

A “Fed-Treasury Accord” Could Work

Warsh and Bessent should be comfortable with such a banking maneuver from their days on Wall Street.

By Donald L. Luskin

When **Kevin Warsh** goes before the **Senate Banking Committee** as the nominee for Federal Reserve chairman, he will face tough questions about his commitment to the Fed’s independence from the White House and the Treasury. Despite having said interest rates should be cut – a litmus test for President Trump – Mr. Warsh should have compelling answers. For more than a decade, he has called for reducing the Fed’s holdings of Treasuries and agency mortgage-backed securities, **ending an era** of “quantitative easing” in which the central bank has become entangled in fiscal and housing policy.

The problem is how to do that. Mr. Warsh’s **goals** seem to work against each other. Cutting rates eases Fed policy and supports today’s productivity-led growth. But shrinking the Fed’s assets is “quantitative tightening,” undoing the good work of lower rates.

Is there a way for Mr. Warsh to square the circle? Yes. Perhaps it can be found in his hints about a new **“Fed-Treasury accord,”** evoking the landmark 1951 agreement that established the modern Fed as an independent institution. Here is a modest proposal for how an accord between Mr. Warsh and Treasury Secretary Scott Bessent could work.

It’s a reasonable goal to reduce the central bank’s securities holdings to \$2.5 trillion, which is the level of **currency in circulation**. Until the Fed’s asset-purchasing spree began in the banking crisis of 2008, the level of currency in circulation – determined by market demand, not the Fed – was always approximately the ceiling for the Fed’s asset purchases. Above that, it’s monetization of debt, and that is what Mr. Warsh wants to counter. The pandemic crisis compounded the problem.

In rough terms for illustration, to get to \$2.5 trillion, the Fed would have to shed about \$3.9 trillion of its assets – \$1.9 trillion in Treasury securities and \$2 trillion in mortgage-backed securities.

It would also have to shed \$3.9 trillion in liabilities, which funded the asset purchases in the first place. About \$3 trillion of the liabilities are so-called excess

reserves of banks. This is an Orwellian misnomer, because there are no reserve requirements for banks whatever. The \$3 trillion is nothing more than deposits made by banks with the Fed – a full-faith-and-credit savings account with daily liquidity, earning a floating interest rate pegged to the policy target.

The other \$0.9 trillion is the Treasury's General Account, where the Treasury parks cash awaiting disbursement – an entangling service the Fed only began providing in 2008.

The challenge for the Fed is that if it sells or runs off its assets, the market – primarily banks – would – have to absorb them. This requires the banks to accept longer-term fixed-rate Treasury and mortgage-backed securities while giving up their overnight floating-rate deposits. In other words, banks would be required to take market risks – primarily duration and liquidity – they aren't taking now. When the Fed takes those risks instead, it creates the entanglements with those securities' issuers that Mr. Warsh wants to end.

How can Mr. Warsh get the Fed untangled? Simply transfer both the assets and liabilities to the Treasury. It's a version of a banking maneuver that Mr. Warsh and Mr. Bessent should be comfortable with from their days on Wall Street.

The exact operational and accounting mechanics aren't important. From the Fed's standpoint, the Treasury would effectively buy back \$4 trillion of Treasury and mortgage-backed securities – much as the Treasury does from time to time with outstanding bonds that have become illiquid. That transaction would change nothing for markets. Those securities aren't in the markets now (they are held at the Fed), and they won't be in the markets when they are returned to the Treasury.

The Treasury would pay for those securities by assuming \$3.9 trillion of the Fed's liabilities: the \$3 trillion of so-called excess reserves and its own \$0.9 trillion General Account.

The Treasury would put those liabilities into a new kind of security it has never offered before – what amounts to a savings account. Nothing would change for the banks now holding so-called excess reserves at the Fed. The Treasury savings account would offer full-faith-and-credit, daily liquidity and a floating rate indexed to the Fed's policy target.

Over time, Treasury could make this new savings account available to the public. Stablecoin issuers would be especially interested in a Treasury facility that provides perfect collateral, and the Treasury would be thrilled to have them as a new source of funding debts and deficits.

Is this legal? The Treasury has broad statutory authority to issue debt in any form, subject to the debt limit. Ideally the Treasury's new savings account would be exempted from that limit, considering it would be entirely demand-driven by savers.

The Fed is barred from trading directly with the Treasury, but it isn't clear that would rule out this swap of assets and liabilities. Legislation no longer than one sentence could fix that if deemed necessary. Other complications may arise, but doubtless they could be engineered away.

When it's done, banks would have everything they have today – what the Fed calls “ample reserves” – but they would be parked at the Treasury. The Fed would still be there for all its traditional functions. The federal government overall – considering the Fed and the Treasury together – would have exactly the same assets and liabilities with the same overall risk profiles.

But the distribution of assets and liabilities and of decision-making responsibilities would be optimized. The Fed would go back to being a central bank, and the Treasury to being a treasury. That's Fed independence, and how wonderfully counterintuitive it is that it may happen under this president.

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