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## We need to talk about Kevin (and Isabel)

- **Warshian balance sheet contraction need be neither psychological thriller nor horror flick**
- **Non-US jurisdictions combine lower reserves with less money market volatility**
- **It's just a question of shifting from supply-led to demand-led liquidity provision**

For such an advanced economy, the US is often surprisingly insular. The many economists dismissing scope for Warsh's plans to shrink the Fed balance sheet are unlikely to number among the almost half of Americans who have supposedly never travelled abroad.<sup>1</sup> But at times they seem stuck in the same mindset.

In all the increasingly copious literature grappling with Warsh's radical proposals, we can find few acknowledgements of why a smaller balance sheet might be desirable, and not a single comparison between the extent of US QT and QT elsewhere.<sup>2</sup>

Aggressive balance sheet shrinkage could indeed have a significant and underappreciated impact on asset prices, as we described in a previous note.<sup>3</sup> But this is seldom the reason it is so often dismissed as impractical.

That instead lies with its potential impact on banks and money market rates. As Cecchetti and Schoenholtz put it, "it could stir interest rate volatility, limit credit supply, cause turbulence in financial market [sic] and even pose a risk to financial stability".<sup>4</sup> Others consider regime change to be all but impossible: "We expect Warsh will support ample

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<sup>1</sup> Preply survey cited in "[Here's how many Americans have never left the U.S.](#)", *Time Out*, Sep25.

<sup>2</sup> See, for example, "[Wall Street Is Sizing Up Warsh's Options to Shrink Fed Portfolio](#)", *Bloomberg*, 17 Feb.

<sup>3</sup> [The radicalism of a Warshian Fed](#), 4 Feb.

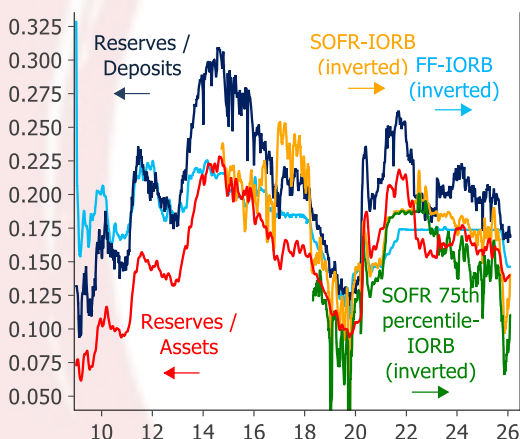
<sup>4</sup> "[Warsh's war on the Fed balance sheet](#)", S. Cecchetti & K. Schoenholtz, *FT Alphaville*, 16 Feb.

reserves, be ineffective at shrinking Fed balance sheet and evolve Fed asset composition in line with current practices.”<sup>5</sup>

Money market volatility is of course the reason why the Fed abandoned QT already last year and indeed moved almost immediately back to balance sheet expansion through reserves management purchases (RMP). 2019’s accidental foray into reserves scarcity is a horror story the FOMC remains anxious not to repeat. But even now, while RMPs have somewhat reduced Standing Repo Facility usage, money market spreads remain somewhat elevated by historical standards. The standard US interpretation is that the system simply needs more liquidity than previously, in large part because of banks’ increased need for HQLA to meet LCR requirements, and that Warsh will therefore find it impossible to reduce it.

**Fed doesn't want a 2019 sequel**

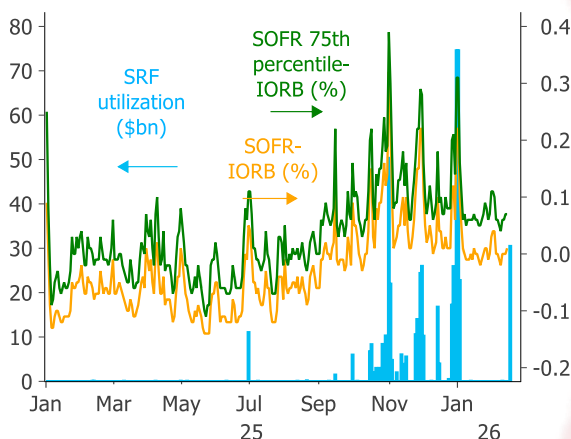
US funding spreads (%) vs reserves, 1m mov avg



Source: Fed, New York Fed, S&P Global, U.S. Treasury, BoE, ECB, ICE, Satori Insights.

**Funding spreads haven't fully subsided**

\$ repo rates vs Standing Repo Facility usage



Source: Federal Reserve, Bloomberg, Satori Insights.

**An overseas education: ample reserves regime change**

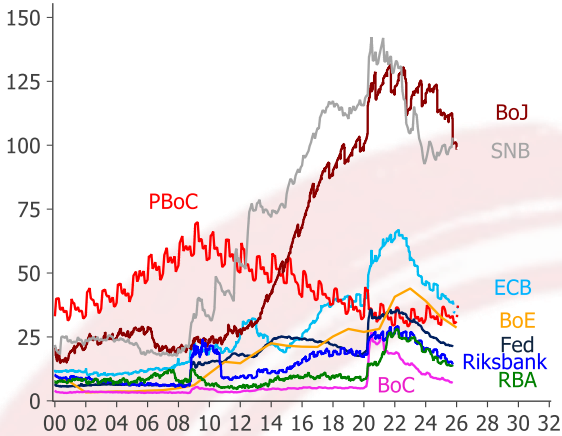
While there is some truth to this narrative, it need not be the limiting factor much US commentary makes it out to be. To see why, Americans need only look over the border.

How has Canada managed to shrink the BoC balance sheet to just 7% of GDP while the Fed lingers at 21%? The contrast in bank reserves levels is if anything greater still. Canadian banks hold just 0.7% of assets in reserves, versus 12% in the US.

<sup>5</sup> M. Cabana & K. Craig, cited in “BofA Says Warsh Unlikely to Be Balance-Sheet Hawk Markets Fear”, *Bloomberg*, 6 Feb.

### Shrinkage is clearly possible

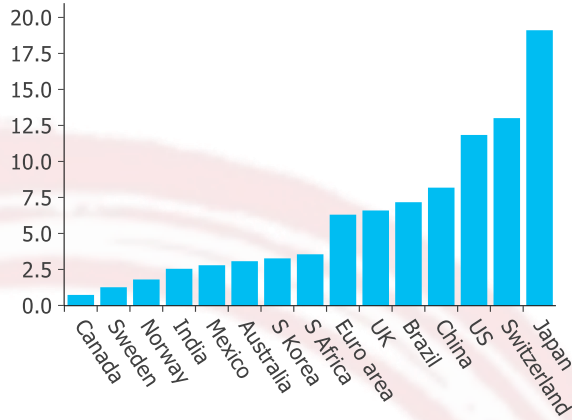
Central bank balance sheet sizes, % GDP



Source: ECB, PBoC, BOJ, SNB, Fed, BoE, Riksbanken, RBA, StatCan, Macrobond, Satori Insights.

### Non-US reserves ratios are often lower

Bank reserves levels (% bank assets)

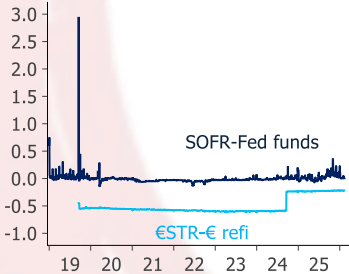


Source: APRA, OSFI, PBoC, BOJ, Fed, BoE, RBA, StatCan, SNB, ECB, Riksbanken, SCB, Bank of Norway (Norges Bank), SSB, RBI, BCB, BOK, FSS, SARB, BANXICO, Macrobond, Satori Insights.

Nor is this story specific to Canada. Multiple jurisdictions have been more aggressive than the US in dealing with what Warsh calls central bank balance sheet ‘bloat’, and almost everywhere other than Japan and Switzerland runs with lower bank reserves ratios. And yet ironically it is the US, and not these other regimes, which has had to deal with more high-profile bank failures in recent years and the US which has had by far the greatest level of money market rate volatility.

### Rate spikes are not inevitable

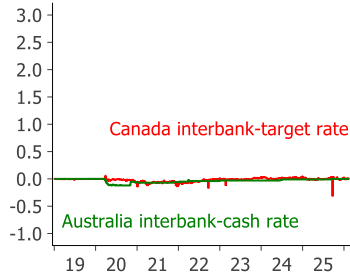
Overnight interbank-policy rate spreads, %



Source: ECB, Fed, Macrobond, Satori Insights.

### They can even be eliminated

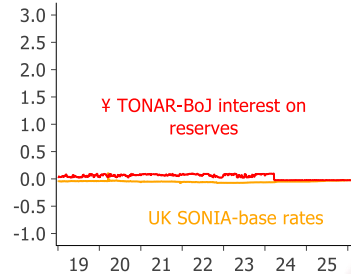
Overnight interbank-policy rate spreads, %



Source: Macrobond, Satori Insights.

### It's just a question of policy

Overnight interbank-policy rate spreads, %



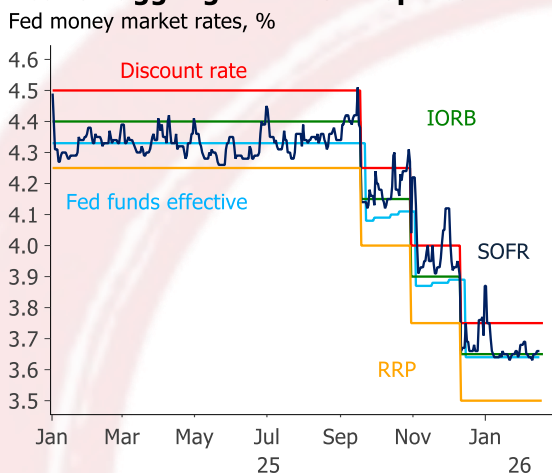
Source: Macrobond, Satori Insights.

The reason for the difference is really quite simple – but may involve a conceptual leap for those brought up in the US system. It is just a question of running an elastic demand-driven liquidity framework – such as those most other central banks around the world use – as opposed to the US’ relatively rigid supply-driven one.

In the Fed’s supply-driven ample-reserves framework, the central bank proactively supplies a large, fixed quantity of reserves – via asset holdings – to ensure they remain ample or abundant. The cost of ensuring administered interest rates feed through to the market is a persistently oversized footprint. Reserve quantity is set by the central bank; demand adjusts passively.

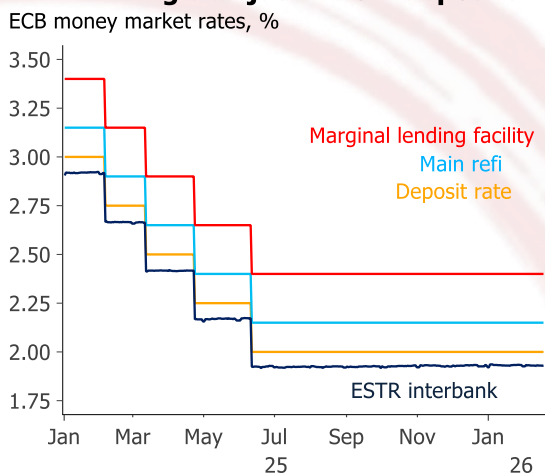
In demand-driven frameworks, in contrast, the central bank sets the price (e.g. via repo facility rates) and stands ready to meet banks' demand elastically. Reserves become endogenous (determined by banks' borrowing needs). This enables leaner balance sheets whilst maintaining orderly market rates without the need for perpetual abundance.

### Fed: struggling with SOFR spikes



Source: Fed, Macrobond, Satori Insights.

### ECB: ESTR glued just below deposits



Source: ECB, Macrobond, Satori Insights.

A shift from supply-driven to demand-driven needn't necessitate abandoning the current corridor (as Cecchetti & Schoenholtz suggest).<sup>6</sup> It would just constitute a different means of enforcing it.

As we see it, it would be rather like shifting from imperial to metric.

## Lessons from Isabel

Central bank money market operations are specialized and complex – and frankly of limited interest even to many economists. The usual presumption is that they can be safely ignored unless things are going obviously wrong. But it is precisely this asymmetric approach – caring only when reserves become scarce, not when they are ample or abundant – which we see as the hallmark of the current regime,<sup>7</sup> the feature most likely to be altered under Warsh, and which has the most far-reaching implications for markets.

For a perfect summary of the Fed's current attitude, see Christopher Waller's balance sheet speech from last year:

<sup>6</sup> "More fundamentally, shrinking the balance sheet dramatically – taking it back to 'scarce reserves' territory – would almost certainly require abandoning the corridor system altogether." in "[Warsh's war on the Fed balance sheet](#)", S. Cecchetti & K. Schoenholtz, *FT Alphaville*, 16 Feb.

<sup>7</sup> [The asymmetric Fed](#), May24.

"...the Fed can provide all the liquidity that banks need at zero marginal cost, which makes me wonder why some want to make reserves scarce. I often use the following analogy to drive this point home: If governments could provide clean, safe drinking water for citizens at zero cost, why would they make it scarce?"<sup>8</sup>

The key unquestioned assumption in this otherwise seductive analogy is that there is no risk of citizens drowning when liquidity runs to excess. In a supply-driven framework it is the Fed and not the citizens who control the tap.

Contrast Waller with Isabel Schnabel's description of the ECB's framework in her outstanding and comprehensive speech on the balance sheet last November.<sup>9</sup> Admittedly the style is a little less prosaic ("Elastic reserve supply decouples the pace of QN from interest rate control.") But she even goes so far as to mention the Fed:

"A key advantage of a framework in which the marginal unit of liquidity is provided on demand, rather than through asset purchases, is that liquidity is always available when banks need it, *but is never intentionally supplied in excess* [emphasis added].

Another advantage is that it frees the central bank from having to estimate the uncertain volume of reserves necessary to steer short-term money market rates towards the key policy rate, as would be the case in a supply-driven framework.

If reserves are primarily supplied through asset purchases, as in the US Federal Reserve System's operational framework, the central bank needs to calibrate the pace of QN<sup>10</sup> carefully, as money market rates could rise abruptly if liquidity becomes scarce.

By contrast, in a demand-driven framework, there is no direct link between the pace of QN and interest rate control. In the euro area, a rise in repo rates would therefore not lead to a slowdown in, or the end of, QN.

We expect that our monetary policy bond portfolios will be run down completely..."

We have no hard evidence that this is the sort of shift Warsh (and Bessent) have in mind. But he clearly has the motivation. His deep markets pedigree (as opposed to the PhD-heavy Fed norm) and his hands-on review of the BoE's monetary policy procedures provide the means. The question is whether he'll be given the opportunity.

## Regime change is always sudden

The final point to make is one which featured already in our previous piece: regime change, when it comes, is almost always sudden. And on such a technical topic as this we

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<sup>8</sup> "[Demystifying the Federal Reserve's Balance Sheet](#)", FRB Dallas, Jul25.

<sup>9</sup> "[Towards a new Eurosystem balance sheet](#)", 6 Nov.

<sup>10</sup> "Quantitative Normalization" – which she argues is a more accurate description than QT.

think there is considerably more scope for Warsh to win over a sceptical FOMC than on, say, his more dubious arguments about productivity reducing inflation.<sup>11</sup>

The real shift required is the abandonment of the idea that running a large balance sheet with liquidity in abundance carries no associated disadvantages. The idea that “small is beautiful” may come more naturally to Europeans like Schnabel, but it is clearly one Warsh shares and which we think others could be won over to. Beth Hammack’s Apr25 balance sheet speech suggests she is not far from Warsh’s camp already, citing not only financial and reputational but even financial stability risks stemming from a large balance sheet.<sup>12</sup> She even cites Schnabel. Even if others are unlikely to share the same concerns around excessive risk taking by investors, they too seem to be finding disadvantages, such as Jeff Schmid’s worry around blurring the lines between monetary and fiscal policy, or Michelle Bowman’s concern about “masking signals of market stress”.<sup>13</sup>

Just as we argued previously, we see scope for Warsh to sway the FOMC relatively quickly on this point precisely because it is so technical. Bring over Logan and Perli and others might start to see the benefits of a combined package of renewed balance sheet reduction, additional rate cuts to offset the tightening in financial conditions, and most likely banks making the same sort of additional Treasury purchases to meet LCR requirements that Schnabel notes have already happened in Europe.<sup>14</sup>

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<sup>11</sup> For an excellent counterargument see [“The real Greenspan lesson for Warsh on inflation”](#), J. Furman, *FT*, 12 Feb.

<sup>12</sup> “I see costs from having a balance sheet that is larger than necessary in an ample regime. There are costs to the public from having to pay more interest on reserves than would otherwise be needed. There are costs coming from potential communication challenges if we do not execute on our plan to achieve the ‘just-above-ample’ point. And there are costs of sequestering valuable collateral by holding too many Treasury securities on the Fed’s balance sheet. Treasury bonds are the linchpin of the money markets. Locking them up by holding them on our balance sheet removes that collateral for repo transactions and reduces the quantity of low-risk assets available for investors to hold.

Perhaps relative to some others, another cost I see from a large balance sheet comes from financial stability risks. To the extent that a large balance sheet with more-than-ample reserves dampens money market volatility, it also promotes risk-taking in financial markets. We have seen this with the increase in hedge fund basis trading and invoice spreads, a trend worth watching and one I’ve noted elsewhere.

Fortunately, there are alternatives to maintaining a very large supply of reserves...” – [“The Federal Reserve’s Balance Sheet: Some Major League Questions”](#), *FRB Cleveland*, Apr25.

<sup>13</sup> [“Bowman Says Fed Should Use Smallest Possible Balance Sheet”](#), *Bloomberg*, Sep25.

<sup>14</sup> “Over the past three years, the repayment of LTROs and QN have reduced the overall supply of reserves in the system by more than €2tn.

As excess reserves count one-to-one towards the high-quality liquid assets (HQLA) that banks hold, the decline in reserves mechanically leads to a fall in their HQLA, unless banks choose to absorb the newly issued bonds replacing the maturing central bank holdings.

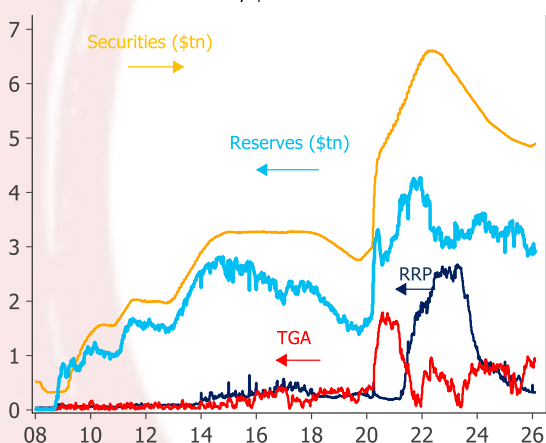
In a counterfactual scenario without such bond purchases, the liquidity coverage ratio (LCR) of significant institutions would already have fallen below 130%.

In reality, however, we have seen banks purchase sizeable amounts of government bonds,

The Fed prides itself on avoiding frequent, discretionary interventions in markets – yet it turns a blind eye to the most pervasive intervention of all: the massive, unpredictable swings in reserves driven by TGA fluctuations. These passive drains and floods – often hundreds of billions in weeks – tighten or loosen liquidity without any FOMC vote, distorting money markets and complicating QT far more than any deliberate repo operation ever could. Staff work suggests insiders are starting to see the drawbacks of this hands-off approach<sup>15</sup>, with one recent note even acknowledging that the current setup sacrifices efficiency for the illusion of stability, and recognizing some of the advantages of demand-driven regimes.<sup>16</sup> A little market-savvy leadership from Warsh could easily tip the balance.

### Bad vibrations

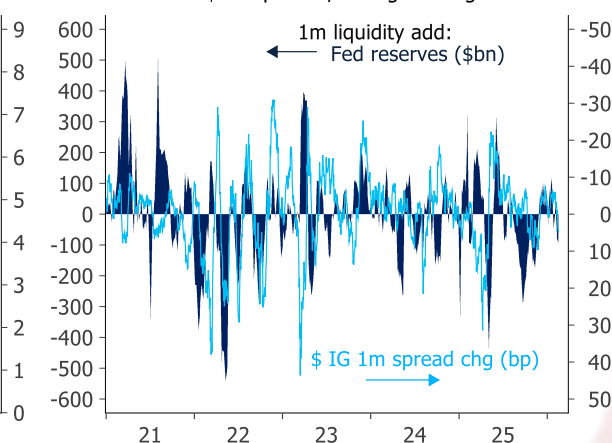
Fed balance sheet items, \$tn



Source: Federal Reserve, Satori Insights.

### Recipe for financial instability

Fed reserves vs \$ IG spreads, rolling 1m chg



Source: Federal Reserve, S&P, Satori Insights.

We covered the potential implications for markets in our [previous note](#): not necessarily a steeper yield curve, but less momentum-chasing, weaker risk assets and ultimately much more rate easing than the economy might currently seem to merit. While it's too early for these considerations to act as sole drivers of market views given both fiscal stimulus and the increasing ructions from equity rotation and AI, it's interesting that this has already been markets' direction of travel.

In sum, the real horror story isn't a Warshian balance sheet contraction – it's the difficulty many US commentators have seeing beyond their existing domestic paradigm. The lesson

effectively transforming part of their reserve holdings into securities that qualify as HQLA.

As a result, the aggregate LCR of significant institutions in the euro area has fallen only marginally since 2022 and remains well above pre-pandemic levels. In fact, banks' HQLA holdings have even marginally increased over this period." - [Towards a new Eurosystem balance sheet](#), 6 Nov.

<sup>15</sup> ["Fluctuations in the Treasury General Account and their effect on the Fed's balance sheet"](#), A. Vissing-Jorgensen, *FEDS Notes*, Aug25.

<sup>16</sup> ["The Central Bank Balance-Sheet Trilemma"](#), B. Duygan-Bump & R. Jay Kahn, *FEDS Notes*, 14 Jan.

from Isabel – and increasingly from Fed staff themselves – is that small can indeed be beautiful, if only the consensus dares to look.

