US Rates Strategy

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Capping the Treasury's account

Since the Warsh nomination, there has been more discussion of ways to shrink the size of the Fed's balance sheet. One proposal which does not directly address bank reserve demand might be to cap the size of the Treasury's account on the Fed's balance sheet.

- The Treasury keeps its large and growing operating deposit at the Fed. **The deposit drains bank reserves, so shrinking it – or at least reducing its daily volatility – might allow the Fed to trim its balance sheet**.

- **In theory, the Treasury could agree to maintain a fixed balance (of, say, $500bn) at the Fed and invest the surplus directly in the Treasury repo market**. To keep rates from falling, the Fed could simultaneously reduce its Treasury holdings by the same amount.

- **But the Treasury might not want to replace a significant portion of its cash deposit at the Fed with tri-party repo or to become the single largest cash lender in the market**. Ultimately, this limits the Fed's capacity to shrink its balance sheet.

- **Tri-party transactions normally settle and unwind in the afternoon, but the Treasury's payment flows might require more flexibility**. While the tri-party market can handle "early return" unwinds, there is not much demand from borrowers.

- **The demand for reserves could increase if the Treasury's repo cash proves too unpredictable.**

- **In effect, by fixing the size of its Fed deposit, the Treasury would be transferring all the volatility in its daily cash flows into the repo market. While the level of bank reserves may be steadier as a result, repo rates may not.**

Treasury balances

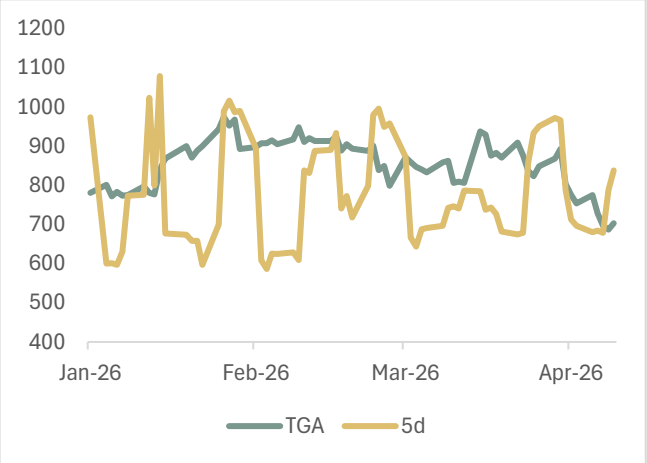
The Treasury keeps its operating balance on deposit at the Federal Reserve, its fiscal agent. The balance is unremunerated. The size of the balance is scaled to meet 5-7 days of expected cash outflows from debt servicing, paying out social security benefits, as well as federal government payrolls (Figure 1). Over time, as these payments grow, the Treasury's average balance at the Fed has increased (Figure 2). The balance is likely to exceed $1trn at month-end.

Like deposits at banks, the Treasury's balance at the Fed is a liability. Because the asset side of the Fed's balance sheet is fixed (in the short run), increases in the Treasury's cash balance must be offset by

reduction in the Fed's other liabilities – the largest are currency and bank reserves.[1] In practice, cash is shifting back and forth between bank reserves and the Treasury's account as household and business pay taxes and tariffs while the Treasury services debt and makes payments.

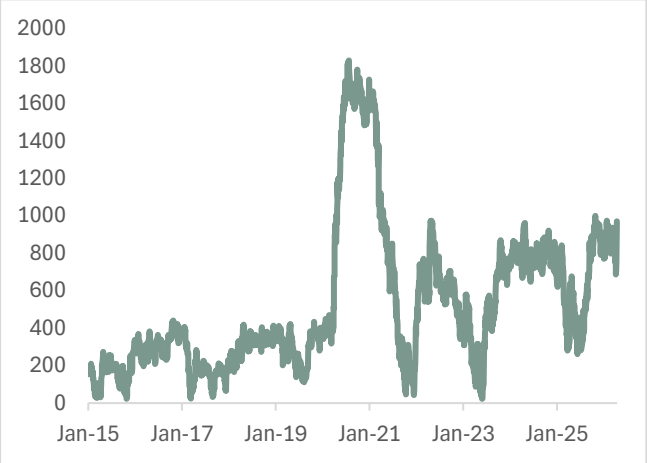
In theory, if the Treasury maintained a smaller cash balance, its drain on bank reserves would be smaller. As a result, the asset side of the Fed's balance sheet would not need to be as large since it would not need to offset as large a reserve drain. But, the Treasury has been clear; it does not intend to maintain a smaller precautionary cash balance.[2]

Figure 1: Treasury 5d outflows and cash ($bn)



Source: US Treasury, SMBC Nikko

Figure 2: Treasury cash balance ($bn)



Source: US Treasury, SMBC Nikko

Return to the past

Since the Warsh nomination, there has been more discussion about reducing the size of the Fed's balance sheet. Most of the focus has been on ways to reduce banks' demand for reserves – either through tiering IORB, changing bank liquidity rules to recognize pre-placed discount window collateral or improving payments efficiency.[3] Dallas Federal Reserve Bank President Logan also recently outlined a series of options for shrinking the size of the Fed's balance sheet.[4] Logan and Schulhofer-Wohl suggest that the Treasury could agree to reduce the size and variability of its balance at the Fed.

In practice the Treasury might target a (lower) fixed dollar amount in its account, of say, $500bn. This would be maintained every day, **and all balances over the amount would be invested in overnight**

[1] Currency increases over time; its growth slows as interest rates increase and seasonally, as cash accumulated during the holidays returns to the Fed. Secularly, currency might decline as electronic payments and, perhaps, stablecoins, become more prevalent. That said, total currency is near $2.5trn.
[2] See "Remarks at the 2025 Annual Primary Dealer Meeting", Treasury Assistant Secretary McMaster, September 29, 2025.
[3] See, for example, "The Payment System Puts a Floor on the Fed's Balance Sheet," D. Duffie, Stanford University and Brookings Institute, March 26, 2026.
[4] See, "Options for Reducing the Size of the Fed's Balance Sheet", L. Logan and S. Schulhofer-Wohl, Federal Reserve Bank of Dallas, April 2, 2026.

Treasury repo. Legally, the Treasury Secretary has the authority to invest in Treasury repo with "acceptable counterparties". Cash held off the Fed's balance sheet in repo would remain in bank reserves.

Such a strategy would be reminiscent of the Treasury's pre-financial crisis operating regime when the Fed maintained a fed funds target through small changes in the level of scarce bank reserves. Such a system required the Fed to be able to accurately forecast the components of its balance sheet – even those over which it did not control. Large or unexpected swings in its liabilities would echo through funding markets forcing banks to borrow from the discount window. It was more likely that banks would tap the fed funds market late in the day and borrow at very high rates.

To prevent the Treasury's balance from creating swings in scarce reserves, the Fed and Treasury agreed to maintain a $5bn daily balance at the central bank. The Treasury held the remainder in bank deposits in special Treasury, Tax and Loan (TT&L) accounts. The Treasury would issue a call/draw on these banks when it needed to transfer cash to its account to make payments. Not all banks participated in the program and participation was tiered based on banks' liquidity preferences. **Banks holding Treasury cash would agree to a dollar cap on the funds that they would take from the Treasury.** This helped their cash planning as banks were subject to (unremunerated) reserve requirements. The Treasury's balances were collateralized. Other banks might only process tax payments for the Treasury. Although TT&L accounts pre-date the Basel III liquidity requirements, as a "public sector enterprise", the Treasury's deposits would have a 0% outflow assumption – that is, they would be considered a sticky source of bank funding.

Investing in repo

Investing the Treasury's non-deposit cash in the repo market would have the advantage of keeping the cash circulating in the banking system. The Treasury would earn a return (a tri-party repo rate) compared to its existing unremunerated central bank deposit. Since the cash is no longer on the Fed's balance sheet and is instead circulating in the repo market, repo rates would fall if the Fed did nothing else. **To keep repo rates from falling, the Fed could allow a similar amount of its Treasury holdings to mature without replacement**. The Fed could shrink its balance sheet without altering the supply and demand balance of reserves.

The Treasury already does something similar with its cash management buybacks. It uses some of the cash it accumulates after its quarterly tax dates to pay down short maturity Treasuries (1m to 2y). This keeps its deposit at the Fed from climbing too much and draining bank reserves. The cash used to buy back this debt returns to the market as bank reserves.

Structural and operational issues

Conceptually, moving the Treasury's cash off the Fed's balance sheet and into the repo market might allow the Fed to shrink its balance sheet. **However, our sense is that structural and operational issues may limit how much the balance sheet can be reduced while increasing repo rate volatility**.

We assumed a $500bn target Treasury balance. But this would mean that the Treasury's daily tri-party repo operations would have averaged $350bn/day with a daily standard deviation of $66bn this year. Assuming the Fed's balance sheet fell by the same amount, the reduction would have accounted for just 5% of its $6.75trn balance sheet. **Moreover, the $500bn target may be too small for the Treasury**. Unlike tri-party repo, its balance at the Fed is immediately available and accessible for a longer period during the day. Consequently, the Treasury might prefer maintaining a larger deposit at the Fed and a smaller repo pool. At $800bn, for example, the Treasury's target would equal the average 5d expected

outflow this year.[5] But it would reduce the Treasury's average repo pool to just $50bn/day and limit the scope for balance sheet reduction.

For the Treasury to invest larger amounts in the repo market, it needs some confidence that it can gain access to this cash in an emergency. We assume the Treasury's cash would be invested in tri-party repo because these trades are operationally easier than other settlements. Given the Treasury's payment needs, our sense is that these trades would all be overnight.[6] Tri-party is a funding market rather than a market for specific issue collateral. In a tri-party trade, the cash and collateral move simultaneously on the balance sheet of the clearing bank. We think the market is large and well-established enough for the Treasury to feel comfortable enough to lend *some* of its cash in.

Mechanically, we think the Treasury could "auction" its tri-party cash in a daily operation. The timing of this operation is a bit unclear. The heaviest demand for tri-party funding occurs in the morning but this may also coincide with the Treasury's biggest (planned) outlays. It may prefer to wait until later in the morning before auctioning off its cash to have a better sense for any unplanned outflows. Tri-party transactions normally settle and unwind in the afternoon. However, like the FHLBs, the Treasury might prefer to have its unwinding cash returned first thing the following morning. This makes it easier to plan its daily cash outflows. And while the tri-party market can handle "early return", there is not much demand from borrowers.

In addition, the Treasury might like to have the ability to pull out of a trade before it has settled in the afternoon. Our sense is that dealer *might* be able to accommodate this if it occurs before the Fed's 1pm SRP operation. Dealers could replace the Treasury's funding with cash raised from the Fed's afternoon liquidity program. Alternatively, the Treasury would need to raise the cash it needs through an unscheduled (and likely expensive) bill auction. We suspect that banks, leery of facing an unexpected draw from the Treasury, might instead keep higher precautionary cash balances at the Fed. That is, the demand for bank reserves could increase because of pushing Treasury cash into the repo market.

Separately, substituting $350bn of overnight tri-party cash from multiple (largely money fund) providers with a single provider could mean the Treasury becomes the single largest cash lender on some days. Depending on the auction rate, the Treasury could crowd out money fund tri-party lenders. As a result, the Treasury might want to maintain a smaller footprint in the repo market. But this would mean increasing the size of its target cash deposit while reducing the capacity of the Fed to shrink its balance sheet.

We suspect that the Treasury's repo trades would need to be cleared even though they probably would not be subject to the SEC's clearing mandate. Since the Treasury's activity is one-directional, there are no naturally offsetting transactions that dealers could use to net down their own balance sheet. Like the SRP, we suspect that the Treasury's repo trades would need to be cleared through some remote access model where it does not become a direct member of the CCP and does not participate in loss mutualization or pay margin. While we do not know the exact structure, it is possible that a 'collateral in lieu' (CiL) framework might work. The Treasury would have a lien against the collateral pledged by borrowers in the tri-party account. For the intermediating dealer CiL is more margin cost effective.

More fundamentally, it is unclear how much demand there might be for the Treasury's repo. Dealers typically provide term financing to their clients against overnight borrowing raised from money funds. As a result, they prefer funding sources that are stable from day-to-day. But the Treasury's repo cash is likely to be considerably noisier than money fund flows. The standard deviation of the change in

[5] Assuming no confidence interval.
[6] Although it might be interesting for it to consider term transactions, say between days with large inflows.

the Treasury's daily cash balance is about $40bn/day. Unpredictable swings in the supply of tri-party cash on the order of $40bn/day may increase repo rate volatility. Dealers might prefer money fund tri-party cash instead. **In effect, by fixing the size of its Fed deposit, the Treasury would be transferring all the volatility in its daily cash flows into the repo market. While the level of bank reserves may be steadier as a result, repo rates may not**. Moreover, analysts covering the repo market have less detailed knowledge about the Treasury's day-to-day cash flows than the Federal Reserve. Poor forecasts would add to the volatility in repo rates.

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