Hoover Monetary Policy Conference, May 9, 2025
Session on Fiscal and Debt Sustainability Issues: Implications for Monetary Policy

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In March of 2022, in the wake of the COVID-19 pandemic, the Federal Reserve announced that it would stop expanding its balance sheet to absorb the issuance of Treasurys. Central banks in other advanced economies followed suit. As the price discovery process in government bond markets has resumed since then, we have seen several instances in which government bond yields in advanced economies spiked in response to fiscal and macro shocks.

In July of 2022, The Eurozone saw large increases in spreads between core and periphery bond yields. The most dramatic example was the announcement of the Truss budget on Sept. 23 of 2022, announcing large tax cuts. France experienced a bout of bond market volatility after prime minister Barnier's fiscal consolidation plan ran into trouble in December of 2024. More recently, in March of 2025, Germany released its constitutional debt brake in order to increase defense spending, triggering increases in the 5-year German Bund of around 30 bps in the next 24 hours. More recently, in early April of 2025, in response to the reciprocal tariff announcements, U.S. long-term interest rates rose significantly from April 4 to April 14. The yield spread between 10-year US Treasury bonds and 10-year German Bunds increased by 50 bps.

In most of these cases of bond market turmoil, market observers and policy makers have suggested that there is a problem with the functioning of the bond markets that calls for central bank intervention. In July of 2022, the ECB rolled out the Transmission Protection Instrument designed to suppress spreads that are not driven by fiscal fundamentals. In September of 2022, the BoE briefly resumed its bond purchases only a few days after it had announced the end of large scale asset purchases.

[1] Based on "Fiscal Discipline Through Bond Markets," (2025), joint work with Roberto Gomez-Cram, Thilo Kind, and Howard Kung.

Policy makers and market observers have adopted the *safe debt view.*[2] If the debt is safe or zero beta, then these large yield spikes are not supposed to happen if markets function well. In this safe view of government debt, one would expect to see flight to the safety of government bonds, especially US Treasurys, when an adverse shock like COVID in March 2020 or the tariff announcements in April 2025 hits the economy. In that case, the yields on US Treasurys would decline, as they did for example in the last quarter of 2008, during the worst months of the GFC, as investors bid up the price of US Treasurys (Gomez-Cram, Kung, and Lustig 2024). But that is not what happened in Treasury markets March of 2020 or April of 2025.

When you adopt the safe debt view, these yield spikes are the signature of market dysfunction. There is a plumbing problem in the bond market. In the UK in September of 2022, the liquidation of highly levered gilt positions by pension funds was blamed. Similarly, in April of 2025, some market observers blamed the unwinding of the Treasury basis trade in which hedge funds buy U.S. Treasurys and short futures on Treasurys to earn the cash-futures basis. Central banks have increasingly invoked these types of plumbing problems in the bond market as a reason for intervention. Central banks are unconstrained and they can use their balance sheet to provide liquidity to the bond market by buying underpriced securities.

However, there is a different view, the *risky debt view*. When governments implement large spending increases or tax cuts that are unfunded, i.e., they are not offset by future tax increases or spending cuts, the market value of all outstanding debt will have to be marked down, and yields will increase. That happens through increases in term premia, increases in expected inflation, decreases in the convenience yields on government bonds, or even increased in default risk premia.

The UK mini-budget crisis offers a compelling case study. On Sept 22, the BoE's MPC announced that they were done purchasing gilts. On Friday, September 23, 2022, Chancellor Kwasi Kwarteng delivered a Ministerial Statement to the House of Commons. The statement commenced at 9:30 AM BST. The Growth Plan introduced a sweeping package of tax cuts and policy changes betting that reducing marginal tax rates would stimulate long-run economic activity. This package represented the largest set of tax cuts announced in the UK for 50 years to be funded through significantly increased government borrowing.

[2] Please see "Government Debt in Advanced Economies: Risky or Safe?" by Roberto Gomez-Cram, Howard Kung and Hanno Lustig.

Figure 1 shows the 30-year and 10-year nominal gilt yields on September 23, 2023. The Budget statement, including the subsequent debate, lasted for three hours. During the initial part of the opening statement and debate, there was a sharp rise in bond yields, with the 10-year nominal yield increasing from around 3.5% to 3.7%, while the 30-year yield also rose significantly, adding 27 basis points on the day.

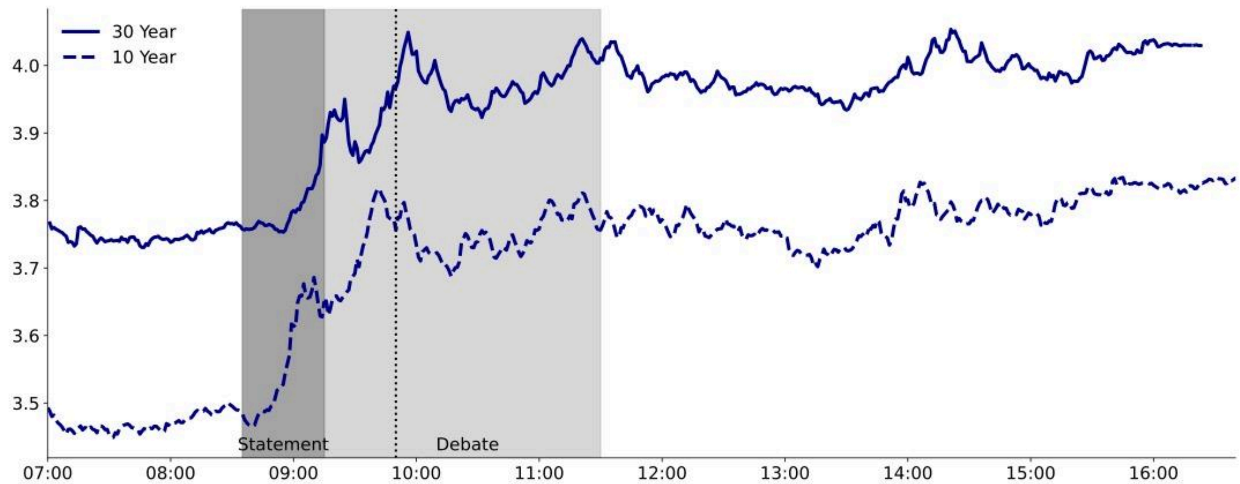

Figure 1: UK Mini Budget announcement on September 23, 2022. This figure shows the 30-year and 10-year nominal gilt yields on September 23, 2022. The dark shaded area represents the opening statements by the Chancellor of the Exchequer, Mr. Kwarteng, and the Shadow Chancellor, Rachel Reeves. The light gray shaded area marks the debate, with a dotted line separating the first part, which focused on debt implications and the absence of Office for Budget Responsibility forecasts, from the second.

This happened well before there were any plumbing problems in gilt markets. Subsequently, in the following days, a real plumbing issue did materialize. The sharp and rapid rise in long-term gilt yields following the mini-budget triggered a crisis in Liability-Driven Investment (LDI) strategies used by UK defined benefit pension funds. These strategies rely on leverage and derivatives, making them highly sensitive to gilt price declines. As yields surged, LDI funds faced large mark-to-market losses and urgent collateral calls, often requiring cash. To meet these, funds were forced to sell assets. The plumbing problem merely amplified what was a fiscal shock. On September 28, 2022 at 11:00 AM BST, the Bank of England announced a temporary program to purchase long-dated UK government bonds, effective immediately, reversing the MPC's earlier decision from Sept. 21. In early October, the tax plan was abandoned and the PM was forced to resign. After that, gilt yields permanently came down. But what would the BoE have done if the tax plan had not been abandoned?

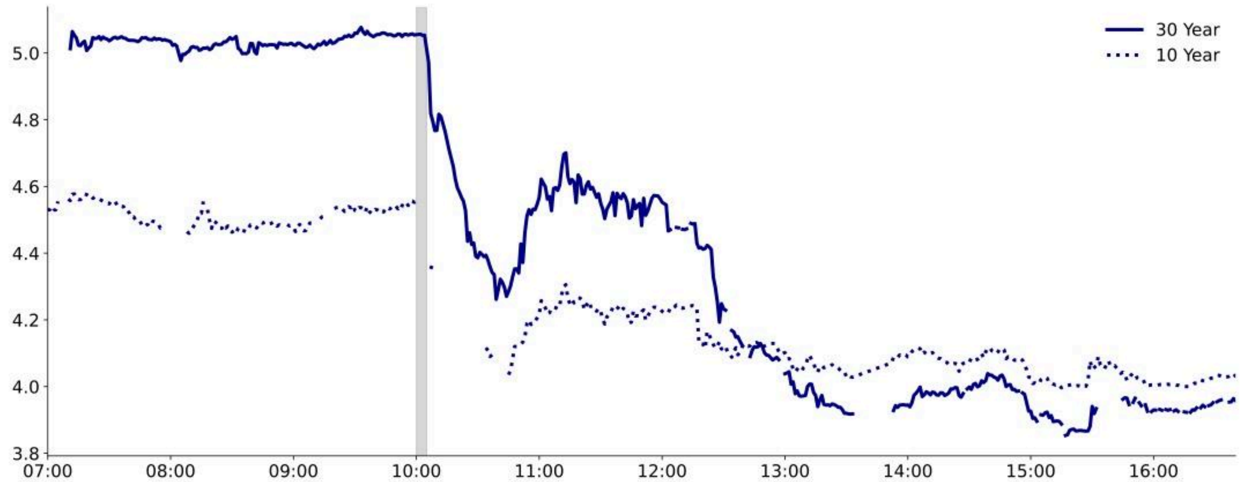

Figure 2: This figure shows the UK 30-year and 10-year nominal gilt yields on September 28, 2022, the day of the BoE announcement.

COVID-19 provides a cautionary tale. Between March 9 and March 18, 2020, the 10-year US Treasury yield increased by 68 bps, as bond markets were slowly starting to digest the largest post-war fiscal shock. Some economists pointed out that primary dealers in the US may have been running out of balance sheet capacity in March of 2020. The US was not an outlier. Yields in Germany, France, the UK and other advanced economies increased by about 64 bps, in line with US yields. These events triggered massive intervention by central banks around the world. The Fed absorbed most of the subsequent massive issuance of U.S. Treasury Notes and Bonds between March of 2020 and March of 2021, as shown in Figure 4.

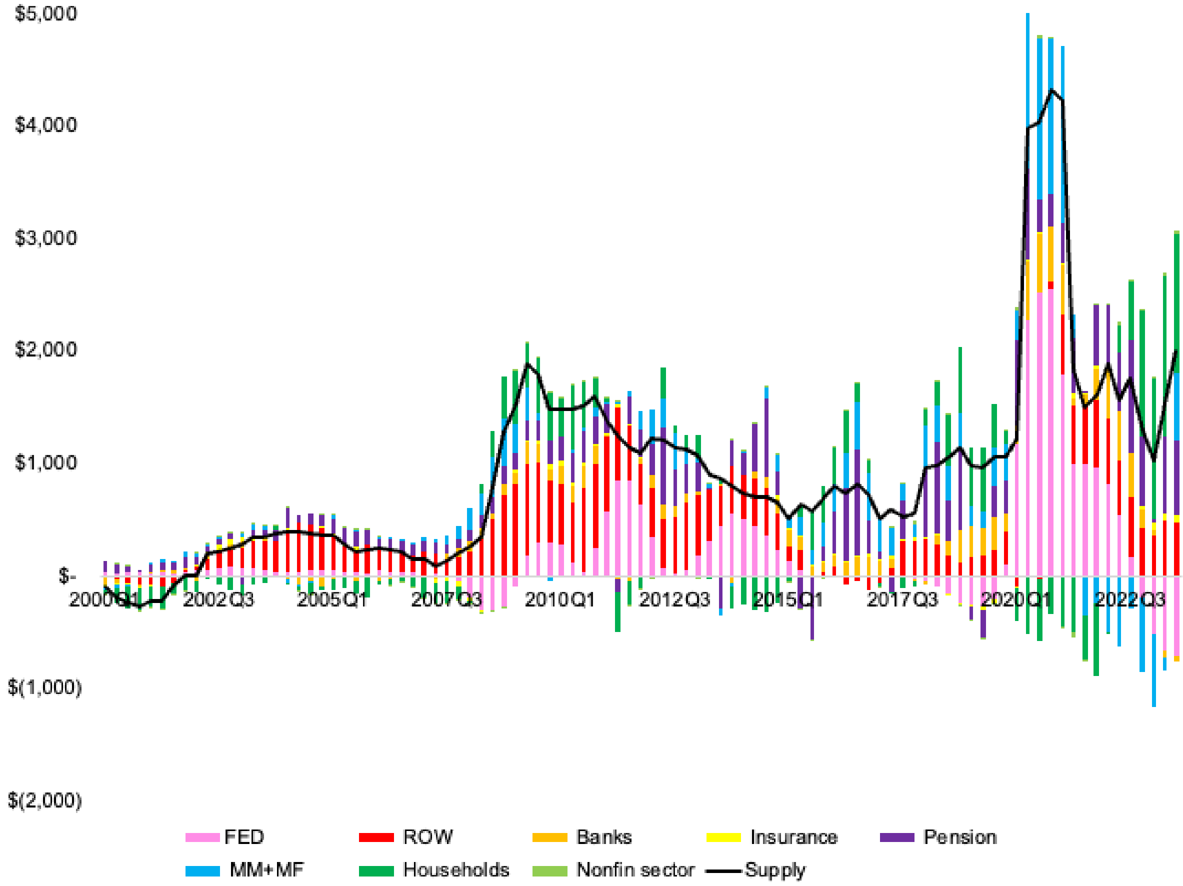

Figure 3: Purchases of all Treasurys (including T-Bills) by different sectors. Annualized flows in billions of dollars.The figure plots 4-quarter moving averages. Source: Flow of Funds.

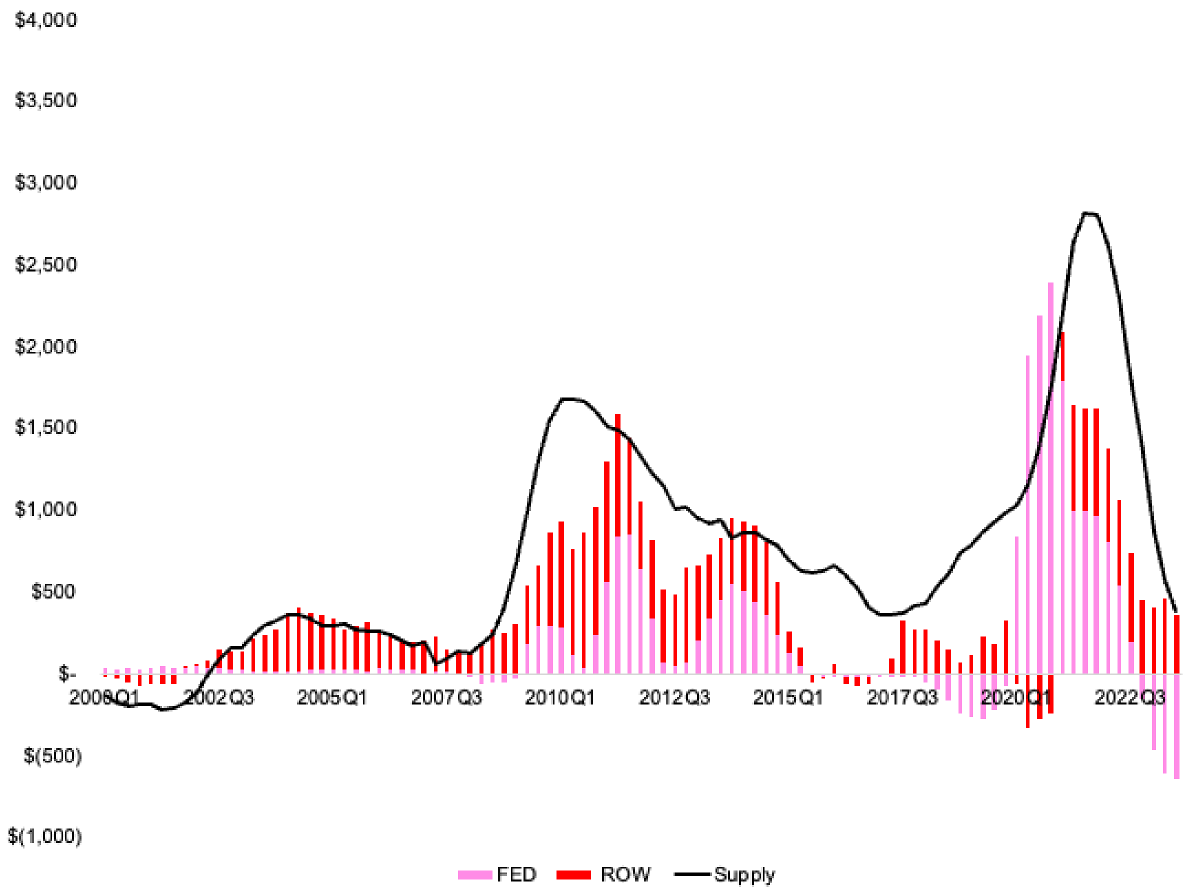

Figure 4: Purchases of Notes and Bonds (excluding T-Bills). Annualized flows in billions of dollars.The figure plots 4-quarter moving averages. Source: Flow of Funds.

It is important that central bankers, including the Fed, use the right model of government debt when judging whether the bond market is functioning and whether sustained intervention is called for.

The US federal government is not on a sustainable fiscal trajectory. In the baseline case, the CBO projects that the federal government will be running primary deficits (the deficits excluding interest expense) until 2053. The federal debt held by the public in the baseline scenario will hit 153% of GDP in 2053. That's the baseline scenario. However, if the 2017 Tax cut is extended, the debt/GDP ratio would hit 214% of GDP, 47 percentage points higher than in the CBO's baseline scenario. The price discovery process in Treasury markets ensures that fiscal fundamentals are priced. This imposes discipline on fiscal policy. If government debt really is risky, then large yield increases in response to adverse fiscal news may be appropriate as part of the price discovery process. If central banks use the wrong model of government debt, then they may end up using their balance sheet to continue to absorb most of the issuance, as in the case of Japan, potentially at a great cost to taxpayers and to savers.

Gomez-Cram, R. G., H. Kung, and H. Lustig. 2024. “Government Debt in Mature Economies: Safe or Risky?” *A Symposium Sponsored by The Federal Reserve Bank of Kansas City*. https://www.kansascityfed.org/Root/documents/10796/Jackson_Hole_Symposium_2024-web.pdf#page=141.

Roberto Gomez-Cram, Thilo Kind, Howard Kung, and Hanno Lustig. 2025. “Fiscal Discipline Through Bond Markets.”