EconoFact Chats: Treasury Bonds, Safe Havens, and Financial Stress
Jeremy Stein, Harvard University
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I'm Michael Klein, executive editor of EconoFact, a nonpartisan, web-based publication of The Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein
We all would like to find a safe haven in a storm. For financial markets, the traditional safe haven is United States Treasury bonds, especially the longer maturity bonds. This has meant that investors were willing to pay a premium for the bonds, and since bond prices are inversely related to their yields, high Treasury bond prices mean that the United States government can borrow at a relatively low interest rate. But very recently, all this has changed. In the wake of President Trump's tariff policies, the stock market plunged, but the market for US Treasury bonds has also recently weakened, with bond prices falling and yields rising. Why has this happened? What could be some of the consequences? And what policies are needed to stem this problem? To talk about these issues, I'm very pleased to be speaking today with Jeremy Stein. Jeremy is a professor in the Department of Economics at Harvard. He was a member of the Board of Governors of the Federal Reserve from 2012 to 2014, and during the global financial crisis served as a senior advisor to the Treasury Secretary and on the staff of the National Economic Council. Jeremy, welcome back to EconoFact Chats.

Jeremy Stein
Thanks, Michael. Thanks for having me. It's nice to be back.

Michael Klein
It's great to have you again. So first off, Jeremy, what's meant by a safe haven in financial markets, and why have US Treasury bonds been viewed as a safe haven asset?

Jeremy Stein
Well, one way to think about it is to ask: What would you like to have in something where you're going to put your safe money—the safest claim that you have? So one obvious characteristic is that US Treasury bonds have been seen as default-free. You don't have to worry about them being paid back. But also, very importantly, they've been seen as extremely liquid. That is to say, you can get your money back when you need it, and in large size. So, the liquidity means that people can trade very large amounts of Treasury securities at a moment's notice without much moving the price against them. So those have been two of the defining characteristics of the Treasury market – safety and liquidity.

Michael Klein
Isn't it also the case that in the last two decades longer maturity Treasury bonds have offered a good hedge against the prospects of declines in the stock market?

Jeremy Stein
Yeah, that's been true. That's not always true. As you said, it's been largely true the last couple of decades, that on days when the stock market has gone down, typically Treasury prices have gone up—i.e., yields have gone down. That tends to be a little less true when there are a lot of worries about inflation, because bad news on inflation tends to be bad news for both the stock market and the bond market.

Michael Klein
One of the striking things was even in 2008, when the global financial and economic crisis started in the United States, capital inflows to purchase Treasury bonds meant that the dollar strengthened. Isn't that the opposite of what typically happens? A country that starts a financial crisis sees a flight from its assets and its currency weaken, instead of an attraction of currency and a strengthening of the exchange rate?

Jeremy Stein
Yeah, I think that is not the normal pattern, but that has been one of the benefits, I guess you would say, of the dollar being seen as the ultimate safe haven asset. So when investors get scared—even when they get scared about the US economy—where do they go? Where have they gone? Traditionally, it's to US Treasury bonds. So that has tended both to push down their rates, and if it's foreign investors who are rushing into US Treasury bonds, it'll tend to push up the dollar's value relative to other currencies.

Michael Klein
So why is this pattern being reversed now? Some people say it's because of what they call a dash to cash—that investors are trading in bonds to raise cash. Why would they do that?

Jeremy Stein
Yeah, I think that the so-called dash for cash was particularly an issue the last time we saw this kind of pattern, which was in March 2020 at the onset of the COVID pandemic. And that, I think, really was something of a dash for cash. People were extremely risk-averse and were wanting to get not only long-term Treasury securities, but the safest possible interest rate risk-free assets, like literally bank cash or short-term T-bills. I think this time, it's a couple of possible different things going on. One, you know, it has been sort of the unquestioned role of the dollar as the world's global currency. And I think that's a hard thing to mess up, but, you know, if you were going to try to do things to mess that up, we're in the process of doing that now. So you could imagine—and it's hard to know in real time—but you could imagine that foreign central banks, foreign—what are called reserve managers—who hold a lot of assets in currencies other than their own; those have predominantly been dollars. But at this point, they may be looking to shift some of that out of dollars and into other currencies. So that could account for some of the selling of Treasury securities. I think that's a piece of the story. The other piece that I think is quite clearly going on is a little bit more technical—it has to do with the role of hedge funds in the Treasury market. And I think you're seeing—and we can talk about this in more detail—I think you've been seeing some liquidation of highly leveraged hedge fund positions in Treasury securities.

Michael Klein
In fact, I had you on an earlier podcast where we talked about the Fed's response in March of 2020 and the way that at that time it helped prevent a sort of financial meltdown by intervening in the markets. And I want to get back to that in a minute. But first, when people talk about the dollar as a reserve currency, what it seems to be is really that it's Treasury bonds that are this safe haven asset—but you need dollars to buy the Treasury bonds. So it's really, in a way, the Treasury bonds that are the kind of reserve asset, although the dollar does have other important roles, like as a vehicle currency—trade is invoiced in dollars. Would you agree with that?

Jeremy Stein
Yeah, I think you're exactly right. I think—you know, people talk about the dollar as sort of the dominant global currency, and I think that's importantly kind of a multifaceted thing. So as you said, one aspect of it is a very large fraction of international trade is invoiced in dollars. That's point number one. In part as a result, people who are going to be buying imports like to have dollar-denominated bank accounts. It's a sometimes surprising fact that the size of the dollar banking system outside the United States is roughly on the same order of magnitude as the dollar banking system in the United States. A tremendous amount of dollar banking. And then again, the third piece is that foreign central banks like to hold a lot of their precautionary reserves in the form of dollars. And because all these things, in some sense, mutually reinforce one another—once you get to be the dominant global currency, it's pretty hard to dislodge you. So you know, the pound sterling was the dominant currency in the years—in the pre-war years. You know, eventually the dollar came along and knocked it off. But it's basically been the dollar for the last many, many decades. And again, I think it's unlikely that it will be kind of knocked off that perch anytime soon. But I think it's fair to worry about damage below the surface. You know, if we damage our trading alliances, since trade is a piece of what holds this up, that doesn't help. And then people start thinking, "Well, if that's happening, maybe I don't want to have quite as much of my reserves in dollars." And there goes another leg of the stool. Again, I wouldn't predict anything as happening real fast, but over a sort of decades-long horizon, this is probably not great news for the role of the dollar.

Michael Klein
Also, recently, there's been talk among some people in the administration of effectively doing something like charging people to hold Treasury bonds, which would be, in a way, a partial default—and that would be another thing that's going on under the surface that would affect the role of the dollar.

Jeremy Stein
Absolutely. I mean, it's a peculiar thing. I think it's long been seen as a benefit to the United States—this sort of special role of the dollar—for a number of reasons. One, the fact that there's so much global demand for Treasury bonds has allowed us to finance our deficits somewhat cheaper. I mean, estimates vary, but it's surely been a little bit helpful both in terms of price and also just not having to worry really about whether there'll be buyers for dollar securities. I think national security folks also think it's quite important—it gives us certain levers basically because we can apply, for example, sanctions on dollar-banked accounts and that kind of thing. So I think it's—you know, it's been a boon to the United States in a variety of ways. My understanding of your point—it's not 100% clear in my mind—is that, of course, all this tends to strengthen the

dollar, which, if your real focus in life was not running a trade deficit, you might say, “I don’t like a strong dollar.” But somehow getting to the weaker dollar by undercutting, again, this sort of global role in the financial system seems like a funny way to go.

Michael Klein
So getting back to what’s been happening recently, another possible reason that’s been floated for the increasing yields on Treasury bonds—for the falling price—is that investors are trying to take profits now and get out of the Treasury bond market before bond prices fall even further and interest rates rise. What would be the reasons for that?

Jeremy Stein
That I’m less sure of. I mean, if you look, what’s been a little—what sort of amplified the puzzle, in a way—is if you look at shorter-term interest rates, sort of one year out, two years out, those have actually been going down as the longer rates have been going up, on the essentially speculation that the Fed is going to be cutting interest rates. So I don’t think that the longer-term movement in rates—again, which is in the opposite direction—is easily rationalized based on some fundamental expectation about, for example, future policy.

Michael Klein
Jeremy, you were quoted in a newspaper article recently as saying that the Treasury market is a kind of foundation of global finance. Why is that?

Jeremy Stein
Well, I think we talked about it. I think the fact that it has been the unquestioned safe asset—safe and liquid asset—is at the core of it. So for a couple of examples: One, pretty much everything else—certainly in dollars, but as well in other currencies—is priced off the Treasury. So we think of the interest rate on corporate bonds as being at a spread to Treasuries. So first of all, it’s just a benchmark. The other thing—again, it’s got so many uses because of the fact that people accept it as the ultimate safe asset. So if you want to engage in some kind of derivatives transaction, or pretty much any other transaction that requires you to post margin or to post collateral, what are you going to use? You’re basically going to use Treasury securities. If you are a bank or a bond fund and you need to keep some assets available that can be sold quickly—sort of a front line of liquidity—what are you going to use? Again, Treasury securities. So if in any way their safety or their liquidity comes into question, their utility in all these different sorts of transactions gets compromised. And in some sense, part of what they’re doing is greasing the wheels of our financial system. Our financial system needs a liquid asset. It needs something that can be posted as collateral—all of that.

Michael Klein
So for those reasons, I guess that’s kind of the inertia behind the Treasury bond market being so central, and in some ways it’s hard to see it being dislodged. But as you were saying, there are things going on now that could disrupt that.

Jeremy Stein
Yeah, I think so. Again, I don’t—you know, these are, at the end of the day to me, sort of chinks in the armor. I’m not predicting—I would not want to predict in any way, shape or form—that

the Treasury market or the dollar is likely to lose its primacy anytime in the foreseeable future. Nevertheless, it's a tremendous franchise to have, and I think that franchise should be jealously guarded.

Michael Klein
So we were talking a few minutes ago about in March of 2020, the disruptions to financial markets. Can you compare and contrast what's happened in the most recent past over the last couple of weeks, and what happened in March 2020? In what ways are they similar? And how are they different?

Jeremy Stein
Well, one—again, I think we alluded to this earlier on—I think one important commonality, and this is I think part of the disruption in the Treasury market, has to do with the role of hedge funds and what is called the basis trade. So—and this gets a little bit technical—but it has become a very important piece of what's going on in the Treasury market. There are hedge funds who basically do the following relative value trade: They buy Treasury securities—cash Treasury securities—they then short an equivalent amount of Treasury interest rate futures. Okay? Because there's a very small price discrepancy, or interest rate discrepancy, between the two, there's effectively a slightly higher yield on the physical Treasury securities than is implicit in the futures contract. Now, maybe that difference is 10 basis points, something like that—relatively small. But then, because the Treasuries are such good collateral, they're able to borrow 50 to 1, or even 100 to 1, to leverage up that trade. So this 10 basis points, if you leverage it 100 to 1, becomes interesting to the hedge funds. And in fact, their position in this trade has gotten to be close to a trillion dollars—very, very large—roughly double what it was on the eve of March 2020, on the eve of the pandemic. And because it's so highly levered, small shocks can basically force them to start liquidating their positions. And these shocks can come from a number of sources. I think in 2020 it was that the futures exchanges got nervous and started asking for more margin from these hedge funds, and then they didn't have the ability to come up with all the margin, so they had to liquidate their positions. My guess is that this time around it's in part just as risk has gone up, their tolerance for risk and their risk models are telling them to shrink their positions. And so when they shrink—since they were initially long Treasuries and short futures—shrinking means reversing both of those positions, which means selling the physical Treasuries and covering by going long futures. So again, anecdotally—this is hard to know in real time—but anecdotally it seems to have been quite a bit of forced selling by these hedge funds that has at least in part been responsible for the spike in Treasury yields.

Michael Klein
You have a very recent Brookings paper on economic activity where you talk about this problem, which—I guess you wrote well in advance of this actually materializing—and you suggest a policy response that's different from what the Fed did in March of 2020. What do you suggest doing now, and why is it different from what was done in March of 2020?

Jeremy Stein
So in March of 2020—again, just to be clear—I think the dysfunction in the Treasury market in March 2020 was significantly worse than what we've seen so far. So I don't think we're at the point of there needing to be a Federal Reserve intervention yet. I mean, things may get worse,

but so far we're not at that point. In March of 2020, it was very bad. The Fed tried a bunch of things, but ultimately the big bazooka that they brought out was just buying a tremendous amount of these Treasury securities—at a scale like nothing we've seen. So at a scale that would have made their earlier quantitative easing policies look small. They did something over a trillion dollars of bond purchases in the space of a week. So very powerful. On the one hand, that helps. You know, if the private sector is dumping a bunch of Treasury securities and the Fed comes in and takes the other side, that will do the trick—if you do it powerfully enough. The sort of issue with that is that it looks a lot like monetary policy. So this is not intended, in the first instance, to be monetary policy—it's intended to fix a market function problem. But if you buy a lot of bonds, people are going to say, "Oh, that kind of looks like quantitative easing." So there's that issue, and I think especially in the current environment where we have to worry about inflation picking up, I think the Fed would want to be very careful about addressing market function with a policy that can be confused with easing monetary policy. So I think that's the problem we were looking to deal with.

Michael Klein
And for our listeners, the standard way in which the Federal Reserve affects the money supply and has monetary policy undertaken is by purchasing bonds. So when they were purchasing bonds back in March of 2020, they were taking money from basically out of circulation in their vaults and injecting it into the system to purchase bonds. So, as you say, Jeremy, that was then akin to monetary policy. What's the alternative, then, that they could do this time that wouldn't have an effect on the money supply and monetary policy?

Jeremy Stein
So, I mean, I would not characterize it so much as the money supply. I would have said that the monetary policy aspect of buying bonds is that you're trying to push down the interest rate on those bonds, right? You're trying to drive up the price and push down the interest rate on those bonds. That's what makes it monetary policy. So what we would suggest in this market function case is—because the hedge funds are basically dumping a bundle, they're dumping a position that is long bonds and short futures—really what the Fed needs to do is just take the other side of that trade. That is to say, to buy bonds, but to hedge the position with futures. In that way, the Fed is not taking any interest rate risk off the table. Said a little differently, they're not trying really to lean against long-term interest rates—they're trying to fix more of a micro dislocation in the market. So they'd be doing this without taking interest rate risk onto their books, the way they did in a very, very large way back in 2020. One way to say this is, you know, after they did all this bond buying in 2020, later, when inflation kicked up and the Fed had to raise rates, they lost money—effectively—on their very long-term position in bonds. Were they to do what we're sort of thinking of here, with this hedged position, they'd be immune to further interest rate increases. So it's really a more technical fix, as opposed to outright bond buying.

Michael Klein
So earlier we were talking about how the Treasury bond rates—the long-maturity Treasury bond rates—are a benchmark, as you put it, for lots of other rates. If the Treasury rates do rise, I guess you would expect to see that spill over to other interest rates for mortgages, car loans, and corporate debt. What would that mean for the economy?

Jeremy Stein
I think that may actually be more significant. So, you know, there's Treasury market function, which is a concern in its own right. If you asked me to just call out the things that I thought were really indicative of things that could amplify the macroeconomic effects, I would look, for example, at high-yield bond spreads. This is the additional spread on a corporate bond above the Treasury rate. Those had been quite low in the period leading up to all of this, and they've spiked very sharply. That, to me, is a somewhat worrisome indicator for macroeconomics. That tells you quite a bit about the potential availability of credit to households, to businesses—all of that. So that's one of the first things I would be looking at as an alternative indicator.

Michael Klein
And do you think these spreads are increasing just because of underlying uncertainty and the risks associated with that?

Jeremy Stein
Well, I think there are two things, and it's always hard to know in the exact moment. Surely an increase is merited because of the uncertainty. Obviously, these spreads tend to be pretty good at rising ahead of recessions. So if you think we're more likely to have a recession than we were a couple weeks ago, corporate defaults are likely to be higher. That calls for an increase in the spreads. The other thing to keep an eye out for—and this was a big deal in 2020—is if interest rates go up and credit spreads go up, if you're an investor in a corporate bond fund, you're going to see pretty bad returns over the last month or whatever. And since those bond funds are open-ended, you may start pulling your money out of them. These corporate bond funds saw very big outflows—enormous outflows—in March of 2020, at which point they're forced first to sell their Treasuries, the first line of defense, and then eventually to sell the corporate bonds. So that can become an amplification mechanism that puts further pressure on credit spreads. So, haven't seen that yet. That was a big deal in March 2020. The Fed eventually had to create, in cooperation with the Treasury, these corporate bond buying facilities to, in effect, try to lean against that pressure. I don't think we're going to have those facilities this time around. It takes a lot of sort of bipartisan cooperation to get them up and running. And I do worry that if we have sort of another leg of market pressure, we might start seeing these kinds of bond fund outflows, and that, I think you start worrying, has pretty direct potential for macroeconomic consequences.

Michael Klein
So at a broader level, Jeremy, what you're describing is this amplification cycle or a vicious circle—where financial market weakness feeds into macroeconomic weakness, which feeds back into further financial market weakness. And we saw that obviously in the Great Depression, we saw the possibility of that in 2008, although eventually the Fed undertook policies that stemmed it. And that's something that policymakers always have to worry about, especially at times like now, when there seems to be spiking uncertainty and spiking risk, right?

Jeremy Stein
I think that's right. I would distinguish a little bit in the following sense: If the stock market falls a lot, as it had the last several days, I think that is—to a first approximation—not causing the problem. It's just reflecting the underlying economic costs associated with the tariff policy. Where I start worrying more about amplification is when we get stuff in credit markets, as I just

mentioned. And another worried kind of layer on in this case is, we've gotten accustomed to the Fed—or the Fed in cahoots with the Treasury—basically riding to the rescue in these episodes. And it kind of keeps ratcheting up. They rode to the rescue in a very big way in 2008. They played a huge role in the pandemic. I think for a variety of reasons, it's going to be harder for them to help this time. One of the obvious reasons is inflation is a big worry. In the previous episodes, you could think of them more as demand shocks. So at the same time that output was weakening and unemployment was going up, inflation was on the soft side. So there was really no conflict between their mandates in terms of putting the pedal to the metal to try to help. Here, this looks much more like a supply shock in the sense that we can have a weak economy and inflation—which puts the Fed in a very, very tough place. I think depending on the relative balance of those two, it may be very difficult for them to be in a position to cut rates to be helpful.

Michael Klein
Well, Jeremy, I remember we had a conversation a long time ago where we were talking about financial markets, and you were saying you have to pay attention to the plumbing. And I think you've done a good job today illustrating why the details can be very important and what the implications of that can be. So thank you very much for joining me once again on an EconoFact Chat.

Jeremy Stein
My pleasure. Good to be with you. Thanks, Michael.

Michael Klein
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