

Should There Be a New Treasury–Fed Accord?

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Task Force on Monetary Policy, Treasury Market Resilience, and Economic Prosperity
Revisiting the Treasury–Fed Accord

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Chairman Lucas, Ranking Member Vargas, and members of the Task Force on Monetary Policy, Treasury Market Resilience, and Economic Prosperity, thank you for the opportunity to discuss “Revisiting the Treasury–Fed Accord.” The purpose of the original accord was to clarify roles and responsibilities between the US Department of the Treasury and the Federal Reserve System (Fed), both among the most important financial institutions in the world. The question of a new accord comes at a time when the US is running ever larger fiscal deficits, and monetary policy is under increasing pressure to help the Treasury smoothly fund those deficits; some fear this funding comes at the expense of too-high asset and consumer price inflation.

I appreciate this opportunity to share my perspective on the topic, and I begin with my conclusion: An accord is needed, but I would emphasize that to be successful, it also will need the explicit support of Congress.

Over the past nearly two decades, the Fed and Treasury have expanded their roles within the economy. The Fed has been an increasingly significant buyer of Treasury debt, first to inject liquidity into the economy during crises, but then to support Treasury funding of an ever-larger national debt. The Fed’s support has helped keep interest rates stable and low. This situation is similar to what occurred in the period following World War II, when the Fed bowed to the Treasury’s insistence that the Fed help fund the nation’s debt at low interest rates.

In 1951, the Fed regained its independence from the Treasury by negotiating an accord that defined their respective roles and recognized that the Fed should focus on price stability and not be involved in fiscal policy. Circumstances today mirror that period, and the idea of a new Treasury–Fed Accord is a timely one.

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The Fed's Expanding Mandates

The Fed's legislative mandate is to conduct monetary policy "so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."¹ In pursuit of these goals the Fed has remained mostly insulated, or independent, from short-term political control and influence.

In theory, when the economy is growing too slowly or below potential, the Fed can lower policy rates, as it judges necessary, to stimulate the economy to bring it back to potential. That's the easy part of independence. When inflation is increasing, or threatening, because of too-rapid credit growth or related factors, the Fed can raise rates to slow the economy and bring it back to normal. That's the harder part of independence.

When there is a crisis, a liquidity crisis for example, the Fed provides a temporary liquidity facility to preclude a possible collapse of the system. But then, as quickly as possible, the Fed is expected to remove the stimulus and return to a more normal policy, thereby minimizing the likelihood of unintended distortions within the economy.

In practice, however, the Fed has taken on an expanded role in financing the nation's growing debt. Over time, an independent Fed, with no objection from Congress or administrations, has broadened its interpretation of the mandate, and at its own discretion has deepened and extended its role in fiscal matters and within the financial economy. This evolution toward fiscal policy is well illustrated in the way the Fed has operated since the great financial crisis (GFC) of 2008.

Although the GFC ended in 2009, the Fed continued its use of large-scale asset purchases of government and government-guaranteed debt—a practice called quantitative easing (QE)—into the next decade. This exceptional policy became one of the Fed's standard operating tools, teaching Congress and the Treasury that it was a ready buyer of the federal debt. Between 2010 and 2015, for example, the Fed's balance sheet increased from \$2.3 trillion to \$4.5 trillion. After the pandemic, the Fed again extended its QE program, increasing its balance sheet to nearly \$9 trillion. Through these QE programs the Fed has come to dominate the Treasury debt market and has weakened the market's role in controlling the government's propensity to spend and borrow.

The Fed also purchased mortgage-backed securities during the GFC and still holds them today. These purchases further expanded the Fed's fiscal reach by supporting the housing market, which at the time was under severe stress. While well intended, the purchases involved the Fed in a form of credit allocation, an issue that is proper to fiscal rather than monetary policy.

In 2019 and 2020, the Fed again engaged in large-scale asset purchases to support a highly leveraged government securities market that ran into difficulty from a significant spike in the securities repo rate. The purpose of the Fed's intervention was to keep the Treasury market calm and operating smoothly, and to avoid economic volatility. It is noteworthy that the temporary liquidity intervention continued into 2020, well after the September 2019 repo rate spike.

Recently, the Fed began offering the banking industry a standing repo facility. This facility is a substitute for the discount window and is much easier for banks to access. It may be accurate to say that

¹ 12 U.S.C. § 225a (2000).

the facility makes the Fed the lender of first resort, the goal being to ensure that the Treasury market functions smoothly, remains highly liquid, and stays elastic as it grows ever larger.

My concern is that these Fed actions have left in their wake a less independent central bank, a less accountable market, and, I fear, a less constrained government budgeting process. There is now a deep-seated expectation on the part of the Treasury, Congress, Wall Street, and even some within the Fed, that the Fed has an implicit mandate to intervene as necessary to maintain asset values and a smoothly functioning securities market. The risk is that by embracing this mandate, the Fed also implicitly accepts the tradeoff of higher inflation in assets and consumer prices. For example, this past December the Fed lowered its policy rate and restarted QE, although inflation at the time remained close to 3 percent, already above the Fed's 2 percent inflation target.

To get a further sense of the effects of the government's growing debt and Fed's expanded mandate, here are some economic trends that occurred between 2005 and 2025:²

- Nominal GDP increased two and a half times, from \$13 trillion to more than \$30 trillion, while real GDP has increased one and a half times.
- The Consumer Price Index (CPI) almost doubled (increased 1.7 times).
- The gross federal debt increased 4.8 times, from about \$8 trillion to over \$38 trillion, exceeding 100 percent of GDP.
- The Standard & Poor's 500 index increased 5.5 times.
- The median price of a home increased 1.6 times.
- By contrast, real weekly earnings, wage and salary, increased 1.1 times over that same period.

The above numbers show how significantly large government spending and the Fed's monetary accommodation affected US asset inflation and the CPI over a relatively short period.

Gross federal debt will reach \$40 trillion this year. The US will add another \$2 trillion to its debt this year and each successive year for many years to come. Should demand for Treasury securities among foreign or domestic buyers slow relative to this increasing supply, it would put upward pressure on interest rates. The Treasury would most likely expect the Fed to increase purchases of the debt to keep markets calm and prevent rates from rising.

This past fall, for example, the secured overnight financing rate rose above the Fed's target rate, reflecting, in part, tightening liquidity conditions in the Treasury market. Not long after this, under the heading of assuring ample bank reserves, the Fed restarted QE by purchasing \$40 billion per month of government securities. These purchases average close to 25 percent of the monthly increase in the nation's debt. This action adds liquidity to the market and helps contain the cost of debt-financed government expenditures. But it also accelerates the growth in bank deposits and the money supply and, over time, contributes to asset and price inflation.

² Thomas Hoenig, "Fiscal and Monetary Policy: On Thin Ice," *FinRegRag*, February 24, 2026, <https://www.finregrag.com/p/fiscal-and-monetary-policy-on-thin>. See also Thomas M. Hoenig, *Knocking on the Central Bank's Door* (Peterson-Pew Commission on Budget Reform Policy Forum, February 16, 2010), <https://www.kansascityfed.org/documents/1776/speeches-washingtondcfiscal021610.pdf>.

Had the Fed chosen not to purchase the \$40 billion of Treasury securities per month, would a successful Treasury auction have required higher interest rates? Given the Fed's implied mandate to assure a smoothly functioning Treasury market, did the Fed expand its balance sheet to accommodate this mandate instead of moving inflation more deliberately to the 2 percent goal? These are fair questions given the rapidly expanding national debt. Under current conditions, it seems likely that pressure will only build for the Fed to monetize future debt, thereby leading to fiscal dominance.

A New Treasury–Fed Accord

So long as the Fed continues to monetize the nation's deficits, asset and price inflation will follow. Stable prices cannot be achieved without fiscal and monetary policy discipline. Fortunately, there is a playbook that points toward a solution. After World War II, the US had a similar problem. The federal debt was over 100 percent of GDP, and Treasury expected the Fed to keep interest rates low in order to keep the cost of the federal debt low. Inflation was also increasing, however, and the Fed could no longer both suppress interest rates on Treasury debt and control inflation. Treasury rates would have to be allowed to increase, raising the government's costs of debt.

The conflict between the Treasury and the Fed was tense, so much so that President Truman called the entire Federal Open Market Committee (FOMC) to the White House to resolve the conflict. Ultimately, a compromise was reached in the form of the Treasury–Fed Accord of 1951, which confirmed the Fed's right to set interest rates independent of the Treasury.

A new Treasury–Fed Accord that scales back the Fed's role in the Treasury debt market is needed. The Fed must be allowed to focus on price stability, in terms of both assets and CPI. QE should not be a means to monetize Treasury debt. Importantly, also, such an accord does not have to shock the economy. It can be implemented over multiple years, allowing time for the government to reduce its deficits and for the Fed to concentrate on its price stability mandate. A reduction in the deficit from 6 percent to 3 percent, for example, would greatly reduce pressure on interest rates, facilitate private investment, and enable the economy to grow out of its debt dilemma.

To give you a picture of how this could evolve, consider the 10 years following the 1951 Accord. The debt-to-GDP ratio fell from 90 percent to 55 percent, and government deficits over the period averaged below 3 percent of GDP. Real GDP growth averaged near 4 percent while inflation averaged less than 2 percent. Such outcomes benefit all.

Admittedly, today's economy is different from that of 1951. While the fundamental problem is the same, which is that the nation's debt relative to income (GDP) is excessive, in the 1950s deficits were less severe, with surpluses in some years. Today it will be difficult to throttle back the nation's growing deficits, which makes it difficult for the Treasury to fund the ever-rising debt without Fed backup. The pressure to monetize the debt will only increase as annual deficits continue.

Finally, assuming the deficit problem goes unaddressed, a last option would be for the Fed to cease monetizing the debt, thereby slowing the growth of bank reserves and letting interest rates rise, perhaps substantially. Such an option would mirror the policies of the FOMC in late 1979 under Paul Volcker's leadership, in which the FOMC restricted the growth in reserves, letting interest rates rise to double-digit levels. Such a policy would significantly disrupt the Treasury market and plunge the

economy into a deep recession. Such an action might cause Congress to more aggressively address the debt problem, but it also could quicken the demise of an independent Fed.

Thus, a new accord in which the Fed's primary mission is price stability that enables maximum employment, and in which the Treasury is responsible for the management of the nation's debt, is of vital importance. It also is imperative, however, that Congress control the growth of the nation's debt, and that the deficit be reduced to closer to 3 percent of GDP, a far less burdensome level than it currently carries. Under such an accord, history suggests that the US debt-to-GDP ratio would decline, investment levels would rise, and real economic growth and income would increase.