

Partners in prime: The Fed and Treasury's new relationship

NO FINANCIAL institution or government agency matters more to the Treasury market than does the Federal Reserve. The central bank's responsibility for financial stability and monetary policy has made it a mammoth buyer of Treasuries in this century, snapping up trillions of dollars' worth after the global financial crisis in 2007-09 and again during the covid-19 pandemic. As a result, the Fed's balance-sheet is far larger than it once was: it held less than \$1trn in assets two decades ago, but now wallows in around \$6.7trn.

Kevin Warsh, who became chairman of the Fed in May, considers this an unhealthy aberration. He argues that the expansion of the Fed's balance-sheet has mostly enriched people who were already wealthy (because when the Fed splashes money around in financial markets, the prices of the assets held by individuals go up). Perhaps more worrying, he says, the Fed's repeated interventions muddy important market signals, and make it more difficult for investors to discern creditworthy borrowers from risky ones. He dreams of a Fed with a far smaller role in financial markets.

In Scott Bessent, the treasury secretary, Mr Warsh finds a partner with similar views. Mr Bessent argued last year that the Fed's balance-sheet expansion had strayed into territory usually reserved for elected policymakers—showering favour on, say, the biggest firms that borrow in bond markets, while potentially making it harder for small firms to find credit to expand. Mr Bessent could pursue a strategy that would both limit the Fed's role in markets and reduce America's burgeoning interest bill.

Mr Bessent currently hopes for the Treasury to issue more short-term debt (known as bills), since the interest the Treasury has to pay on such bonds is typically lower. That might help with the interest bill, but it would make America's debt far more vulnerable to changes in interest rates, known as "rollover risk".

Mr Bessent hopes to limit the Fed's role in markets

If the Fed wanted to look less meddling, the natural thing to do would be to rejig its holdings to match the maturities of the overall stock of Treasuries outstanding. That would leave it holding less long-term debt and more bills. A retreat from long-term bonds would probably have the opposite effect to that of its buying spree: interest rates on such bonds would have to go up to persuade private investors to pick up the slack. The Fed's share of the Treasury market has already been declining, from 26% of Treasuries in 2022 to just 12% today. (The Fed's balance-sheet has shrunk too, as it has let bonds it holds mature without replacing them, at the same time as the federal debt has surged.)

If the government's borrowing costs rise, so do those of everyone with a loan in dollars. Researchers like Andrew Lee Smith of the Kansas City Fed and Victor Valcarcel of the University of Texas at Dallas have shown how reductions in the Fed's holdings of Treasuries have led to higher long-term interest rates, as investors face a less liquid Treasury market and a little less certainty about the future. The increase seems to have come through the term premium, a tough-to-measure residual that compensates investors for the various uncertainties of holding long-term bonds.

Fed up already

Having a less active buyer in the Fed also increases risks to financial stability should there be a selling panic in Treasuries. Funding markets seized up in September 2019, causing the interest rates on overnight loans between large financial firms (known as the repo market) to spike dramatically, a problem which some economists attributed to the shrinking of the Fed's balance-sheet. And the same market looked stressed again in the final quarter of last year, after the Fed had stopped shrinking its balance-sheet.

In a moment of extreme dysfunction, most analysts believe the Fed would quickly reassert itself to bring stability back to the Treasury market. Mr Warsh himself has made clear that these moments are when the case for intervention is most compelling. "The Fed is always going to step in and do what it can, even if it blows up the balance-sheet," says Darrell Duffie, an economist at Stanford University. "But

even with all guns blazing it can't stop Treasury-market dysfunction. It can only make it less bad." Mr Duffie notes that despite the Fed's intervention during the dash for cash in 2020, it took a number of weeks before the market returned to a state of relative normality.

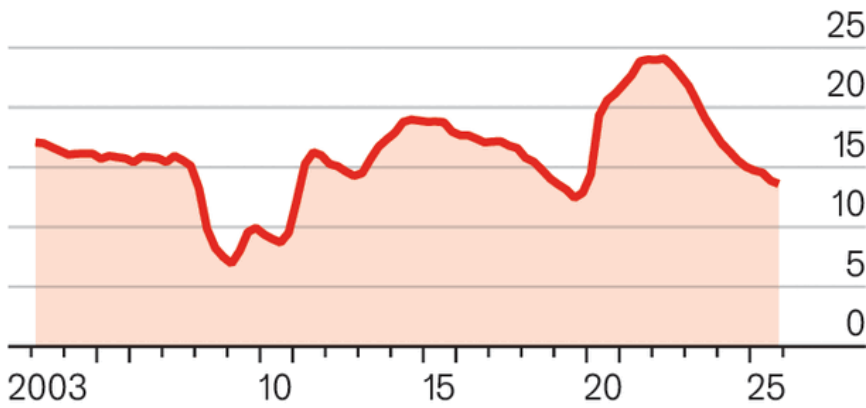
Nellie Liang, a Treasury official during the Biden administration, says that in a fresh crisis the Fed's job would be complicated by a different set of economic conditions. When the Fed began buying Treasuries in huge volumes in March 2020, that suited both its monetary-policy and financial-stability objectives: soothing a chaotic market while boosting an economy in danger of freefall owing to the pandemic.

Today, that would not be the case. Inflation remains stubbornly above the Fed's target of 2%. If a Treasury-market blow-up were to come at the same time as a supply shock—a slump driven by sudden trade restrictions, or a surge in energy prices—the Fed's goals would be in conflict.

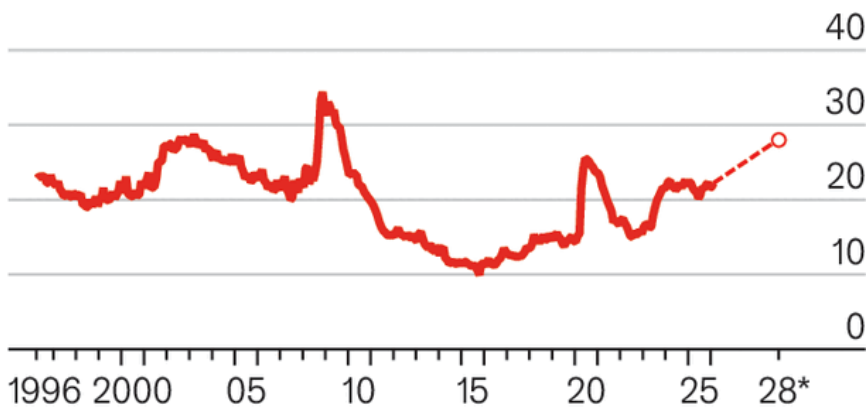
Short-term thinking

United States

Federal Reserve share of publicly held federal debt, %



Short-term government debt, % of total



Ten-year government-bond spread over three-month Treasuries, % points



*JPMorgan Chase heavy-bill-issuance scenario

Sources: Bloomberg; Federal Reserve; JPMorgan Chase

Mr Warsh has talked about the Fed and the Treasury working together to avoid a clash of monetary and fiscal policy. That may mean a formal arrangement whereby they coordinate how much debt the Treasury plans to issue, at what maturities, and what debt the Federal Reserve plans to buy.

But even without a formal understanding, there are ways in which the Fed's and Treasury's priorities may dovetail with one another. The Treasury debt held by the Federal Reserve has a much longer average maturity than the market more generally. If Mr Warsh nurses fears that the Fed is badly distorting financial markets, then holding more short-term Treasury debt and letting long-term bonds mature would more evenly spread the Fed's large footprint.

Although Mr Bessent criticised his predecessor, Janet Yellen, for raising the share of bills in total debt issuance from around 15% to 22%, the path he seems inclined to pursue looks likely to push it even higher still. If the amount of longer-dated debt issued by the Treasury does not increase, analysts at JPMorgan Chase, a bank, suggest that the percentage of issuance accounted for by bills would rise to 28% by the end of 2028. The share of bills was last so high in 2009 (see chart); the Treasury market was then around half its current size relative to the American economy.

A pivot to more short-term financing carries risks

Many investors and traders believe that more Fed demand for short-term debt would give Mr Bessent the opportunity to issue more Treasury debt in the form of Treasury bills. The yield curve, which plots bond rates at different maturities, is sloping upwards again: one-month Treasury bills yield 3.6% while 30-year bonds yield over 5%, so money can be saved by pivoting from long- to short-term debt. Mr Bessent's interest in stablecoins as a [source of demand for short-term Treasuries](#) also indicates that he would be happy to increase the supply of bills.

Buying shorter-term debt would help to avoid the risk of gigantic losses like the Federal Reserve inflicted on itself in the aftermath of the pandemic. Its quantitative-easing programme in effect borrowed short by creating interest-paying reserves owed to commercial banks, while at the same time lending long, by buying long-term Treasuries. When interest rates surged, the value of its bond portfolio holdings

plunged, while the Fed suddenly owed more interest to the banks it had borrowed from.

Mortgaging the future

But a pivot to short-term financing would carry risks for Mr Bessent too. For one, letting longer-term Treasury debt held by the Fed mature without replacing it will probably raise the crucial ten-year Treasury yield, the most monitored benchmark in the world for long-term interest rates. The rates of interest on America's 30-year mortgages are driven by the ten-year Treasury yield. Mr Bessent would struggle politically with any accord that is seen as raising costs for homeowners.

A shorter-term borrowing schedule also means that far larger quantities of debt must be issued at regular intervals, raising the stakes during any moment of funding stress. And if a lot of government debt is funded with Treasury bills, any increase in interest rates feeds through immediately into interest payments. That rollover risk would expose the federal government to much larger payments if rates rise suddenly.

Peter R. Fisher, who served as a Treasury official between 2001 and 2004, shares the sceptical view of the Fed's humongous balance-sheet held by Mr Bessent and Mr Warsh. But he is more concerned about the continued drift towards short-term borrowing under Mr Bessent. "He's got a very short horizon. You can tell he's a former hedge-fund guy," Mr Fisher says, referring to a propensity at hedge funds to take gambles. Doing that with investors' cash is one thing—with America's safest asset, quite another. ■