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### **Revisiting the Treasury-Fed Accord**

It can be hard to visualize the Treasury market at the time of the original Treasury-Fed accord – most Treasury securities were offered at fixed rates (rather than auctioned), maturities offered were based on the views of market conditions by Treasury officials, offerings might not be marketable (that is, could not be sold to other market participants), might be sold with an early repayment option, or might be exchangeable for another Treasury security. In addition to these security characteristics, market participants were accustomed to Treasury leadership on interest rate policies through its choices of interest rates on new issues. Economic conditions in 1951 are even harder to fully appreciate – over the previous six years, WWII had ended, the manufacturing base was transitioning from making military equipment to making consumer goods, the employment and manufacturing transitions had caused sharp spikes in unemployment and inflation, post-war memories were still haunted by the pre-war depression and, at the time of the accord, we were in the midst of another war and inflation was high.

With this background, it may be easier to understand the accord as a way out of an impasse between the Treasury and the Fed: Treasury was accustomed to the Fed supporting its decisions even when Fed officials had become uncomfortable with high inflation. The accord was a compromise that broke the impasse in a way that gave the Fed freedom to focus its policy decisions on economic conditions rather than Treasury financing needs while agreeing to support Treasury offerings as long as they were brought at market yields as determined by the Fed.

The Fed's use of that freedom evolved in the following years, including an attempt in the 1950s to limit its open market activity to buying and selling Treasury bills. Economic and financial market pressures over the following decades led to a Fed portfolio at the beginning of 2007 of Treasury securities unevenly distributed across maturities. On a mostly separate track, the Treasury market slowly evolved to the market we have today – regular issuance of predictable quantities priced through transparent auctions. This

evolution is important context – the government, as a whole, is much less involved in price setting for its debt than it was 1951, partly as a result of the accord and partly from a broader trend away from price-setting.

The current path of projected deficits, if realized, will eventually lead to Treasury market instability that will force the Fed to intervene. The level of debt at which this instability occurs is unknown. While the Treasury market is lauded for its depth and resiliency, it is not immune to shocks that are inherent in financial markets stemming from human nature, not institutional structure. In the context of fiscal dominance, a shock would mean sharply lower prices for Treasury securities that the Fed sees as risking broader financial instability with adverse consequences for the real economy. The Fed would then respond with large scale purchases of Treasury securities which simultaneously increases bank reserves.

The traditional view of money and money supply is that an increase in bank reserves is inflationary so, while sharply lower prices for Treasury securities would normally be thought of as depressing demand leading to lower inflation, an increase in reserves associated with Fed asset purchases would provide off-setting pressure.

I'm not sure that is right though. There is little evidence of any relationship between reserves and inflation in recent decades. In addition, the Fed's large scale overnight reverse repo operations can buffer bank reserves from the Fed's open market operations, as we saw 2021-2024. That is, the economically depressing effects of lower prices (and higher interest rates) of Treasury securities may not be offset by increases in reserves.

So, what are the practical limitations on the Fed's purchases of debt to keep the amount of privately held Treasury securities manageable? Bank reserves are a form of lending by banks to the government. Policies that increase bank lending to the government rather than the private sector stunt economic growth. Policies that entice money market mutual funds to lend to the Fed through the repo market work so long as investors are willing to hold large amounts of their wealth with those Fed counterparties. Either outcome seems sub-optimal.

I will characterize most of the "credit accord" proposals as ways to reduce the Fed's flexibility in engaging in quantitative easing rather than steps to find common ground between the Treasury and the Fed (they have occupied a lot of the same space since the financial crisis). That is, there has not been much discord between the two institutions so what we are talking about is constraining the Fed's use of its balance sheet to limit the risk

that Fed asset purchases go on too long, are too concentrated in long-dated Treasury securities or detrimentally include mortgage-backed securities.

In dire situations, such as the financial crisis and the pandemic, we have seen that rules, regulations and even laws are set aside in the name of expediency so, when we think about constraints on the Fed we have two areas of focus: normal operating conditions and situations somewhere between normal and dire. To me, normal times seem like an easy lift. Most people (and the FOMC) agree that the Fed's balance sheet should contain Treasury securities and little else. We can also likely get agreement that those Treasuries should have maturities that are, at least, tilted towards the short end of the curve.

One difficult question is whether we can have clear guidance for the Fed when the economy is between normal and dire. Ideally, guidance would offset the market and political forces that can push the Fed to a larger, more diverse balance sheet. It is not entirely clear to me what that guidance would look like. The closer we are to a dire situation, the more important the judgments of Fed and Treasury officials are. The closer we are to a normal situation, the more likely that those same officials become complacent about policies that should be limited to dire events.