Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

FED SHADOW

The Warsh-Bessent Fed-Treasury Accord

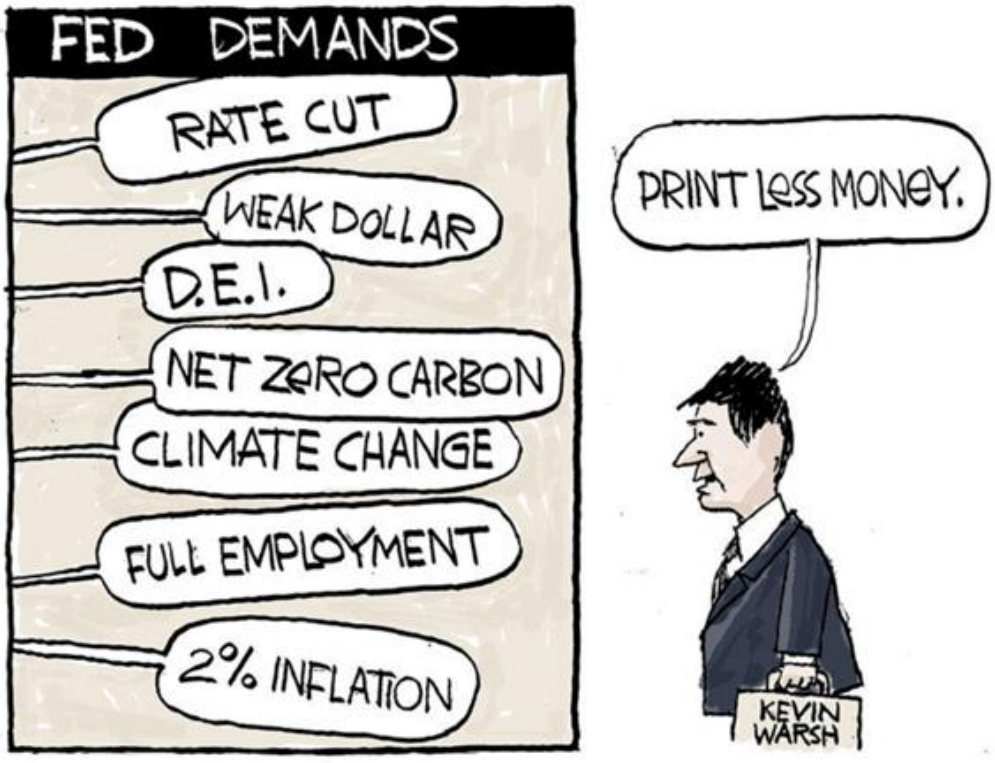
Monday, February 9, 2026

Donald Luskin

How to radically shrink the Fed's balance sheet without quantitative tightening. It's easy.

Kevin Warsh, President Donald J. Trump's nominee for Fed chair, has positioned himself as a reformer, leading to speculation about a new "Fed-Treasury Accord," echoing the accord in 1951 that established the Fed's independence (see "Our Hot Take: It's Warsh" January 30, 2026).

- *Warsh's top objective for reform is the reduction of Treasuries and MBS held on the Fed's balance sheet*. For many years he has argued publicly and privately that these holdings distort capital allocation and dangerously entangle the Fed in government debt management.
- *So while Warsh has said he favors lower interest rates now – a litmus test for Trump to nominate him – wouldn't a large reduction in the Fed's asset portfolio be a potentially more-than-offsetting "quantitative tightening"?*
- *No… not if it is carried out in the context of a new Fed-Treasury accord that is appropriately structured.*



Update to strategic view

FEDERAL RESERVE, US BONDS: Warsh wants lower interest rates, but he also wants to shrink the Fed's balance sheet. A new Fed-Treasury accord, echoing the one that gave the Fed its independence in 1951, would allow for a return of the Fed's $6.3 trillion asset holdings to the level of currency outstanding, $2.4 trillion – without any quantitative tightening. Currently when the Fed accepts so-called excess reserves from banks, it is effectively issuing a riskless security – full-faith-and-credit, one-day maturity, automatic rollover and floating rate. That funds bond and MBS purchases which take maturity out of the public markets, making it easier for the Treasury to fund debts and deficits, and distorts credit allocation. An accord to end all that could swap the bonds and MBS back to Treasury, with the Treasury assuming the obligation of the excess reserves. This would require creation of a new Treasury vehicle like a savings account, which would be as attractive to banks as the Fed's excess reserves, but also to stablecoin issuers and the public. Trump will have reestablished Fed independence.

There is inherent danger in a new Fed-Treasury accord because it would shake up an established order which, for all its flaws, markets have successfully adapted to. But like so many of Trump's initiatives, they seem at first to be overbroad, terribly risky and entirely unprecedented – but then, with a calmer look at history, they aren't as threatening as they seem (see "If These Risks Were Real, We'd Be Worried. Happily, They Are Not." January 26, 2026). *We've seen this movie before, and it ended well*.

- The Fed and the Treasury were heavily intertwined in World War II when the Fed bought Treasury debt to help fund war spending. Yield curve control was introduced to cap long-term Treasury yields at 2-1/2%. Public appetite for long-term bonds was strong, so the Fed ended up buying unwanted issuance at the short end, ultimately owning less long-term debt at the end of the war than when it had begun.
- In 1950 and 1951, with the prospect of an expensive war in Korea that would have to be funded – amidst rising inflation – the Fed wanted these arrangements to end. Then-President Harry S. Truman set the template for Trump. Not only did his surname have the same first four letters, but he wanted to buy Greenland from Denmark, and he hectored Fed chair Thomas B. McCabe to extend the World War II arrangements. It was in a mostly polite letter, not a nasty Truth Social tweet (nor a grand jury subpoena), but it was inappropriate enough and public enough to make McCabe resign.
- Negotiations ensued, between the New York Fed's Alan Sproul and the Treasury's William McChesney Martin. *An accord was agreed*, under which the Fed got out of the Treasury financing business. Martin, ironically, became the next Fed chair. *The Fed gradually ran off its bond holdings over five years*.
- The Fed wasn't worried about tightening monetary conditions by doing so. Then, that was seen as a feature, not a bug, because then, unlike now, the Fed was fighting high inflation.
- And there things stood, pretty much, until the Global Financial Crisis of 2008 and 2009, when the Fed introduced the first in a series of "quantitative easing" programs. Oh, there had been little indiscretions like 1961's "Operation Twist," in which the Fed bought long-term Treasuries specifically at the behest of President John F. Kennedy (you see, Trump is hardly alone in telling the Fed what to do). *But it took the GFC to really break the accord. Maybe it was necessary then to save the world. Now, that's what Warsh wants to fix*.

But how could a new Fed-Treasury Warsh-Bessent accord reform the Fed by reducing its asset holdings without tightening financial conditions, which is the last thing Trump wants it to do? To see how, let's examine what exactly the Fed's asset portfolio does.

- The first thing that must be understood – and this is confusing when thinking about the Fed in relation to the Treasury – *the Fed is, in fact, just like the Treasury, an issuer of government securities*.
- The key difference is that *the Treasury issues bills, notes and bonds, while the Fed issues money, that is, currency and coins*.

Contact TrendMacro

On the web at
trendmacro.com

Donald Luskin
Dallas TX
214 550 2020
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625

tdemas@trendmacro.com
Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

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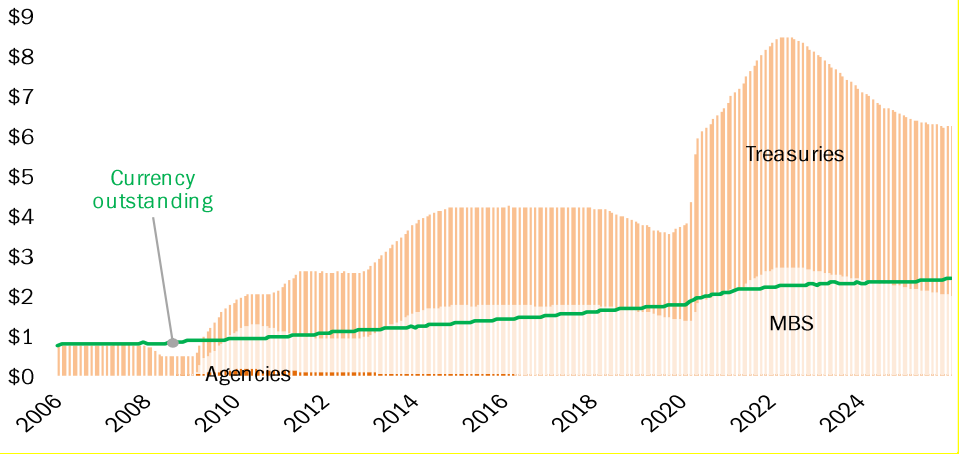
- Currency is special. It differs from Treasury bills, notes and bonds in three key respects:
- *Currency does not pay interest* (you get nothing for holding a $100 bill).
- *Currency has zero maturity* (you can exchange it for goods and services at any time).
- *Currency is demand-driven* (the Fed only produces exactly as much as the public wants to hold and takes back any that the public wants to return).
- *But make no mistake about it, currency is a form of debt of the US government. The proof: the government will accept it from you when you pay your taxes, effectively swapping it for your debt to the government in a mutual cancellation.*
- Before the GFC, *the Fed's asset portfolio consisted mostly of Treasury bills financed by the currency the Fed issued, and a little bit by required minimum reserves deposited by banks*. *So the level of currency outstanding was a limit to the level of assets held by the Fed* (please see the chart below).

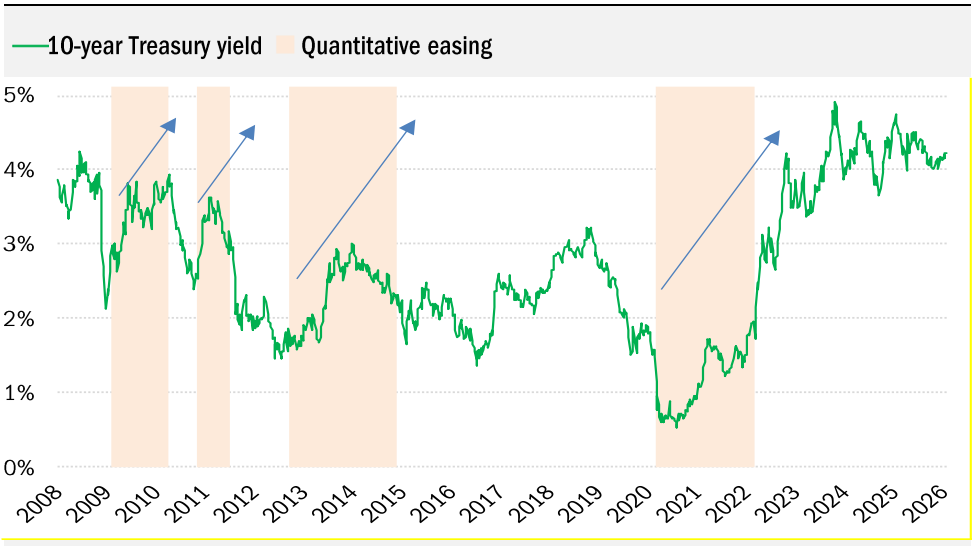
Currency outstanding versus Fed holdings of government-issued securities (USD trillions)



Source: FRB, TrendMacro calculations

- The currency earned no interest, and by law the required reserves didn't either. So the Fed got to keep the interest earned from the Treasury bills without, in turn, having to pay any interest. This is the ancient concept of seignorage.
- Yes, the Fed remits the seignorage to the Treasury (minus its own operating expenses – "carrying charges, my boy, carrying charges"). But we don't see this as a form of the Fed financing the government, because the currency the Fed issues is a service demanded by the public as a medium of exchange – the seignorage is only a toll charged to drive that road.
- Further, the fact that *the Fed held primarily short-term bills – more than half had maturities of less than one year – meant that it was not distorting very much the maturity profile of Treasury issuance the public must absorb* – the Fed was giving the public zero maturity currency and absorbing mostly near-zero maturity bills.

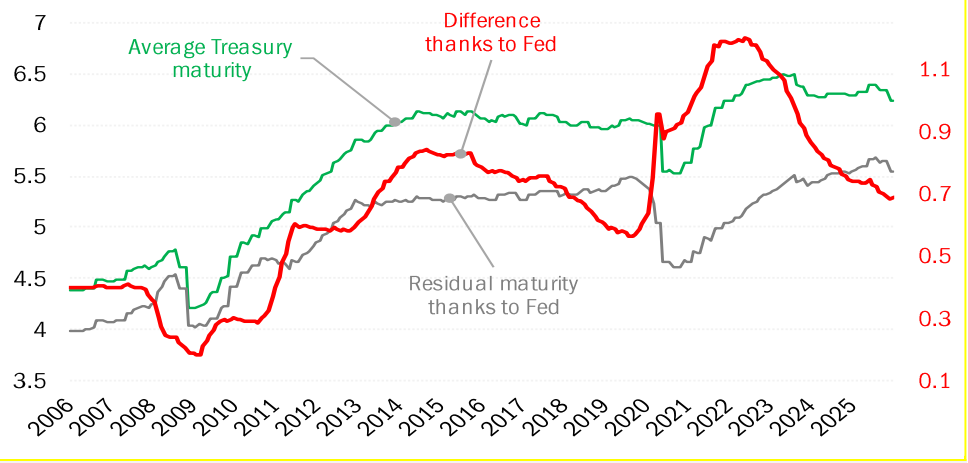
- With the Great Financial Crisis, all this was abrogated. Suddenly, with the advent of what would come to be called "QE1," the Fed would hold government-issued securities far in excess of currency outstanding. And soon thereafter, the Fed would hold securities with long maturities.
- Instead of funding its assets only by issuing non-interest bearing securities – currency – the Fed began to issue an interest-bearing security called, rather deceptively, "excess reserves." It required an amendment to the Federal Reserve Act, which was first made in 2006, but with a deferred effective date in 2011. The date was accelerated to the present by a single sentence buried in the massive 2008 bill that authorized the Troubled Asset Relief Program. That's why they are called "excess reserves," so the interest paid on them will comply with the statute. They are not reserves at all. Simply deposits by member banks.
- The interest rate – IOER, or interest on overnight excess reserves – is set by the Board of Governors, not the FOMC, at will.
- *That was the original sin – when the Fed became, alongside Treasury, an issuer of interest-bearing full-faith-and-credit US government debt.*
- The Fed's debt was unique and irresistible for the banks, and later, the handful of other select institutions, to whom the Fed offered it. *These so-called "excess reserves" are full-faith-and-credit, 1-day maturity, automatic rollover and floating rate. There is not now and never has been another security as riskless as this*.
- *Then came the next sin*. With the proceeds from issuance of this new asset class, the Fed not only bought Treasury bills but also Treasury notes and bonds, and GSE Mortgage Backed Securities. *Now the Fed was suddenly in the business of managing the average maturity of Treasury securities the public must absorb* – by buying longer-maturity assets for its own balance sheet, while issuing to the public 1-day maturity securities, the Fed effectively lowers the average maturity of government debt outstanding, and make it less risky overall for the public to hold.



Source: FRB, TrendMacro calculations

- *That, and only that, is how QE works as stimulus*. The Fed takes duration risk (and in the case of MBS, other risks as well) onto its own balance sheet, effectively de-risking the banking system and thus enabling banks to generate private credit.
- *QE does not lower long-term yields, as was initially claimed by Chair Ben Bernanke*. It has failed at that spectacularly every time (please see the chart on the previous page).
- QE *does not create reserves*. *QE does not print money*. *QE is not inflationary*. *QE simply takes risk out of the market*. There are times of crisis when that is important and appropriate, we suppose. But most of the time it is not, and unless there is an overriding urgent need, *the dangerous side-effect of QE is to artificially reduce the government's funding costs (by reducing the maturity risk the public must bear) and therefore, at the margin, enable the government to borrow more than it might be able to otherwise, and do so with longer maturities.*
- *That is the operational core of Warsh's critique, and he is right*.
- Quantifying this is difficult, especially with the complexities of MBS in the mix. But we can get the idea by just looking at Treasuries.
- In 2006, the year Warsh joined the Fed as a Governor, the average maturity of Treasury debt was 4.37 years. Because even then the Fed was cheating a little and holding Treasuries with over 1-year maturities against currency it had issued, the effective average maturity experienced by the public was 3.97 years, a difference of 0.40 years thanks to the Fed (please see the chart below).

Maturity of total Treasury issuance, with and without the Fed (years)



Source: FRB, Treasury, TrendMacro calculations

- As multiple episodes of QE took place, first during the GFC, again in its aftermath of "secular stagnation," and again in the pandemic, two things happened. First, the average maturity of Treasury issuance lengthened, and second, the Fed's holdings absorbed more of that maturity. Today, average maturity of issuance is 6.23 years. Thanks to the Fed, the public experiences that as 5.54 years, a difference of 0.69 years. The Fed's thumb on the scales, therefore, is 73% greater than it was the year Warsh was first on board.

What reform looks like, then, is for the Fed's holdings of government securities to shrink from about $6.29 trillion now to $2.43 trillion, the present level of currency outstanding.

- *Media reports that Warsh wants to shrink the balance sheet to something like $800 billion, the level of currency outstanding when he first joined the Board in 2006, are simply wrong*. The size of the nominal economy has tripled since then, and currency outstanding has grown more than commensurably. He is well aware of this.
- If the shrinkage of Fed holdings comes from the long end, then the Fed subsidy of Treasury maturity would be returned almost perfectly back to 2006 levels at 0.36 years.
- *But that couldn't be done with a patient run-off*, because long-maturity bonds obviously mature after short-maturity bonds. They would have to be sold outright, which would maximize the potentially risky injection of maturity risk back into the market, with all the tightening of financial conditions that might entail.

And therein lies a potential accord, in which normalization is carried out jointly with Treasury.

- *It's simple. If it were done today, with today's values, the Fed would, first, forgive $1.85 trillion of its $4.28 trillion Treasury securities holdings and at the same time, second, Treasury would assume the same $1.85 trillion of the Fed's so-called excess reserves*.
- The Fed's balance sheet would shrink by $1.85 trillion on the asset side and by $1.85 trillion on the liability side, leaving $2.43 trillion in bonds funded by $2.43 trillion in currency. We'll get to MBS in a moment.
- The Treasury's balance sheet would see its liabilities shrink by $1.85 trillion (with the forgiveness of the Fed's bonds) and grow by $1.85 trillion (with the assumption of the so-called excess reserves). *The government's net issuance is unchanged.*
- The owners of the so-called excess reserves still have a full-faith-and-credit claim, with one-day maturity, automatic rollover and floating rate. *The market would face exactly the same net maturity profile from the Treasury that it does now*.
- The rate could be just what it is now, pegged to the Fed's IOER, so *the Fed would still have effective control over short-term rates*. And this would not impact the satisfaction of Fed reserve requirements for banks, because those requirements were abolished in 2020.
- The Fed may continue to be the Treasury's checking account through the Treasury General Account on its balance sheet. It would be odd for Treasury to invest in its own new vehicle instead. That said, the Fed just invested the TGA balance in Treasury securities, which is just as odd, but nobody ever thinks about how odd it is.
- It amounts to the Fed simply rendering unto Caesar that which is Caesar's, and Caesar accepting it. Nothing in the world changes except the names of the owners and the obligors.

- To be sure, this would require Treasury to create a facility it has never had – what amounts to a savings account. Perhaps it could offer it to the public via the Treasury Direct website, not just banks as the Fed now does. *We're quite sure issuers of stablecoins would be very interested in it, and we're equally sure Treasury is interested in interesting issuers of stablecoins.*
- *This new facility would be demand-driven as to its total size, but the Treasury would remain in control of determining net maturity by adjusting issuance at the long-end.*
- *The debt of the US government that the public must absorb remains fundamentally unchanged as to its full-faith-and credit status and everything else.*

The presence of $2 trillion of agency MBS on the Fed's balance sheet complicates the idea, but doesn't change it.

- The need for reform is the same, only more so. The Fed's MBS holdings not only take maturity out of the market, but also the other unique risks attendant to those very tricky securities.
- We lack the historical datasets to do the same maturity-transformation timeline for MBS that we did for Treasuries, but we think the magnitudes are similar – there's utterly no question that the direction is similar.
- In Warsh's view, the Fed's holdings of MBS embed an additional corruption – they distort capital markets in favor of housing. We have other federal agencies tasked with that – the Fed doesn't have to get into the act. If it does, then perhaps the Fed should be an all-purpose engine of industrial policy that would, say, encourage lending to hyperscaler datacenters. Not.
- The accord solution is the same – the Fed swaps assets and liabilities with the Treasury – enabled by the fact that now the Treasury has formal control over the GSE issuers.
- The Fed's MBS, if not cancelled as the Fed's Treasuries could be, would be transferred to their respective issuers. The issuers would then issue commensurate guarantees to the Treasury, which would assume the so-called excess reserves.

And none of it involves even the slightest bit of quantitative tightening.

- Maybe that's why – for all the reporting about a Warsh-driven accord entailing some form of quantitative tightening, rate cut expectations have improved without the slightest whiff of a taper-tantrum.

Is any of this so hard? No, all it takes is the will to do it.

- We don't think it would take any new legislation from Congress. Warsh would likely have to bring the FOMC along on it, and that could be problematic – considering that the committee, like all committees, is invested in the status quo.

We'd end up with a Fed that stays in its lane, a newly independent Fed that can concentrate on its dual mandate instead of putting its thumb on the scale in favor of certain privileged debt securities. We'd end up with a Treasury that stays in its lane, and has to take responsibility for managing the maturity of its issuance to be attractive to the market rather than to an informationless captive buyer – the Fed. And we'd have a marvelous new offering from the Treasury that could perform a service for savers which, until now, has been the exclusive privilege of banks that can access the Fed's balance sheet (and open up a whole new market for Treasury debt – the stablecoin issuers).

Will this happen? Something like it will. The stars are aligned for it. And by stars, we mean Warsh and Treasury Secretary Scott Bessent. And how ironic: *Donald Trump, the president who supposedly is trying to destroy the Fed's independence, will have restored its independence*.

Bottom line

Warsh wants lower interest rates, but he also wants to shrink the Fed's balance sheet. A new Fed-Treasury accord, echoing the one that gave the Fed its independence in 1951, would allow for a return of the Fed's $6.3 trillion asset holdings to the level of currency outstanding, $2.4 trillion – without any quantitative tightening. Currently when the Fed accepts so-called excess reserves from banks, it is effectively issuing a riskless security – full-faith-and-credit, one-day maturity, automatic rollover and floating rate. That funds bond and MBS purchases which take maturity out of the public markets, making it easier for the Treasury to fund debts and deficits, and distorts credit allocation. An accord to end all that could swap the bonds and MBS back to Treasury, with the Treasury assuming the obligation of the excess reserves. This would require creation of a new Treasury vehicle like a savings account, which would be as attractive to banks as the Fed's excess reserves, but also to stablecoin issuers and the public. Trump will have reestablished Fed independence.