

THE AMERICAN ECONOMY IN A NEW ERA



CHAPTER

America's Risky Debt: What Markets See That Policymakers Don't

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Suggested Citation: Lustig, Hanno. 2026. "America's Risky Debt: What Markets See That Policymakers Don't." In *The American Economy in a New Era*, edited by Melissa S. Kearney and Luke Pardue. Washington, DC: Aspen Institute.

AUGUST 2026



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ABSTRACT

The goal of the Federal Reserve (the Fed) and Congress should be to restore complete price discovery in US Treasury markets. Price discovery ensures that fiscal policymakers in Congress get accurate signals from the bond market about how much fiscal space they have left. To achieve that outcome, the Fed has to commit not to intervene in bond markets, except in narrowly defined circumstances. Currently, the Fed and financial regulators implicitly maintain the view that US Treasuries are safe, even as the premium that investors are willing to pay for their safety has been eroded. When Treasuries sell off in response to adverse fiscal news, Fed officials are likely to interpret the move as a plumbing problem in Treasury markets and respond by absorbing a large share of issuance onto the Fed's balance sheet. That response hampers price discovery by muting the price signals that Congress relies on to assess debt sustainability, encouraging them to postpone the inevitable fiscal correction.

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Acknowledgements: Based on joint work with Roberto Gómez-Cram, Howard Kung, and David Zeke. I thank Luke Pardue and Melissa Kearney for their detailed comments and suggestions, and Jan Hatzius, Greg Ip, Jon Levin, Nellie Liang, Catherine Rampell, Ken Rogoff, Janet Yellen, and other conference participants at the AESG 2026 Summer Meeting for helpful comments.

Introduction

For decades, the US has been the world's safe-asset provider, and the dollar has been the world's reserve currency. As a result, global investors were willing to pay a premium for US Treasuries. US taxpayers benefited because this premium lowered the federal government's cost of funding. That premium has been eroded in the last few years.

Pre-2020, the safe-asset model was a good fit: Treasuries traded at a premium to close substitutes, hedged equity risk, and rallied during stress episodes. Post-2020 each of these predictions has failed. First, US Treasuries are no longer expensive compared to close substitutes like German sovereign bonds or AAA US corporate bonds, especially at longer maturities. Second, the US stock–bond correlation turned positive in 2020. US Treasury allocations no longer hedge the equity risk in an investor's portfolio. Third, there is increasing evidence that investors no longer flee to the safety of Treasuries when volatility spikes in financial markets. An example of this was the arrival of COVID-19 in March 2020, when the 10-year Treasury yield spiked by 68 basis points in just eight trading days between March 9 and March 18.

Bond investors and monetary policymakers now disagree on how to price US government debt. Bond investors increasingly question the safety of US Treasuries, and they have re-priced Treasuries as a risky claim. Central bankers and financial regulators have not adjusted: their models and financial regulation still treat government debt as unambiguously safe.

This disagreement has real-world consequences. When investors sell off Treasury bonds in response to fiscal news, monetary policymakers operating under a safe-debt view read the move as a “bond-market plumbing” problem and respond by deploying some of their balance-sheet capacity to purchase US Treasuries. Market participants, by contrast, drove the sell-off themselves: they sold Treasuries because they read the fiscal news as implying US Treasuries are risky, and the resulting price decline is price discovery, not dysfunction. The two readings imply opposite policy responses. Treating market signals as dysfunction risks suppressing the price discipline that fiscal policymakers rely on to assess debt sustainability, at exactly the moment when global investors are reassessing the safety of US sovereign debt in the face of significant fiscal headwinds.

Government debt is safe only when bondholders believe that the Fed will raise rates against inflation and that the fiscal authority will raise taxes against spending shocks. Post-COVID, investors appear to have lost confidence in the second leg. Taxpayers no longer absorb fiscal risk. Bondholders do, and Treasury valuations respond to fiscal shocks.

Fiscal and bond-market plumbing problems are intertwined. The erosion of the Treasury premium at the long end of the yield curve has pushed the Treasury toward shorter maturities,

raising rollover risk. Primary dealers, the large banks that buy directly from the Treasury at auction and resell to investors, are balance-sheet constrained after the 2008 Global Financial Crisis (GFC); hedge funds have partly replaced primary dealers and absorbed a significant fraction of the Treasury issuance. Together these factors raise the probability that a failed auction or rollover spike forces emergency measures precisely when market confidence is most fragile. If the Fed persists in interpreting Treasury sell-offs through the safe-debt frame, it risks both suppressing the price signal and absorbing a growing share of issuance onto its balance sheet, mirroring the Bank of Japan (Chien et al. 2025a) and the Eurosystem (Chien et al. 2025b). In both cases, these central banks help sovereigns borrow at below-market rates, a form of financial repression (Gómez-Cram et al. 2026).

Financial repression is not a free lunch. When central banks allow governments to borrow at below-market rates, they are in effect imposing a hidden tax on bondholders and other savers. The tax falls mainly on poor, young, and less financially sophisticated households, who save mostly in bank deposits but do not own long-lived assets like stocks, private businesses, or long-dated bonds. Taxation is not within the mandate of the Fed; only Congress can legislate new sources of tax revenue. By engineering this kind of transfer from some households to others, central bankers would be acting outside their mandate. And politicians may conclude that there is no reason to change the fiscal trajectory if the bond market seems to absorb all of the issuance at low yields and inflation does not rise as much as they had feared.

The historical record is sobering. From 1942 through 1951, the Federal Reserve capped long-bond yields at 2.5 percent to help finance the war effort. When inflation reached 14 percent in 1947, American savers, retirees, life-insurance policyholders, and pension funds incurred significant real losses until the 1951 Treasury–Federal Reserve Accord ended the peg. The Bank of Japan has run a version of the same arrangement since 2012: it now owns more than half the outstanding stock of Japanese government bonds. Gross general-government debt in Japan now exceeds 225 percent of GDP, and the yen depreciated by roughly 45 percent in real terms between 1997 and 2023 (Chien et al. 2025a). The United States is not immune; the more the Fed absorbs fiscal news as “plumbing,” the further along this path the US moves. There is no clear exit strategy from financial repression. The longer the Fed waits to restore price discovery, the more difficult it will be to do so without a disruptive market adjustment.

Section 1 states the two competing models side by side. Section 2 documents the erosion of the US safe-asset status across four independent measurements. Section 3 shows that Treasury yields now respond to fiscal news. Section 4 documents the structural fragilities (maturity shortening, dealer balance-sheet constraints, the hedge-fund basis trade) and revisits the UK 2022 mini-budget. Section 5 analyzes the fiscal feedback loop. Section 6 draws policy implications. The conclusion follows.

1. Two models of US government debt

This section states the contrast between the two models using the *risky-vs.-safe-debt* framework of Gómez-Cram et al. (2024). Tables 1 and 2 lay them out side-by-side.

1.1 The risky-debt model used by market participants

All indications are that market participants now operate under the risky-debt model. The fiscal authority is the leading actor, and bondholders absorb part of the risk of spending shocks. The risky-debt column matches stylized facts documented in Sections 3–4.

Treasury yields respond to fiscal news, as bonds are marked to market, valued at current market prices rather than at par or at historical cost. In response to bad fiscal news, i.e., higher future deficits, we would expect higher Treasury yields, either because expected inflation went up, because the term premium or bond risk premium increased (the extra compensation investors require for bearing the duration and inflation risk of long-dated bonds), or because the convenience yield declined. The convenience yield, another name for the Treasury premium, is the return investors are willing to forgo in exchange for the safety and liquidity of Treasuries. When investors pay a Treasury premium, they accept a lower yield; that forgone yield is the convenience yield, and the two terms refer to the same quantity throughout this paper.

Table 1: Risky-debt model of US Treasuries

Regime	Safe	↓ <i>Market Participants</i> Risky
Leading authority?	Federal Reserve	Congress (fiscal authority)
Who bears g risk?	Taxpayers	Bondholders
Bond market response to fiscal news		
Treasury yields	No	Yes ✓
Response to market stress		
		<i>Anticipated</i>
Stock–bond correlation	Flight to safety	Mark-to-market
Yields	Negative ↘	Positive ✓ ↗
<i>Actual: Yields ↗</i>		
Interpretation	Market dysfunction	Market functioning
Causes	Market microstructure Plumbing	Macro Fiscal news
Large-scale asset purchases		
Objective	Liquidity provision	Price support ✓
Price discovery	Improve	Impair
For taxpayers	Create value	Destroy value ✓

Notes: Risky-debt model used by market participants. Shaded column. Under this reading, markets interpret a Treasury sell-off as normal price discovery: investors are exiting long-duration positions in response to bad fiscal news, and the yield spike is the market functioning, not malfunctioning. Large-scale asset purchases (LSAP) by the central bank provide price support, impair discovery, and transfer value from taxpayers to bondholders.

1.2 The safe-debt model still used by monetary policymakers

Central bankers' workhorse macroeconomic models assume that future taxes will adjust automatically to pay off whatever debt the government issues. There is no such thing as an unfunded spending shock: every increase is fully financed by future taxes, so government debt is safe by construction.

Financial regulators apply the same view: US banks do not have to hold extra capital against their holdings of US Treasuries, even when these are long-dated Treasuries that are exposed to significant interest-rate risk. Money-market funds that only hold government-issued securities are subject to a much more favorable set of rules. During COVID, US Treasuries were exempted from a constraint regulators imposed on bank balance sheets relative to their equity capital.

Traders and risk managers price as if debt is risky; macro models and prudential rules assume it is not. Table 2 states the monetary policymaker view explicitly, including the operational consequences for stress response.

If you adopt the safe-debt view, then you do not expect bond yields to respond to fiscal shocks. You would expect the stock–bond correlation to be negative, because you would expect investors to flee to the safety of Treasuries during stress events. And when you do see yields spike, you would immediately attribute that to the bond market malfunctioning. In that scenario, the central bank can step in and use its unconstrained balance sheet to provide liquidity to the bond market by buying up underpriced government bonds.

The two models generate opposite policy prescriptions when yields rise. Under the safe-debt view a yield spike is a market-functioning problem calling for balance-sheet capacity. Under the risky-debt view the same spike is price discovery about a fiscal shock calling for fiscal adjustment. Choosing the wrong model is costly either way: intervening in a true price-discovery episode suppresses fiscal discipline; failing to intervene in a true plumbing event leaves unnecessary stress.

The diagnoses are harder to separate in practice because they are often both correct at once. The plumbing problems in Section 4 (maturity shortening, dealer balance-sheet constraints, the hedge-fund basis trade) have fiscal roots: the shift to T-bill issuance is itself a Treasury response to the erosion of the long-end Treasury premium. Section 5 develops this point with the September 2022 UK gilt episode and the March 2020 US basis-trade unwind as worked examples in which the fiscal trigger and the plumbing crisis that resulted were inseparably linked.

Table 2: Safe-debt view of US Treasurys

Regime	↓ <i>Monetary policymakers</i>	
	Safe	Risky
Leading authority?	Federal Reserve	Congress (fiscal authority)
Who bears g risk?	Taxpayers	Bondholders
Bond market response to fiscal news		
Treasury yields	No	Yes ✓
Response to market stress		
Stock–bond correlation	Flight to safety Negative ↘	<i>Anticipated</i> Mark-to-market
		Positive ✓ ↗
Yields		
<i>Actual: Yields ↗</i>		
Interpretation	Market dysfunction	Market functioning
Causes	Market microstructure Plumbing	Macro Fiscal news
Large-scale asset purchases		
Objective	Liquidity provision	Price support ✓
Price discovery	Improve	Impair
For taxpayers	Create value	Destroy value ✓

Notes: Safe-debt model used by monetary policymakers. Shaded column. Same row structure as table 1, but monetary policymakers interpret the same sell-off as market dysfunction: a dash-for-cash triggered by microstructure frictions in the intermediation chain (dealer balance-sheet limits, repo pressure), calling for a Fed balance-sheet response to absorb the excess supply. LSAP are framed as liquidity provision and improve price discovery.

2. The safe assets that weren't

2.1 The pre-2020 safe-asset benchmark

Through the late 2010s, US Treasurys earned a positive convenience yield attributable to safety and liquidity (Krishnamurthy and Vissing-Jorgensen 2012; Jiang et al. 2021). Four observable predictions characterized this benchmark and all four held in the data:

1. US Treasurys were **expensive** relative to close substitutes: top-rated (AAA) US corporate bonds, after accounting for default risk, and the sovereign bonds of the other major advanced economies (the G10: Australia, Canada, the Eurozone, Japan, New Zealand, Norway, Sweden, Switzerland, and the United Kingdom) once their yields are converted into dollars.
2. The **stock–bond correlation** was reliably negative.
3. Treasurys exhibited a **flight to safety** in stress events: the 1998 Long-Term Capital Management (LTCM) collapse, the 2008 GFC, the 2011 European debt crisis, the 2015 China devaluation, and the initial leg of March 2020.

4. **Foreign reserve managers** treated US Treasurys as the dominant safe asset, allocating more than 70 percent of allocated world foreign-exchange reserves to dollar-denominated assets.

All four have failed in turn since 2020. The remainder of this section documents each failure.

2.2 Yield spreads to close substitutes

Treasurys used to be expensive relative to close substitutes: investors paid a Treasury premium in exchange for the safety and liquidity of those Treasurys. Two independent “rich-vs.-substitute” measures show the same compression of that premium. Figure 1 plots both.

The top panel uses the credit risk-adjusted AAA-Treasury spread from Mota (2023). The adjustment uses credit default swap (CDS) prices. A CDS is an insurance contract on a corporate borrower’s default, with a quoted price equal to the cost of that insurance. We use the CDS to strip the default-risk compensation out of the corporate-bond yield. What remains is a clean estimate of the safety premium that investors pay for Treasurys over otherwise-equivalent corporate exposure. Pre-GFC, the credit risk-adjusted AAA-Treasury spread averaged roughly 30–60 bp; it spiked to about 300 bp during the GFC and to 240 bp during the March 2020 stress episode. Post-2022 it has compressed toward zero, and at points has reversed.

The bottom panel uses the Treasury Premium of Du et al. (2018), defined as the difference between the synthetic-dollar foreign sovereign yield and the US Treasury yield at the same maturity. The synthetic-dollar foreign yield is constructed by swapping the coupon payments on foreign G10 sovereign bonds into dollars using the foreign-exchange forward market. This eliminates currency risk over the life of the bond, so the resulting dollar cash-flow stream is directly comparable to a US Treasury yield of the same maturity. For the 2017–2025 sample the same series averages -18 bp at 5y and -22 bp at 10y, a clean reversal of the customary US Treasury premium at long maturities. At longer maturities, global investors now seem to prefer the safety of foreign G10 bonds.

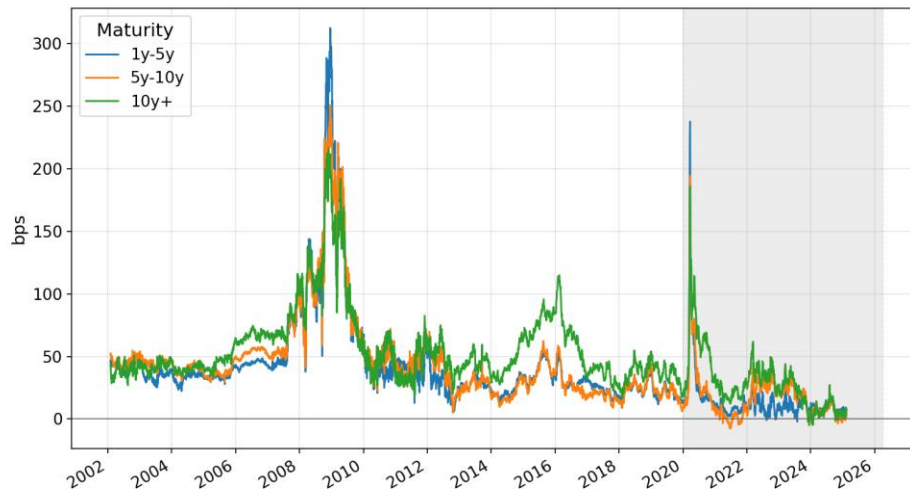
Both measures of the Treasury premium, drawn from different asset classes, show large positive premia in the 2000s and early 2010s, large spikes during the GFC, and compression toward zero or negative levels at long maturities post-2020. Investors are now close to indifferent between US Treasurys and close substitutes.

2.3 Breakdown of the flight-to-safety mechanism

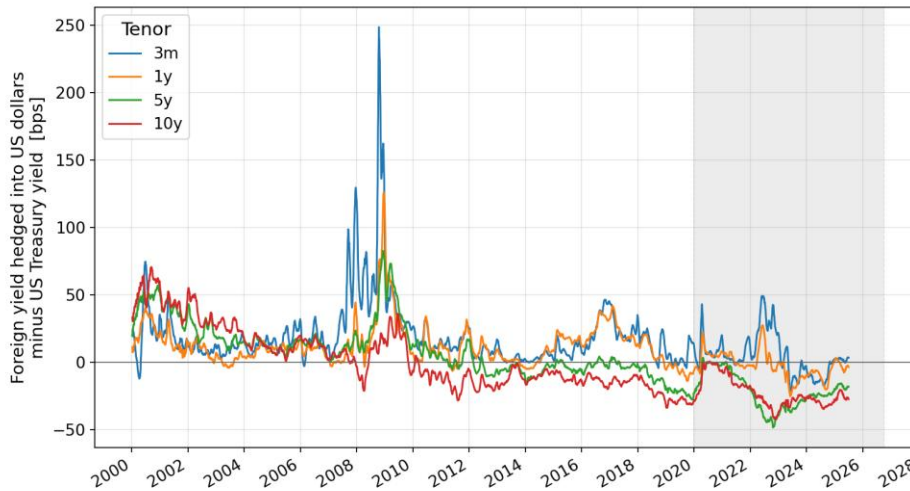
Another footprint of safety, the negative stock–bond correlation, has also disappeared. Figure 2 shows the rolling correlation in the top panel and the April 2025 tariff shock in the bottom panel.

Figure 1: The US Treasury safety premium has eroded

(a) Relative to AAA corporate bonds



(b) Relative to foreign G10 sovereigns

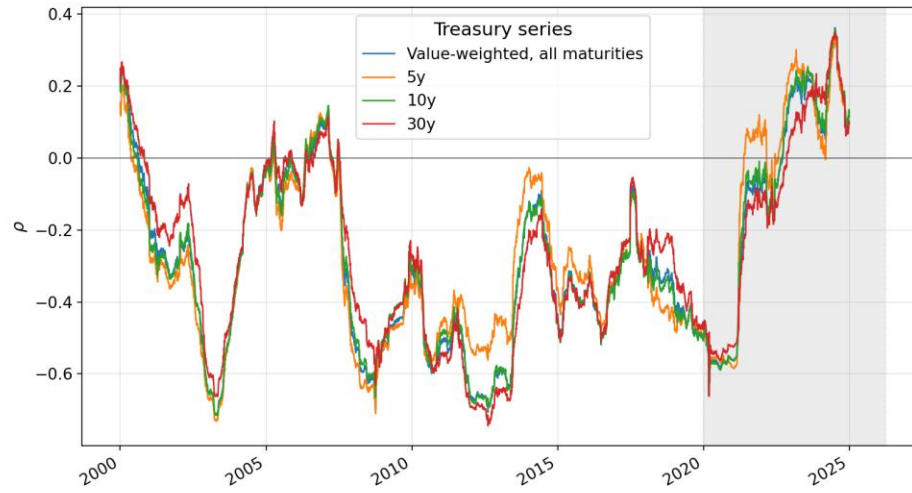


Notes: Panel (a) plots the credit risk-adjusted AAA Treasury spread, which uses credit default swaps to net out default risk from the corporate-bond yield. Panel (b) plots the difference between a synthetic-dollar foreign G10 sovereign yield (equal-weighted mean at the 5-year tenor) and the US Treasury yield at the same maturity.

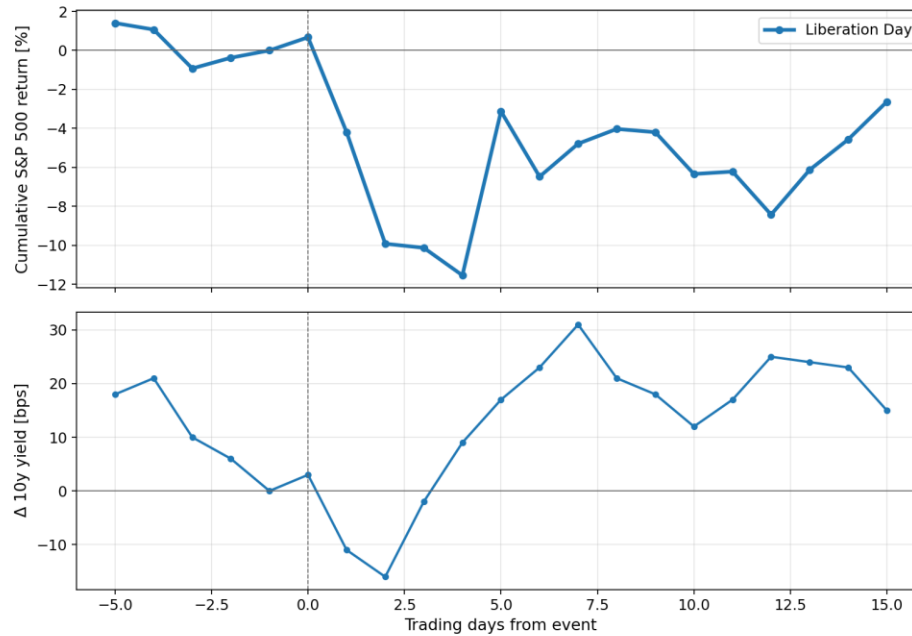
Sources: Panel (a): Mota (2023). Panel (b): Du et al. (2018); Jiang et al. (2021).

Figure 2: Treasurys no longer hedge equity risk

(a) Stock–bond correlation (252-day rolling)



(b) Liberation Day event window



Notes: Panel (a) plots the 252-day rolling correlation between daily US Treasury portfolio returns and the CRSP value-weighted equity index. Panel (b) plots the S&P 500 cumulative return (top) and the change in the 10-year Treasury yield (bottom) in the trading-day window around the “Liberation Day” reciprocal-tariff announcement of April 2, 2025 (first impacted trading session April 3).

Sources: Panel (a): CRSP (2026). Panel (b): FRED (2026) (DGS10 and SP500).

The 252-day rolling stock–bond correlation was reliably negative through 2020 and flips persistently positive from 2022 onward. Treasury allocations no longer hedge the equity risk in an investor’s portfolio.

The natural objection is that this tells us nothing about safe-asset status. In the framework of Campbell, Sunderam, and Viceira (2017) and Campbell, Pflueger, and Viceira (2020), the sign of the stock–bond correlation is determined by the mix of shocks hitting the economy. Supply shocks move stocks and bonds in the same direction; demand shocks move them in opposite directions. The post-2021 period was unusually supply-shock heavy: pandemic supply chains, energy, tariffs. The correlation flip may be a macro fact about the shock mix, not a repricing of sovereign risk, and it will revert once demand shocks reassert themselves.

A change in the shock mix would flip the sign of the correlation without any change in what investors believe about the safety of US government debt. Supply shocks are bad news for both stocks and nominal bonds. Two features of the data speak against the pure shock-mix reading.

First, the correlation flip loads on the wrong component of the yield. Acharya and Laarits (2025) decompose the Treasury yield into a frictionless risk-free rate, a credit-risk component proxied by the sovereign CDS spread, and the Treasury premium/convenience yield, and then decompose the aggregate stock–bond covariance into the three corresponding terms. The covariance attributable to the Treasury premium component does most of the work. Supply shocks move expected inflation and real rates, and that is where a change in the shock mix should show up in the covariance. It does not.

Second, the flip is maturity-specific in a way a macro shock mix cannot easily generate. Acharya and Laarits (2026) apply the same decomposition to the April 2025 tariff episode and find that the rise in stock–bond covariance is concentrated in the Treasury premium component of long bonds, while the short end of the curve retained both its Treasury premium and its hedging property accompanied by a rotation of safe-asset investors toward shorter maturities. The shock mix does not explain why the ten-year should stop hedging while the two-year continues to. Duration-specific fiscal risk does exactly that, and the same term-structure signature appears twice more in this paper: the Treasury-premium reversal in Panel (b) of figure 1 is concentrated at the 5- and 10-year tenors, and the Treasury’s migration toward bill issuance documented in section 4 is the quantity counterpart of the same repricing.

Panel (b) of figure 2 should be read in this light. The reciprocal-tariff announcement is itself a supply shock, so the twin selloff on its own is what the shock-mix account predicts. The informative content of the episode is not the sign of the covariance but its composition: the hedging property failed at the long end and through the Treasury-premium channel, not through expected inflation and real rates across the curve.

The correlation flip is consistent with the risky-debt regime but is not definitive. The

discriminating evidence lies elsewhere: the Treasury premium of Du et al. (2018) in Panel (b) of figure 1 is a relative price, US Treasuries against currency-hedged G10 sovereigns, and therefore differences out any common global change in the shock mix by construction, and the deficit-news evidence in section 3 conditions on identified fiscal announcements rather than on the unconditional covariance.¹

2.4 Summary

All four of the safe-asset model’s observable predictions have failed since 2020:

- Treasuries are no longer expensive relative to substitutes.
- The stock–bond correlation has turned positive.
- Treasuries did not hedge in 2025–2026 stress events.
- Foreign reserve managers are diversifying away from dollar assets.

Whatever model market participants are using, it is not the safe-asset model. The next section turns to a fifth, increasingly visible margin: yields now respond to fiscal news.

3. Treasury yields now respond to fiscal news

If government debt is risky, then bondholders, not just future taxpayers, bear the revaluation risk associated with unfunded fiscal expansions. That mechanism predicts that Treasury yields should respond to fiscal news.

3.1 Systematic evidence: deficit news and Treasury yields

Gómez-Cram et al. (2025a) use a granular, high-frequency approach to isolate the moments when investors learn about future US deficits, and trace the bond-market response. The headline result, summarized in figure 3, is that on large deficit news days the value of the outstanding Treasury portfolio falls by roughly 21 percent, and the 10-year nominal yield rises by roughly 4.33 percent cumulatively between 1997 and 2022. Unfunded fiscal shocks are passed through to bond investors rather than absorbed by future taxes. This is the empirical signature of a risky-debt regime.

The yield response decomposes into three channels: term premia rise, long-run inflation expectations rise, and convenience yields fall. The authors find no systematic effects on CDS spreads or short rates, which rules out a sovereign-credit channel and confirms that the mechanism operates through standard term-structure and inflation fundamentals rather than

¹ In complementary work, Leombroni, Pflueger, and Sunderam (2026) show that subjective expected excess returns on Treasuries, derived from professional forecasts, are tightly linked to bonds’ stock-market betas. That result is consistent with both readings but it establishes that the safety premium and the hedging property are priced together.

through default risk.

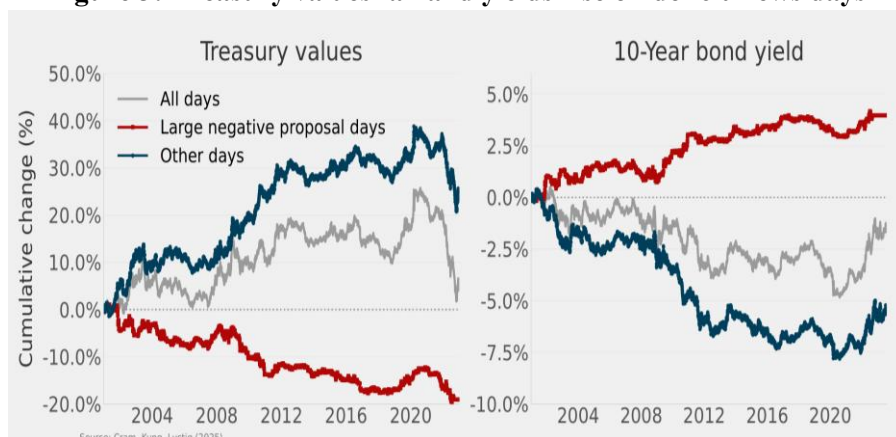
The pass-through has intensified since the pandemic. Both the yield and the value response in figure 3 are flat through 2019 and inflect sharply upward after 2020. Almost all of the full-sample sensitivity of Treasury yields and values to deficit news comes from the post-COVID period; through the 2010s, yields barely moved on deficit-news days, closer to what the safe-debt model predicts. Investors are now re-pricing Treasuries on fiscal news in a way they were not in the 2010s.

Inflation expectations carry a much larger share of the adjustment. The three-channel decomposition shows that the post-COVID rise in the long-run inflation-expectations component is the most visibly accelerating of the three channels, alongside rising term premia and falling convenience yields. The pre-pandemic period had near-zero sensitivity to inflation expectations; the post-pandemic sensitivity is sharply positive. This is the empirical signature of fiscal inflation: bondholders, not future taxpayers, absorb the unfunded part of fiscal expansions, and they do so partly through expected inflation revaluing nominal claims.²

3.2 The One Big Beautiful Bill

In 2025 the US House passed the One Big Beautiful Bill (OB BB), a large unfunded fiscal expansion. The market-implied probability of enactment jumped on the announcement, providing event-time identification of the fiscal shock. Figure 4 plots cumulative Treasury and equity returns around the event window.

Figure 3: Treasury values fall and yields rise on deficit-news days

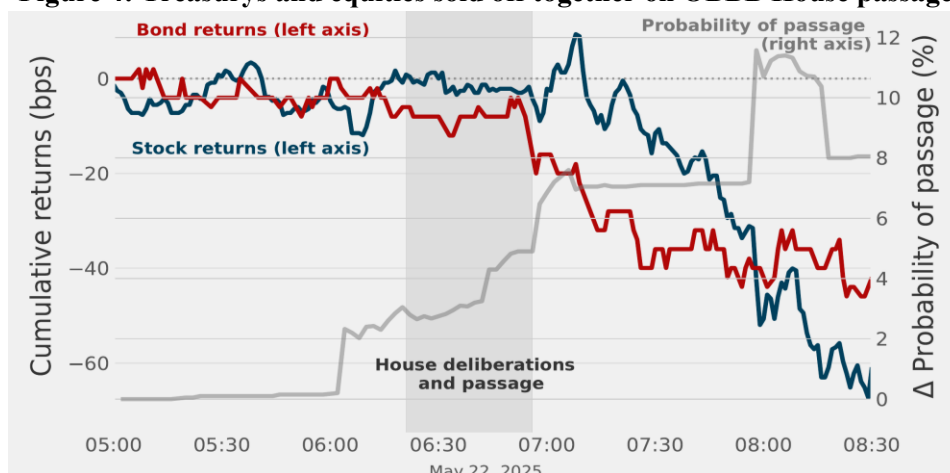


Notes: Cumulative response of the outstanding Treasury portfolio value and the 10-year nominal yield to large US deficit-news days. Large deficit-news days are identified at high frequency using Congressional Budget Office (CBO) cost releases and Bloomberg news articles.

Source: Gómez-Cram et al. (2025a).

² Gómez-Cram et al. (2025b) develop the asset-pricing model that rationalizes these moments under fiscal redistribution risk.

Figure 4: Treasuries and equities sold off together on OBBB House passage



Notes: Cumulative Treasury and equity returns in the trading-day window around US House passage of the One Big Beautiful Bill (OBBB).

Sources: US Treasury and equity returns from Bloomberg L.P. (2026); enactment probability from Polymarket (2026).

Both Treasury and equity returns dropped sharply in the event window — a twin sell-off, not flight-to-safety. The pattern is the footprint of risky debt: bondholders revalue Treasuries on bad fiscal news.³

4. Treasury market plumbing

The erosion of the long-end Treasury premium has interacted with post-GFC regulatory architecture to create a distinctive fragility in US Treasury markets. Three threads are intertwined.

4.1 Maturity shortening and T-bill reliance

The Treasury has leaned increasingly on T-bills, in part as a rational response to the long-end erosion: as investors pay a shrinking premium on long-dated Treasuries, the cost advantage tilts toward short-dated instruments. US marketable debt now has a notably shorter average maturity than the debt of most other advanced economies, with corresponding interest-rate and rollover risk (Jiang et al. 2022; Chen et al. 2025).

The right measure is the bill share of marketable debt held outside the Fed, since the Fed’s \$4.4 trillion System Open Market Account (SOMA) portfolio (the Fed’s own holdings of Treasuries, accumulated through open-market operations and quantitative easing) is not absorbed by the private market. On that ex-Fed measure, T-bills stand at 25.2 percent in April 2026, well above the 15–20 percent range historically recommended by the Treasury Borrowing Advisory Committee (TBAC), and at the upper end of the post-2000 range. The wedge between the ex-Fed

³ Gómez-Cram et al. (2024, 2025b) develop the asset-pricing logic in detail.

and headline measures peaks during episodes of large-scale Fed purchases (30.5 percent vs. 23.7 percent in December 2020). The same conclusion follows from any of the alternative measures.⁴

The combination of (i) shorter maturity in the marginal mix, (ii) a larger debt stock, and (iii) compressed long-end Treasury premium mechanically raises the probability of fiscal stress events: a failed auction or a sudden spike in rollover costs could force the Treasury into emergency measures precisely when market confidence is most fragile.

4.2 Primary-dealer balance-sheet constraints

US primary dealers, the large banks that buy Treasuries directly at auction and resell them to investors, have traditionally absorbed new issuance and played a shock-absorber role. Primary dealers essentially operate large supermarkets for bonds. Since the GFC, their balance-sheet capacity has been limited by post-crisis restrictions that limit how much risk they can hold on their books. US banks are subject to the Supplementary Leverage Ratio, which is a cap on a bank's total assets relative to its equity capital, applied regardless of how risky the assets are. Banks are also subject to the Net Stable Funding Ratio, which requires long-term holdings to be financed with stable liabilities rather than overnight borrowing. As a result, dealer intermediation capacity has not kept up with the growth of the US Treasury market (Duffie 2020).⁵

4.3 Hedge funds and the cash–futures basis trade

As primary dealers have stepped back, hedge funds have stepped in. Hedge funds typically buy a cash Treasury bond and simultaneously sell the corresponding Treasury futures contract, then finance the bond purchase by borrowing overnight in the repo market. Repo is short for “sale and repurchase agreement,” a form of secured short-term borrowing in which the bond is pledged as collateral and repurchased the next day. The futures typically trade at a premium relative to the cash bond. The cash bond price and the futures price converge at the futures' expiry, so the trade locks in a small spread per dollar of position, magnified many times over by the leverage from the repo financing. This is referred to as the cash–futures basis trade in Treasuries. At scale, this trade absorbs a growing share of duration risk in the Treasury market (Barth and Kahn 2025; Kashyap et al. 2025). The trade is leveraged and fragile: when yields move sharply, the cash leg loses value, margin calls on the futures hedge force traders to unwind simultaneously, and the resulting selling amplifies the very yield spikes that triggered the calls. March 2020 is the

⁴ On the unadjusted measure, the T-bill share of all marketable debt was 27 percent in 2001, spiked to 34 percent during the November 2008 GFC funding surge, was actively reduced by Treasury maturity-extension to a record low of 10 percent in October 2015, and has since rebounded to 21.6 percent in April 2026. On a marginal-funding-mix basis, in many post-COVID twelve-month windows T-bills absorbed the *majority* of net new marketable issuance, well above their long-run share. All three measures point to the same shift: the Treasury is leaning more heavily on the short end.

⁵ The temporary 2020–2021 Supplementary Leverage Ratio exemption for Treasuries demonstrated the binding nature of the constraint and arguably created a precedent for future regulatory accommodation.

canonical illustration.

Commodity Futures Trading Commission (CFTC) Commitments of Traders data make the basis-trade footprint directly visible. Figure 5 plots the net short Treasury futures position of the “Leveraged Funds” category in the Traders in Financial Futures (TFF) report, the standard hedge-fund proxy.

The aggregate net short rose from roughly \$0 in 2014 to \$612 bn at its 2019 peak, collapsed in March 2020 (the basis-trade unwind during the dash for cash), and rebuilt rapidly post-2022, exceeding \$1 trillion by 2024 and reaching \$1.15 trillion at year-end 2025. Both the magnitude of the basis-trade absorber and its fragility footprint going into the next stress episode are visible here directly.

The shift in the marginal absorber of US Treasury (UST) issuance is visible in US Treasury International Capital (TIC) data on foreign holdings, which splits foreign holdings between foreign-official (i.e., central-bank reserve) holdings and private holdings.

The TIC data make two contrasts sharp. First, total foreign holdings of US Treasuries grew roughly 9× between 2000 and 2025, from \$1.0 trillion to \$9.3 trillion, but foreign-official holdings grew only ~6.5× (~\$0.6 trillion to ~\$3.9 trillion). The private foreign holdings, the gap between the two, have widened steadily since 2014. Second, the foreign-official share of total foreign UST has fallen from a peak of ~72 percent in 2010 to roughly 42 percent at the end of 2025.

Figure 5: Hedge funds now hold a \$1 trillion net short in Treasury futures



Notes: Aggregate net short position of the “Leveraged Funds” category in CFTC’s Traders in Financial Futures (TFF) report across all US Treasury futures tenors, in \$ billions notional.

Source: CFTC (2026).

The marginal foreign holder of US Treasuries is no longer a central-bank reserve manager but a private, yield-sensitive investor: predominantly foreign banks, asset managers, and hedge funds, with a substantial fraction of the private flow attributable to the basis trade.⁶

Combined with the evidence in section 3, those Treasury investors with less price-sensitive demand have pulled back. The shortfall has been picked up by private leveraged investors whose demand is more elastic to yield and more fragile in stress.

4.4 Why fiscal and plumbing problems are intertwined

The three threads above are usually framed as “plumbing” problems—microstructure issues to be solved with technical fixes (central clearing, Supplementary Leverage Ratio adjustments, Office of Financial Research (OFR) data collection). They are also fiscal problems, and treating them as purely plumbing misses the joint causation.

The shift toward T-bill issuance is itself a price signal: it reflects the erosion of the long-end Treasury premium, a fiscal fact rather than a plumbing one. That shift forces the maturity-mix and intermediation changes that create the plumbing risk. Weak long-end demand and rising hedge-fund participation share a common cause in the market’s revised view of US Treasury risk. Any framework that classifies the resulting stress as purely plumbing will systematically misdiagnose the underlying fiscal pressure.

4.5 The UK September 2022 mini-budget: fiscal news triggers a plumbing crisis

The clearest international illustration of fiscal and plumbing stresses converging is the UK gilt market response to the September 2022 mini-budget. On the morning of September 23, 2022, Chancellor Kwasi Kwarteng announced an unfunded £45 billion tax cut. The 10-year gilt yield jumped from around 3.5 percent on the morning of the announcement to above 4.5 percent within four trading days, while sovereign CDS spreads also widened sharply. On September 28, the Bank of England intervened to stabilize the long end of the gilt curve, citing a material risk to UK financial stability from pension-fund liability-driven-investing (LDI) unwinds.

The unfunded fiscal shock triggered a sovereign-yield spike, and that spike produced a genuine plumbing crisis: UK pension funds running liability-driven-investing (LDI) strategies had hedged their long-duration liabilities using leveraged gilt positions, and the yield jump generated mark-to-market losses that forced cascading margin calls. Pension funds had to sell gilts to meet the calls, which pushed yields still higher in a self-reinforcing loop. The plumbing distress was real and required a central-bank intervention to contain, but it was not autonomous. It was the fiscal shock transmitted through a leveraged segment of the financial system.

⁶ TIC reports holdings at the country of custody, not beneficial owner. The Bertaut and Judson (2014) reallocation matters in levels but does not overturn the plateau-and-decline of the foreign-official share documented above.

The same architecture is in place in the US Treasury market. March 2020 had exactly this character: large unfunded fiscal news (the \$2.2 trillion Coronavirus Aid, Relief, and Economic Security Act, or CARES Act, and its successors) hit a market in which hedge funds running the basis trade had absorbed a growing share of duration risk. Margin calls forced unwinds into a market with limited dealer balance sheet, amplifying the yield spike. The Fed's \$1.6 trillion of Treasury purchases stabilised the market under a plumbing-distress framing. As in the UK, the plumbing crisis was real, the intervention was necessary, and the trigger was fiscal.

The objection that the March 2020 bond move had nothing to do with fiscal news does not survive close inspection. Even setting the fiscal-news channel aside, the bond-market response was a radical departure from the safe-asset template. In previous global stress episodes, most cleanly the fall 2008 depth of the Global Financial Crisis, Treasury yields fell as investors flocked to safety. In March 2020 the opposite happened: the 10-year yield rose by 68 basis points in the eight trading days between March 9 and March 18. Whatever else was going on, this is not the flight-to-safety pattern that the safe-asset model predicts.

There is also direct evidence that market participants were already digesting the coming fiscal expansion during the March–April 2020 window. Gómez-Cram et al. (2024) document that Treasury yields moved on high-frequency news about the emerging fiscal package before the CARES Act was signed on March 27 and continued to respond through the April supplemental appropriations.⁷ The bond market was pricing the fiscal news in real time, not only after the fact, consistent with the risky-debt interpretation of the episode.

And the March 2020 yield spike was not US-specific. Long-dated sovereign yields rose in parallel across the major advanced economies: gilts in the U.K., OATs in France, and bunds in Germany all sold off during the same window. A pure Treasury-market plumbing story (dealer balance-sheet limits, cash–futures basis unwinds, primary-dealer capacity constraints) can explain the US moves but cannot explain the synchronized moves in sovereign bond markets that do not share the same microstructure. The common driver is the global re-pricing of sovereign risk in the face of massive coming fiscal expansions.

In March 2020, hedge funds who had levered up to absorb cash Treasuries were made whole when the Fed bought the same Treasuries at stabilised prices, relieving repo financing pressure on their cash legs. The intervention prevented a forced unwind without ex-ante conditions on the strategies being rescued, a moral-hazard problem for the next cycle. Leveraged intermediaries

⁷ The fiscal-news flow during the bond-selloff window (March 9–18) was already substantial: the \$8.3 billion Coronavirus Preparedness and Response Supplemental Appropriations Act (H.R. 6074) had been signed on March 6, the \$192 billion Families First Coronavirus Response Act (H.R. 6201) passed the House on March 14 and was signed on March 18, and Senate Majority Leader Mitch McConnell introduced the initial \$1 trillion package that became the CARES Act on March 19. The Senate expanded it to \$2.2 trillion and passed it 96–0 on March 25; the House passed and President Trump signed it on March 27.

have learned that the Fed will step in when their crowded carry trade backs up, which lowers their perceived tail risk and encourages further growth of exactly those positions.

That growth has happened. The hedge-fund net short in Treasury futures is now larger than on the eve of March 2020: \$1.15 trillion at end-2025 versus \$0.5 trillion in early 2020 (figure 5). The next stress episode is likely to follow the same template, with a larger basis position playing the role UK LDI played in September 2022. This is exactly the risky-debt/safe-debt asymmetry from section 1: a fiscal shock, transmitted through leveraged intermediaries, then reclassified as a plumbing problem.

5. Price discovery, signal distortion, and fiscal feedback

5.1 The CBO outlook demands market discipline

If the price signal is the only operational discipline on fiscal policy, suppressing it has consequences for the long-run debt trajectory. Under the CBO’s February 2026 extended-baseline long-term outlook, deficits run roughly 6–7 percent of GDP through 2056, net interest outlays exceed 6 percent of GDP, and federal debt held by the public approaches 190 percent of GDP by the end of the projection.

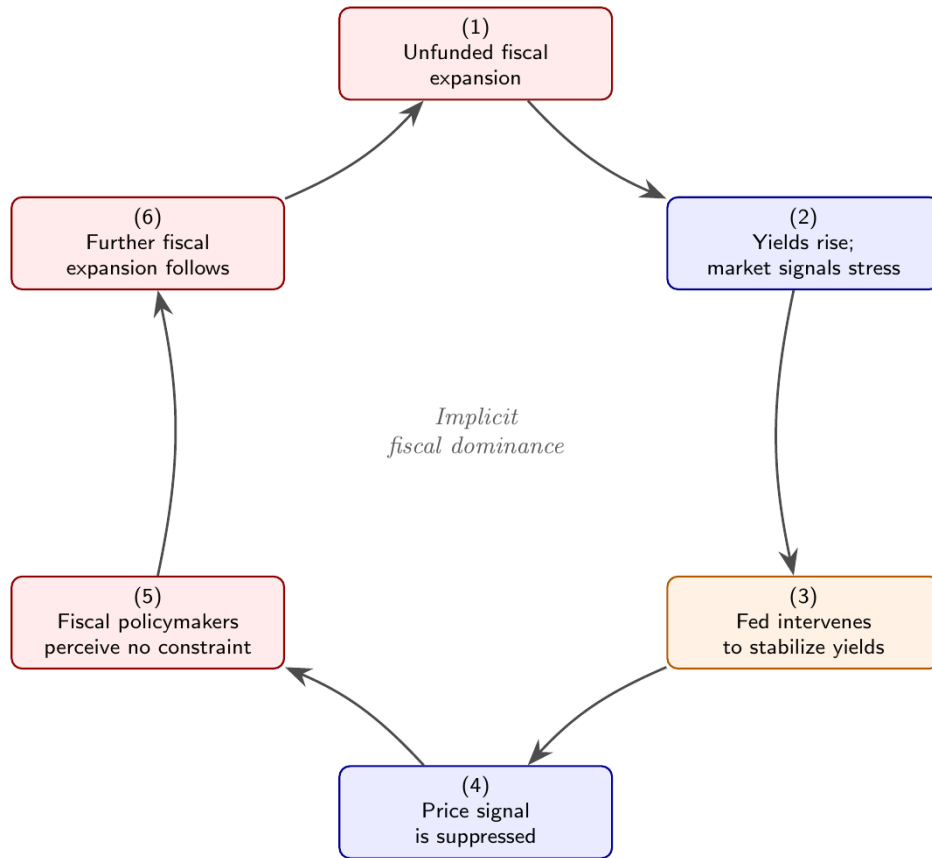
On standard sustainability metrics this path requires either (i) primary surpluses, (ii) the inflation tax, or (iii) financial repression. The bond market is the only mechanism that applies real-time discipline on the fiscal authority: fiscal news moves yields, and rising yields create political pressure. If the central bank cushions every yield spike as “plumbing,” it removes the disciplining mechanism and locks in (ii) or (iii).

5.2 The fiscal feedback loop

When the Fed routinely intervenes to suppress yield spikes triggered by fiscal news, the resulting feedback loop is straightforward (figure 6): each intervention to “fix” what it reads as a plumbing problem removes the price signal that would otherwise discipline fiscal policy, leaving the path open for the next round.

The loop distinguishes implicit from explicit fiscal dominance (Uribe 2006; Leeper 1991). Explicit fiscal dominance is when the central bank is openly directed to finance the government’s borrowing needs; implicit fiscal dominance is when the central bank does so in effect, by repeatedly interpreting fiscal-driven yield spikes as plumbing problems and stepping in to absorb the issuance. The Fed’s formal mandate has not changed, but if its operating doctrine systematically reads fiscal-shock-induced yield spikes as plumbing problems, the practical effect is the same: the Fed may end up warehousing a growing share of Treasury supply indefinitely.

Figure 6: The fiscal feedback loop



Notes: Red boxes: fiscal-authority steps. Blue boxes: bond-market response. Orange boxes: Fed / monetary policymaker steps.

Historical and international parallels are instructive. After 2016, the Bank of Japan adopted yield-curve control: it pledged to hold the 10-year Japanese government bond yield near zero, ended up owning more than half the outstanding stock, and absorbed almost the entire net issuance of long-dated debt at below-market yields (Chien et al. 2025a). The United States itself ran a similar arrangement during and after World War II: from 1942 to 1951 the Fed pegged the long-bond yield at 2.5 percent to finance the war effort, and when inflation reached 14 percent in 1947 American bondholders lost roughly a third of their real wealth before the 1951 Treasury–Federal Reserve Accord ended the peg (Hetzl and Leach 2001; Rose 2021).

The narrow mandate may aggravate the loop. Central-bank independence with a narrow price-stability mandate, far from disciplining the Fed against this feedback, can actually make it worse. The Fed has no institutional standing to discuss fiscal policy publicly (doing so would invite the charge that it is exceeding its mandate), so when a fiscal shock manifests in the bond market, it has an incentive to label the disturbance as “plumbing” or “market functioning,” a category that fits squarely within the operational authority granted by Sections 14 and 13(3) of the Federal Reserve Act. The same independence-and-narrow-mandate combination that is supposed to

constrain the central bank therefore biases its diagnosis toward the interpretation that justifies intervention, which is precisely the interpretation the fiscal-feedback loop requires to keep running.

The loop is already running. Earlier this year the Fed announced that it would halt the reduction of its balance sheet and reinvest maturing securities into T-bills, citing repo market pressure. The stated rationale fits the safe-debt frame: a plumbing intervention to maintain ample reserves and orderly money-market conditions. But the repo pressure traces back to fiscal causes: as the Treasury has leaned more heavily on hedge-fund basis traders to absorb issuance in repo, the demand for repo financing rises with the size of the basis trade. The Fed’s T-bill buying relieves exactly the funding pressure created by the leveraged absorption of Treasury issuance, which is itself a downstream consequence of the fiscal path. The size of the Fed’s balance sheet is already partially dictated by fiscal policy, intermediated through the hedge-fund basis trade. This is the feedback loop in figure 6 in operation.

5.3 Implications for debt sustainability assessment

If yields are administratively suppressed, standard debt-sustainability analyses (CBO, IMF Article IV) systematically understate fiscal risk—a form of “fiscal illusion” in which apparent headroom dissolves the moment the Fed exits or stops absorbing duration. The UK mini-budget remains the clearest cautionary example: the Truss government misjudged its fiscal capacity in part because gilt yields had been quiet, and the gilt market repriced violently once it rejected the unfunded package (Pinter 2023; Wilkins 2024).

6. Policy implications

The Fed has no explicit “market functioning” mandate. Its statutory objectives are maximum employment, stable prices, and moderate long-term interest rates, with broad responsibility for financial-system stability. Treasury market interventions run under Section 14 (open-market operations) or Section 13(3) (emergency lending); the “smooth functioning of Treasury markets” language in Federal Open Market Committee (FOMC) statements is an operational rationale, not a congressional mandate. (The FOMC is the Fed’s monetary-policy decision-making body.)

The narrowest reform is to publish clearer ex-ante criteria for what counts as Treasury-market “dysfunction.” The harder problem is that the liquidity-vs.-fiscal distinction may be unworkable in real time: in September 2022 the fiscal shock caused the liquidity crisis. Any rule that conditions intervention on a clean liquidity-vs.-fiscal split risks failing in practice.

A new Fed–Treasury accord. More fundamentally, restoring real price discovery may require a new Fed–Treasury accord under which the Fed commits not to intervene in the Treasury market outside narrowly defined money-market plumbing functions (Hoenig 2026; Lacker 2026). The

precedent is the 1951 Treasury–Federal Reserve Accord. Fed officials realized in the early 1950s that genuine price discovery in the bond market required the central bank to step back from the government securities market (Hetzel and Leach 2001). An analogous commitment today would reinstate the disciplining link from fiscal news to long-term yields. In the strongest version of such an accord, the Fed would commit to running a much smaller balance sheet going forward, intervening only in narrowly defined money-market emergencies.

Independence and narrow mandate are not enough; we also need accountability. Even a new accord that hardens the Fed’s mandate will not suffice on its own. The Eurozone experience is instructive (Lustig 2026). The European Central Bank (ECB) was deliberately designed with the strictest independence and the narrowest mandate of any major central bank. Yet over the past decade it has engaged in extensive quasi-fiscal operations: sovereign bond purchases, cross-country transfers mediated by TARGET2 (the Eurosystem’s real-time interbank payment system, on which member central banks accumulate large bilateral claims and liabilities), and asset-purchase facilities aimed at peripheral spreads. Each has been reframed as monetary policy. The mandate itself turned out to be a much weaker constraint than the Maastricht architects believed.

Without real accountability, central-bank independence can be positively harmful, because it permits central bankers to engineer fiscal transfers without any mandate from voters to do so. A new Fed–Treasury accord must therefore be paired with explicit accountability arrangements: ex-post legislative review of balance-sheet interventions, transparent triggers and exit conditions for any emergency use of the Fed’s portfolio, and disclosure of the distributional consequences of large asset purchases.

Abandon the safe-debt model. The deeper change is analytical. Financial regulators and the Fed should abandon the safe-debt model that still anchors their workhorse macro frameworks and their prudential rules. The evidence in sections 2–3 indicates that market participants have moved on; the monetary policymakers’ model should follow. Continuing to treat Treasuries as unconditionally safe in stress-testing exercises, capital frameworks, and forecasting models embeds an optimistic view of fiscal capacity that the bond market has already rejected, and makes it institutionally harder for the central bank to read fiscal news as fiscal news.

Make the plumbing more resilient without subsidizing it. A separate set of reforms targets the intermediation chain documented in section 4: primary dealers, repo, and the hedge-fund cash–futures basis trade. The goal is to keep the Treasury market functioning under stress without requiring the Fed to step in as buyer of last resort. Duffie (2023) surveys the post-COVID Treasury-market resilience agenda in detail and arrives at much the same prescription list. First, central clearing of Treasury repo, already mandated by the SEC for implementation in 2026, should be completed on schedule; it reduces bilateral counterparty risk and shrinks the channel through which a single dealer’s stress propagates to the rest of the market. Second, the

Supplementary Leverage Ratio should be recalibrated to reflect dealer intermediation capacity rather than balance-sheet size: the right policy is not a blanket carve-out for Treasuries, which would re-encode the safe-debt assumption that this paper argues against, but a calibration that distinguishes holding Treasuries (which carries real interest-rate risk) from intermediating them through matched-book repo and dealer market-making (which does not).

Conclusion

Market participants and policymakers are using competing models of US government debt. The market has moved to a risky-debt model that is a better fit for the data: long-end Treasury premiums are gone, the stock–bond hedge is broken, stress events mark-to-market rather than produce flight-to-safety, and yields respond to fiscal news. Central bankers and financial regulators still operate under the safe-debt model embedded in their analytical tools and prudential rules.

When fiscal shocks produce yield spikes, the safe-debt view naturally relabels them as plumbing problems, creating institutional space for bond-market intervention and blunting the market discipline the fiscal authority depends on. Repeated interventions result in large central-bank balance sheets that warehouse government debt or in banks induced by regulation to do the same. Either route delivers some combination of financial repression and inflation tax. To avoid this, the Fed and other central banks in advanced economies should credibly commit to running a small balance sheet and to stop intervening in the bond market.

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