year reversal of these policies would allow it to happen without severe market disruption.

Below is a partial list of the results of this experiment.

1) QE expanded the Fed's balance sheet more than 10-fold at its peak, from $850 billion at the end of 2007 to $8.929 trillion in April 2022 – larger than the top nine sovereign wealth funds in the world, combined. The Fed has peeled off some of those assets, but it still has a balance sheet of $6.5 trillion, 7.6 times larger than in 2007. Along with this growth in its assets, employment at the Fed has grown from 17,100 in 2012 to 21,000 today. This has happened in spite of the fact that checks are now cleared electronically. The Fed has used its larger budget to engage in Mission Creep, or as Treasury Secretary Bessent has called it "Gain of Function Monetary Policy." It does research on climate change, lead water pipes and all kinds of other issues like "inequality" and "racism." This research has nothing to do with monetary policy, although the Fed claims it does.

2) In 2007, the Fed's balance sheet was equal to just 5.8% of GDP. Today it is equal to 21.3% of GDP. The Fed owns 12.5% of all Treasury bonds outstanding and 11% of all mortgages. Between Q1 2020 and Q2 2022, the Fed bought almost one-half (45.4%) of all Treasury Securities issued. In other words, the Treasury only needed to find buyers for $4.0 trillion of the debt it issued, not $7.3 trillion. This allowed the Treasury to borrow at artificially low interest rates. While this may seem to be a positive, it isn't.

3) Quantitative Easing is a way to shift the risk of federal government debt issuance from an independent bond market to the Fed. The Treasury issues debt to primary dealers, which are mainly large money center banks. When the Fed purchases these bonds with Quantitative Easing, it credits the banks with reserves (new money). The Fed takes those bonds onto its books, banks get reserves (cash). While the Fed claims to make its decisions independently of Treasury decisions, QE and large deficits after 2008 and again during COVID happened simultaneously. This was not a coincidence. Banks are fully aware of the Fed's schedule for purchasing those bonds. The Fed announces its QE intentions in advance so banks know exactly how long they may be exposed to the risk of holding bonds. As long as the Fed is doing QE, it is in effect financing government borrowing and spending.

4) This process increases the money supply (M2) by injecting new money into the banking system. This money is technically excess liquidity which could cause inflation. As a result, back in 2008 the Fed set up a regulatory system to contain these inflationary pressures. It raised capital requirements on banks, instituted new liquidity ratios and requirements and runs banks through Stress Tests. These rules are designed to force banks to hold more cash and make fewer loans than they could if they were to use all the new reserves created by the Fed when it bought Treasury bonds from the banks. The Fed also asked for, and received from Congress, the right to pay Interest on Reserve Balances (IORB). So, the Fed has a "carrot and stick" approach to stopping inflation. Interest payments encourage banks to hold reserves (the carrot), while regulations force them to hold them (the stick).

5) During COVID, however, the Treasury needed banks to be conduits for its COVID spending. Paycheck Protection Program (PPP) loans, and direct deposits of COVID Economic Impact Payments, all went through banks. In order to facilitate this the Fed eased liquidity rules to allow banks the ability to push that money out. This is why the second round of QE (during COVID) led to a huge surge in the money supply and inflation while the first round (after 2008) didn't. When COVID payments finally ended, the Fed reinstituted the liquidity rules.

6) The inflation these policies caused have undermined living standards and created more inequality in the United States. The Fed tripled the money supply between 2007 and 2022. People with assets (equities, homes, other property) won as the prices of those assets rose. People without assets face higher prices (inflation) with no positive wealth effect. This has set off a great divide in America, between the haves and the have nots and younger and older generations. This divide is not driven by productivity and entrepreneurship, it is driven by excessive liquidity, which is an artificial driver of inequality.

7) Many will use what is called a "counterfactual" to say all of this worked. They say "if the Fed had not done QE, the world would have collapsed, either in 2008, or during COVID." However, this is an unprovable claim. An economy is much too complex to argue that one policy changed all outcomes. Moreover, as the failure of Silicon Valley Bank shows, the distortions in interest rates that these new policies cause can lead to catastrophic results.

8) It is much more likely that because of QE, government expanded more than it should have. The Fed does not care about losses in its portfolio, it can print money to offset any losses. Banks do care. And if the Fed had not done QE, and the private markets, including banks, were the end purchasers of ALL new debt, interest rates would have been higher than they were. The market would have demanded it. If the Treasury had faced real market interest rates, it is highly likely spending decisions by politicians would have been adjusted and smaller. In other words, the government is bigger and more indebted today than it would have been if the Fed had not bought its debt. Simply put…the Fed has a different risk appetite than the private sector because the Fed does not face market forces. As a result, the real cost of government programs was hidden.

9) The Fed started this entire experiment in 2008 when a faltering subprime loan market was exposed. Total failing subprime loans were estimated to be between $400 and $500 billion. Large, but not large enough to take down the entire banking system. Mark-to-market accounting was the reason the crisis spread; it compounded losses and froze markets. Few discuss the facts, but QE was started in September 2008, TARP was passed in October 2008, and yet stocks continued to fall, with the S&P 500 down another 40% between QE/TARP and March 2009. Only then was the mark-to-market accounting rule (FASB 157) changed. That was when the stock market and economy both bottomed. It was not QE that saved the world, but the end of this highly damaging accounting rule.

10) Mr. Chairman, Fed Chair Jerome Powell recently said that these new abundant reserve policies promote “financial stability.” However, because the Fed held interest rates artificially low during QE, both the Fed itself and banks have investments on their books at rates well below current market rates. With rates now up, combined un-realized losses at the Fed and in the banking system total roughly $1.5 trillion. In other words, this new policy regime has created losses three times larger than the losses that precipitated the Great Financial Crisis. How can anyone call that financial stability? One reason this is not a crisis is that overly strict mark-to-market accounting rules for banks no longer exist while the Fed has no reason to worry about losses. The other is that markets expect the Fed to do further rounds of QE if something goes wrong, allowing the system to sweep problems under the rug and finance debt at artificially low rates.

11) In addition, the Fed is now paying more in IORB than it is earning on its portfolio of bonds. Contrary to those who dismiss this as a costless movement of money, it actually does cost taxpayers. The Bank of England includes similar losses in the deficit of the United Kingdom, while the Fed dumps the losses into an accounting entry called a “deferred asset” with a promise to make profits again in the future. Losses are hidden from taxpayers. Somehow, even with losses exceeding its capital, the Fed still pays its enormous staff, funds the building of a new headquarters, and keeps the lights on. It appears that it does this by printing more money, which undermines the value of the dollar because it is printing money to fund its own activities which do not add to GDP. Interestingly, the Fed has created an environment with the press where questions about this are never asked.

12) So far, we have avoided talking about other implications of this experimental monetary policy. Prior to 2008, banks traded federal funds, because reserves were scarce. If one bank had excess reserves, it could lend those reserves to a bank that had fewer reserves than required. Just about every bank had a "Federal Funds Trading Desk." The Fed influenced the federal funds rate by adding or subtracting reserves, but the rate was set in a marketplace. With the advent of QE, reserves became abundant. So abundant that banks no longer trade federal funds. No bank needs to borrow them. With no actual market for federal funds, where does this interest rate come from? The answer: the Fed just makes it up. The rate may be too low, or it may be too high. No one really knows.

13) In monetary policy terms, the Fed separated the money supply and interest rates. They no longer have anything to do with each other. The Fed claims this isn't true and points to pressures in the repo market as a sign that they have shrunk their balance sheet too much – taken too many reserves out of the system. They say we will know when reserves are no longer abundant by observing pressures in repo markets. But these are artificial pressures, created by whatever liquidity and capital rules exist. If the Fed raises liquidity or capital requirements on banks, they can make money tight. If they reduce them, they can encourage banks (and the money supply) to expand. In the scarce reserve model, there were simple rules and the trading of federal funds sent a signal. Today, the signal is distorted by rules and regulations. In essence, the US is moving toward a national bank where government policy is more important than market forces. This process is slowly, but surely, undermining capitalism in numerous ways. One of those ways in the world of banking is making it more and more difficult for small and mid-size banks to compete.

14) Chair Powell argues that if the Fed were not allowed to pay interest on reserves, it "would lose control over rates." This is absolutely true. The reason it is true is that there is no real market (borrowing and lending) for federal funds. The Fed completely controls the level of rates with no real market signals. Yet, the Fed did hold rates near "zero" for nine years – from 2008-2015, and again 2020-2022. So, what the Fed is really saying is that it will hold rates at zero when it wants to, but it doesn't want to be told they should be zero. If the Fed were to lose the ability to set rates where it wants – if the Congress does force the Fed to stop paying IORB – then the Fed would need to completely reverse quantitative easing and go back to a scarce reserve model. At that point it could influence rates again. The Fed would need to exchange its bonds for the reserves in the system. The Fed is right that this would cause dislocations if done too quickly. So, a transition period would be appropriate in order to make this process orderly.

15) Government programs, once started, create new behaviors and alter the make-up of markets. Throughout history, governments have resisted reversing course because it might be disruptive. Jerome Powell spoke of this in October…"If our ability to pay interest on reserves…were eliminated, the Fed would lose control over rates." He added "To restore rate control, large sales of securities…would be needed to shrink…the quantity of reserves in the system. [This] could strain Treasury market functioning and financial stability. Market participants would need to absorb the sales of Treasury securities and agency MBS, which would put upward pressure on the entire yield curve, raising borrowing costs for the Treasury and the private sector…[and] the banking system would be less resilient and more

vulnerable to liquidity shocks." In other words, now that this system is in place, we can't change it. This is a woefully inadequate argument. Just because unwinding something is difficult does not mean it should not be unwound. In addition, it is not clear at all that the banking system really is more resilient. Certainly, both the Fed and overall government are larger than they would have been without these changes in the policy regime at the Fed.

16) One thing not discussed so far is a massive growth in the Treasury General Account (TGA) – basically the Treasury's checking account at the Fed. For decades this account was managed at a level of roughly $5 billion. The Fed and the Treasury settled on this amount because of this accounts potential to impact monetary policy. When people pay their taxes, or buy Treasury bonds, for example, they write a check. In other words, money in the banking system is transferred to the Treasury. When the government spends that money it comes right back into the system and the money supply does not change. But if the Treasury deposits it in the TGA it is removed from the banking system and it reduces M2. This account started to grow in 2008, with the advent of the abundant reserve system. Today, the TGA has $900 billion in it and taxpayers are paying interest on debt so that the Treasury can maintain this cash balance. Why the Treasury needs that much cash in a checking account is a mystery. Moreover, Jerome Powell says "unpredictable swings" in the TGA are one reason to maintain the abundant reserve regime. In other words, once started we can't go back. Again, this is a highly inadequate defense. For decades there were no unpredictable swings in this account…so why are there unpredictable swings now? The Treasury can borrow at will and was able to operate normally prior to 2008. It could do so again.

17) So, to summarize. Having the Fed pay "private banks" and "foreign banks" hundreds of billions of dollars, which make up a significant share of their profits, violates the separation of government and markets in an unprecedented way. Mr. Chairman, your proposal to end these payments is appropriate. And moving in this direction would force the Fed to unwind its "crisis-era" management of monetary policy. This also is appropriate. The Fed has become too large. Already, we have seen that these new policies are not risk free. Unwinding these policies too quickly would be disruptive. So, in your bill Mr. Chairman, set a timeline of three years to wind down IORB, realizing fully that it will also force the Fed to pull back abundant reserves, and then make sure they can never come back again.