Financial Markets: Too Many Faultlines?

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Based on Acharya (Dec 2026, IMF Finance & Development)

Central Bank Balance Sheet… a Policy Put?

The plumbing view

- Banks need reserves to settle payments, and the central bank supplies or drains them to keep money-market rates near the policy rate
- Banks and nonbanks also hold Treasuries and tap repo for reserves as needed
- Purchases restore market liquidity and create reserves (takes the rest of the economy as given)

The macroprudential view

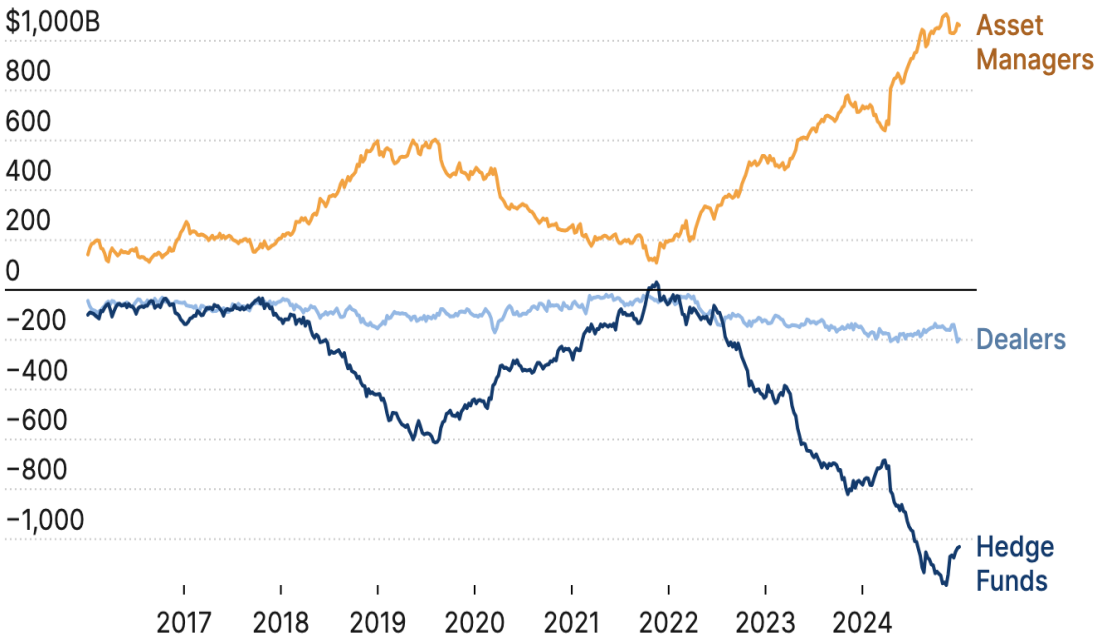
- In a crisis investors demand more compensation for risk and prices fall; losses spread through **interconnected balance sheets** (GFC, COVID)
- Central bank "put" (Haddad, Moreira and Muir 2025): readiness to buy puts a floor on prices in whichever market the central bank defends: **a system-wide backstop against instability**

If interventions overstay to become semi-permanent or permanent, questions follow:

- What made the financial system fragile in the first place? How much leverage did banks, nonbanks and the government carry into the crisis?
- How has actual or expected support changed their behavior going forward?
- Could easing financial conditions in a crisis make it harder to control inflation later?

Rise in Private and Government Leverage

Net Treasury futures positions of dealers, hedge funds, and asset managers



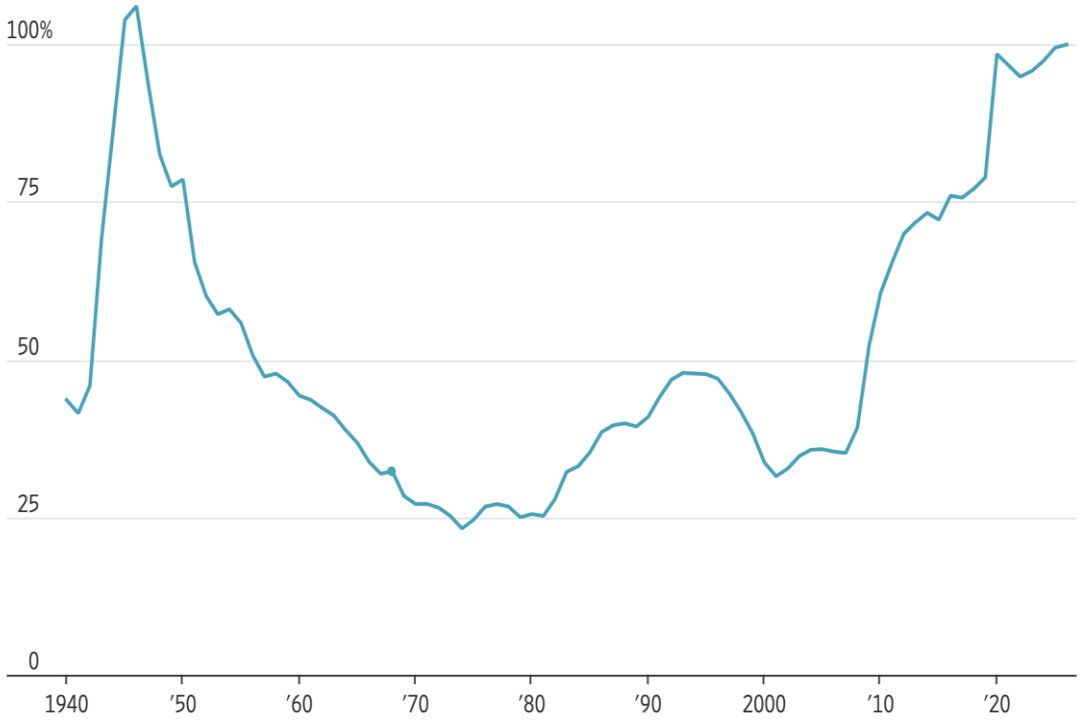
Source: Commodity Futures Trading Commission

BROOKINGS

Note: Hedge fund positions correspond to those labeled "leveraged money positions" in the CFTC data.

Source: Kashyap, Anil K, Jeremy C. Stein, Jonathan L. Wallen, and Joshua Younger. 2025. "Treasury Market Dysfunction and the Role of the Central Bank." *Brookings Papers on Economic Activity*, Spring: 221–265.

U.S. publicly held debt as a share of GDP



Note: Data are for fiscal years ended Sept. 30 except the figure for 2026, which is as of June 30.

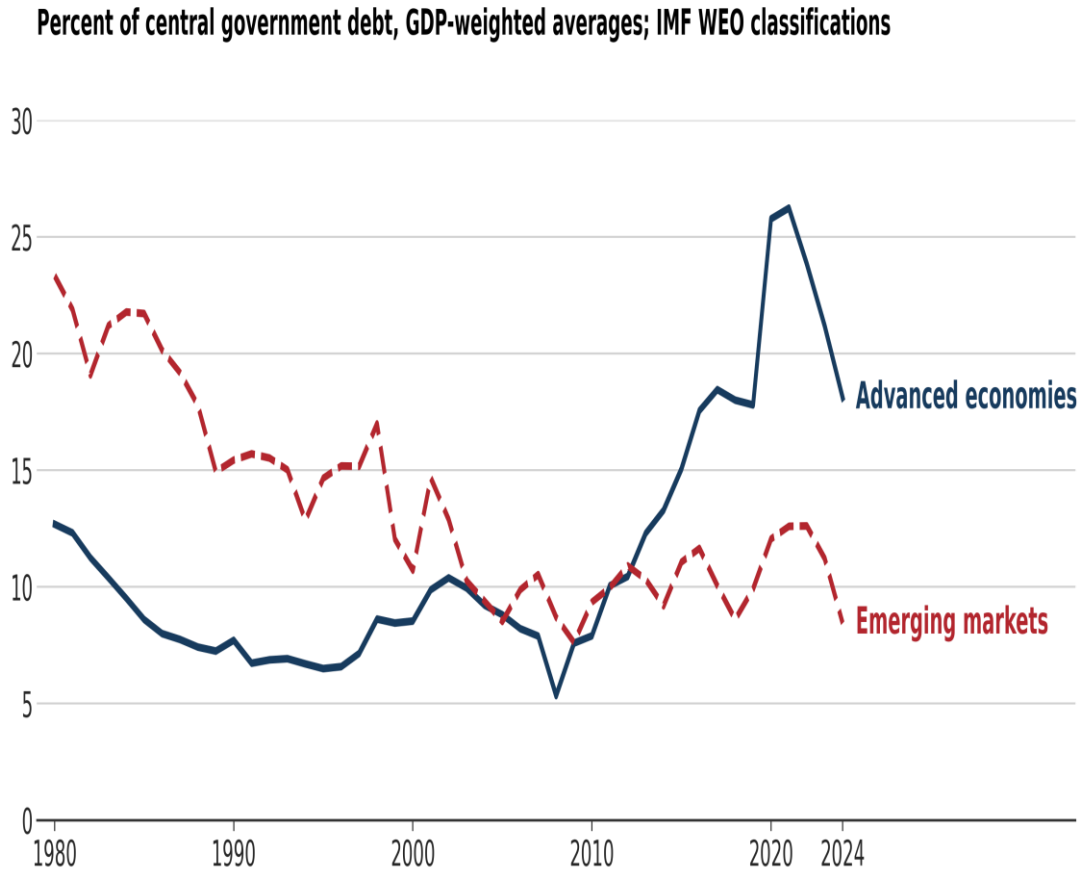
Sources: Office of Management and Budget (1940-2025); Treasury Department and Commerce Department (latest)

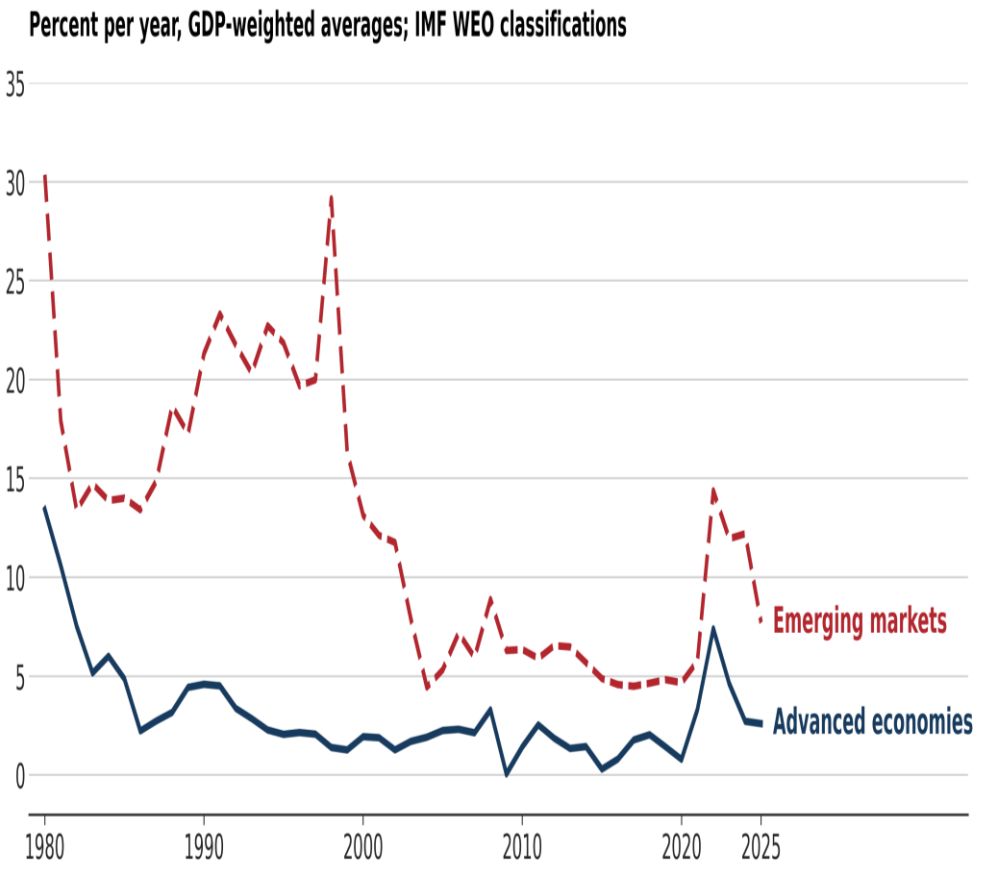
Source: Wall Street Journal, "U.S. Debt Just Topped $40 Trillion," August 2026; US Treasury, Debt to the Penny and Monthly Treasury Statement.

Two Routes to Dominance, and Why Support Persists

- **Financial dominance: the debt sits on fragile private balance sheets**
  - Rising yields (rate hikes or QT) ⇒ losses at thinly capitalized banks and leveraged investors ⇒ forced sales, higher yields ⇒ CB buys to stop spiral
  - The same fragility then blocks tightening when the inflation-growth tradeoff calls for it
- **Fiscal dominance: the budget cannot absorb market yields**
  - QE turns bonds into reserves, possibly at lower yields, but still a nominal liability of the consolidated public sector
  - If the fiscal path is unsustainable and default is unacceptable, under FTPL (Cochrane 2023), **inflation** cuts the real value of debt to what the surpluses can support; alternatives include growth and financial repression
- **Why support persists: the put feeds the leverage**
  - Expecting support, governments borrow more, fragile intermediaries take more leverage ⇒ stress arrives before inflation, so pressure to intervene rises
  - With large deficits and fragile financial firms, exit is resisted and government + central bank b/s are priced as one
  - US warning sign: the Treasury basis trade (40–50x leverage), after Fed intervention in 2020, has doubled to about $830bn (Monin 2026) and now helps finance the government's borrowing

Trading Places… Will AEs' inflation swap places with EMs?





Question: when and why do large central bank balance sheets have adverse consequences?

Source: IMF IFS, Global Debt Database, WEO, national central banks; author's calculations. Central bank claims include government securities and direct advances. GDP-weighted averages, 15 advanced and 11 emerging economies.

References

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Haddad, Valentin, Alan Moreira, and Tyler Muir, "Whatever It Takes? The Impact of Conditional Policy Promises," *American Economic Review*, 2025, 115 (1), 295–329.

Monin, Phillip J., "Decomposing Hedge Funds' U.S. Treasury Exposures," FEDS Notes, Board of Governors of the Federal Reserve System, June 22, 2026.