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When Financial Regulation becomes Financial Repression

Rashad Ahmed, Adam Josephson, Alessandro Rebucci [1]

- *The version of the One Big Beautiful Bill passed by the House is currently projected to add about 3 trillion dollars to the national debt, while the economy is still near full employment and the government struggles to finance its existing debt.*
- *The GENIUS Act and SLR reform proposals will boost demand for government debt when investors are retrenching, and dealer inventories are at all-time highs.*
- *While potentially desirable on their own merits, the GENIUS Act and SLR reform may lead to financial repression, which is well understood to distort capital allocation, raise the cost of capital for bank dependent businesses, and undermine long-run growth.*

Debt levels rise, investors question the safe haven status of US Treasuries

US government debt held by the public has hovered close to 100% of GDP since the pandemic. At the same time, price-insensitive investors such as foreign central banks and the Federal Reserve are reducing their holdings, while price-sensitive domestic investors now hold more than half of all US debt (Figure 1, left-panel).[2] Other economies, such as

 Rashad Ahmed and Alessandro Rebucci are Andersen Institute Economist and Scholar, respectively. Adam Josephson is the Founder of Sakonnet Research and author of the "As the Consumer Turns" Substack. The views expressed in this note are those of the authors and do not represent an official position of The Andersen Institute for Finance and Economics or affiliated organizations.

[2] Both Federal Reserve and foreign official purchases of Treasuries significantly impact US Treasury yields, e.g., Krishnamurthy and Vissing-Jorgensen (2011) and Ahmed and Rebucci (2024).

the Eurozone, the UK, and Japan, are also facing precarious fiscal conditions as their respective central banks pull back.

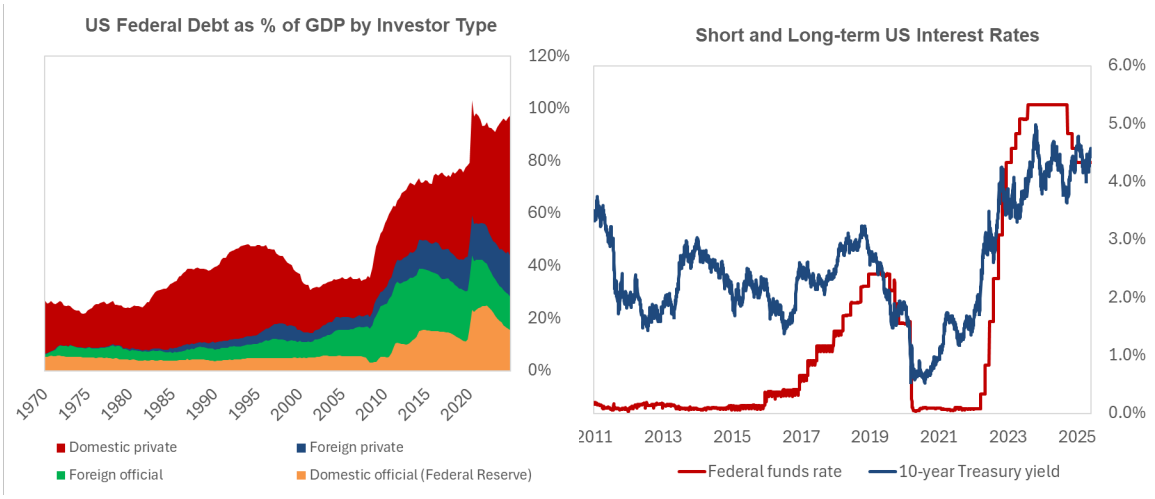

Figure 1. The left-panel plots US federal debt held by the public, which excludes intra-governmental debt**.** The right-panel plots the effective federal funds rate and the 10-year US Treasury yield. Source: FRED and Federal Reserve quarterly Flow of Funds.

With increasing supply and weakening price-insensitive demand, interest rates on US Treasuries rose sharply, reaching nearly 5% in recent years, despite the Fed cutting policy interest rates (Figure 1, right-panel and Ahmed and Rebucci, 2025). Private investors and credit agencies have also reassessed the government's creditworthiness. Moody's downgraded US sovereign credit in May 2025, citing rapidly growing national debt and interest payments as key factors, while US sovereign CDS spreads widened to levels similar to countries rated BBB+, although some question the liquidity of such instruments.

The 'One Big Beautiful Bill' will widen the deficit and add to the national debt

Despite growing fiscal concerns amid a deficit at multi-year highs and a US economy close to full employment (Figure 2, left-panel), the administration plans for an

expansionary budget with the 'One Big Beautiful Bill' (BBB). The bill is still being finalized, but calls for extending the corporate and individual tax cuts in the 2017 Tax Cuts and Jobs Act, increasing the debt ceiling by $5 trillion, increasing tax deductions and credits, while eliminating certain taxes such as those on tip income and overtime hours. The Congressional Budget Office estimated that the BBB will increase the 10-year cumulative deficit by $2.8 trillion, of which $441 billion are debt service costs, with federal debt held by the public reaching 124% of GDP by 2034.

Resorting to unconventional revenue sources

While such a fiscal policy impulse at full employment is not unprecedented, the novelty in the draft BBB is the reliance on unconventional sources of revenue including higher tariffs and taxes on remittances and foreign capital income. The most heterodox source of revenue is Section 899 of the BBB that proposes "retaliatory" taxes on non-resident investors, potentially escalating from 5% to 15-20%, to be applied to the returns earned on investments in the US.[3] An upgraded EB-5 program offering US citizenship for a $5 million price tag is also expected to bring in some tax revenue. Some senators have also discussed eliminating interest payments on bank reserve balances (IORB), claiming potential interest rate savings of more than $1 trillion and openly challenging Fed operational independence.

The current US Treasury Department's debt management policy, which aims at minimizing the interest burden of government debt through short-term Treasury bill issuance and maturity extension (Figure 2, right-panel), continues the previous administration's efforts in this direction and is a common policy response in advanced and emerging countries facing high and rising debt.[4] However, using unconventional sources of fiscal revenue as the debt burden increases is rare in OECD countries. In

[3] Section 899 would increase taxes on dividends and interest on US stocks and some corporate bonds. Applicable taxes also include income taxes payable on sales of US real property interests, income taxes payable by foreign corporations on income connected with trade or a business in the US, and US branch profit taxes. It is unclear whether US Treasuries would be covered or fall under tax exempt status.

[4] The sharp increase in T-bill issuance in 2020 reflects the bills-heavy financing of the fiscal stimulus during the COVID recession, while the sharp increase in T-bill issuance in 2023 was driven more by rising structural demand for T-bills after the Fed started to raise interest rates.

contrast, it is common practice among countries with low credit ratings attempting to avoid or defer default. The unconventional revenue-raising strategies in the draft BBB, in conjunction with other even more heterodox debt financing proposals previously floated that did not make it to the BBB, inevitably raise questions about the ultimate motivation behind the financial deregulation and innovation proposals also being considered by Congress and the regulatory authorities.[5]

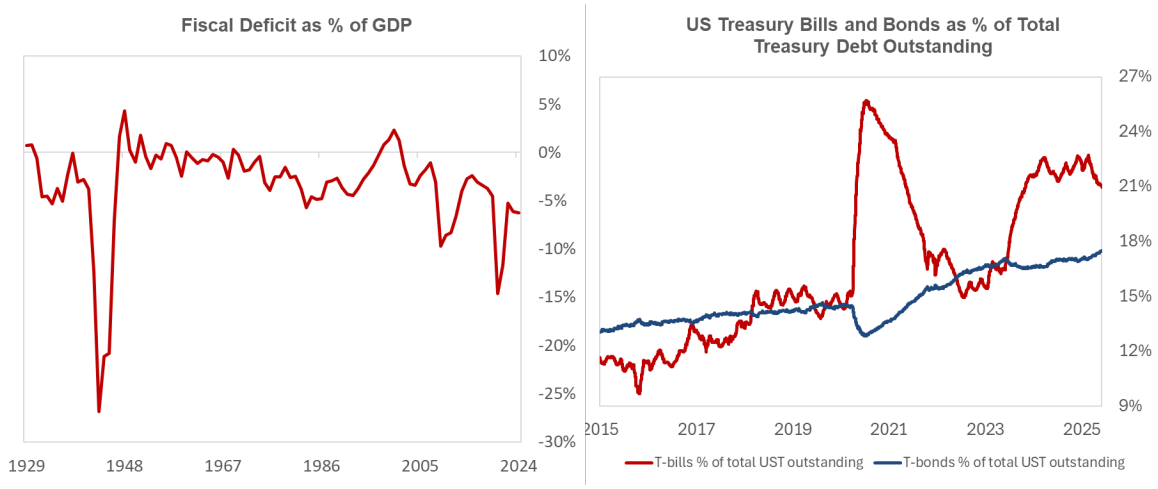

Figure 2. The left-panel plots the US fiscal deficit as a % of GDP. The right-panel plots the T-bill and T-bond share of US Treasury debt outstanding, respectively. T-bills are Treasuries with maturities of 1 year or less. T-bonds are Treasuries with maturities greater than 10 years. Source: FRED, US Department of the Treasury and Treasury Direct.

Supporting financial innovation and fine-tuning bank regulation

In principle, existing proposals for stablecoin legislation and reforming banks' Supplementary Leverage Ratio (SLR) appropriately aim at fine tuning the macro-prudential regulatory framework and providing the necessary foundations for the healthy and productive development of the crypto industry. In practice, these proposals may be

[5] Administration officials or advisors to the Trump campaign at some point in recent months proposed financing the budget deficit through revaluing federal gold holdings, forced conversion of foreign-held US Treasury debt to ultra long-term maturities, and monetizing federal assets such as land.

driven at least in part by the need to finance an unsustainable debt trajectory fueled by an expansionary fiscal policy stance at this juncture of the economic cycle. This is because the likely policy changes will boost, directly or indirectly, demand for US Treasury debt.

Stablecoin legislation will increase demand for US Treasury bills

Pending cryptocurrency legislation, and specifically stablecoin regulation via the GENIUS Act, seeks to establish clear regulatory guidelines that promote industry growth and responsible innovation. Although not explicitly stated, it is also likely to boost demand for short-term US Treasury debt. Since US dollar stablecoins will require 1-for-1 backing with short-term, high quality liquid assets (HQLA) such as Treasury bills, reverse repos, and bank deposits, a growing stablecoin market implies a growing investor base for Treasuries so long as stablecoins' T-bill purchases do not crowd out other sources of Treasury bill demand.

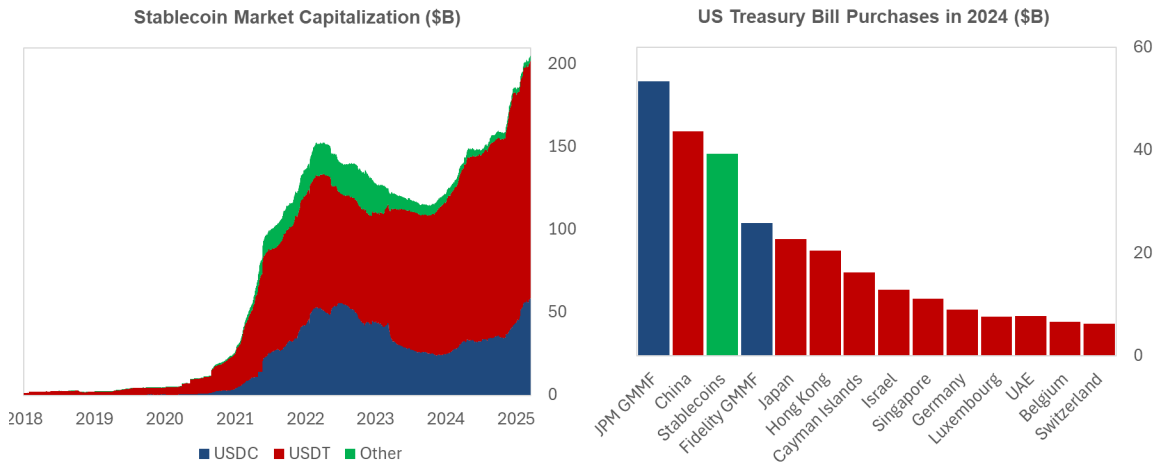

Figure 3. The left-panel plots stablecoin market capitalization for USD-backed stablecoins. Other includes TrueUSD (TUSD), Binance USD (BUSD), First Digital USD (FDUSD), and PayPal USD (PYUSD). The right-panel plots US T-bill purchases for stablecoins, foreign countries, and select government money market funds (GMMFs). Stablecoin T-bill purchases is the sum of USDT and

USDC T-bill position changes from December 2023 to December 2024. Source: Ahmed and Aldasoro (2025), US Treasury TIC, OFR, CoinMarketCap, and USDT and USDC reserve reports.

Figure 3 shows that the market capitalization of US dollar-backed stablecoins exceeds $200 billion, and the sector purchased nearly $40 billion of US T-bills in 2024. The market capitalization is small relative to the $2 trillion bitcoin market or the $7 trillion money market fund industry, but some evidence suggests that stablecoins' Treasury purchases are already leaving a footprint in financial markets (Ahmed and Aldasoro, 2025). Once the GENIUS Act is passed, some estimates point to a $1.6 to $3.7 trillion stablecoin market by 2030 that generates over $1 trillion in demand for short-term US Treasury bills.

SLR reforms would increase demand for long-term US Treasuries

While stablecoin regulation will boost demand for short-term debt, SLR reform may raise demand for long-term Treasuries. On paper, SLR regulation intends to fine tune macro-prudential regulation by relaxing what is widely perceived as an excessively tight regulatory constraint on intermediaries (Duffie, 2023). In practice, proposals to exempt Treasuries from the SLR may indirectly address waning demand for longterm debt. For example, critical sources of long-term Treasury demand are drying up: the share of long-term Treasuries held by foreign central banks has been steadily declining (Figure 4, left-panel), and the Fed stopped purchasing long-term Treasuries in 2022. Consequently, domestic and foreign private ownership rose to fill the gap. Meanwhile, Treasury positions on dealer balance sheets are approaching a record $450 billion, as dealers have had to absorb more and more long-term Treasuries while the stock of outstanding US Treasury debt grows larger and demand from other buyers languishes (Figure 4, right-panel).

Exempting Treasuries from the SLR is garnering support from industry, academics and policymakers. Federal Reserve officials met on June 25 to consider changes to the enhanced SLR for the largest banks. As it stands, the SLR is the most binding capital requirement for large broker-dealer banks (Cochran et al., 2024). Under the existing framework, Treasury positions impose the same regulatory capital requirement on dealer banks as holding riskier assets, for a relatively low risk and high-volume activity.

Consequently, Treasuries are costly for dealer balance sheets. If Treasuries were permanently exempted from the SLR, or alternatively if the SLR was made non-binding, then dealer banks could expand their absorption capacity for Treasuries, improving Treasury market depth and overall functioning (Braüning and Stein, 2024).[6]

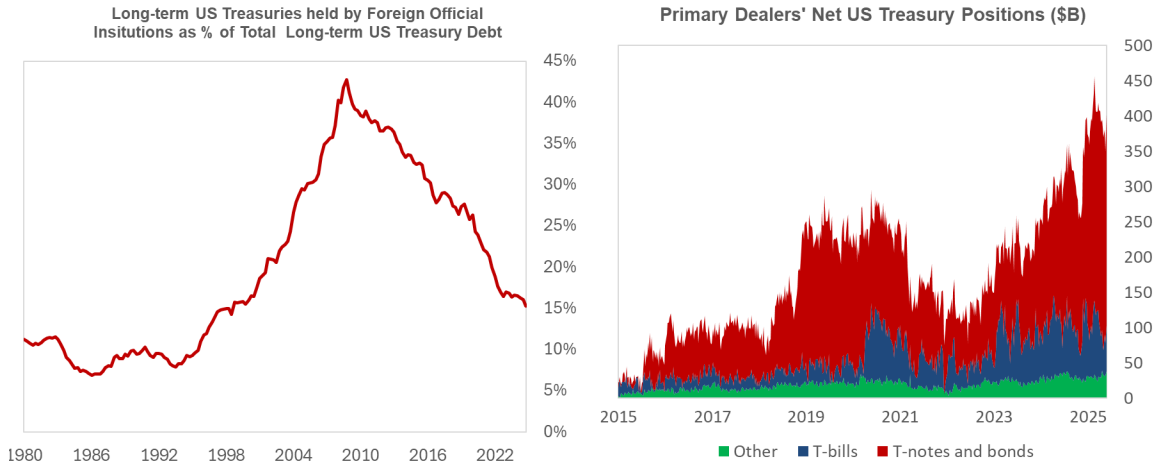

Figure 4. The left-panel plots US Treasury notes and bonds held by foreign official investors, divided by total marketable long-term Treasury notes and bonds. The right-panel plots net US Treasury positions on primary dealer balance sheets. Source: FRED, Federal Reserve quarterly flow of funds, and NY Fed primary dealer statistics.

Is it financial repression?

While advocates argue for these regulatory changes on their theoretical merits, when viewed together with the broader government debt financing strategy in the draft BBB and other debt financing options previously considered, it is difficult to ignore their potential as tools of *financial repression.* Financial repression refers to a policy regime in which regulation is used to channel capital to the government at below-market rates (Reinhart et al., 2011). Policies enabling financial repression include capital controls, directed credit,

[6] Other regulations have provided favorable treatment for government debt. For example, government debt has a zero risk weight under the risk-based capital framework and all Treasury securities are treated as Tier 1 HQLA under the Liquidity Coverage Ratio.

above-target inflation, central bank purchases of government debt, and financial regulation such as yield caps and liquidity rules (Reinhart et al., 2015).

Financial repression has been used previously in the US and in other developed countries. For example, the US government actively supported prices of government securities during World War II. And after the war, the government offered exchanges in which marketable securities could be swapped for non-traded, non-marketable securities. Following the Great Depression, interest on savings and time deposits were capped. Known as Regulation Q, this policy was eventually phased out in the mid 1980s, with statutory limits on interest for demand deposits finally completely removed in 2011. Following the 2010 European sovereign debt crisis, the Eurozone made regulatory capital changes that maintained zero risk weights for all sovereign debt issued by EU member countries, incentivizing banks to hold more government debt.

Financial repression is costly

Financial repression is well understood to distort capital allocation, thereby reducing long-term economic growth as capital is no longer deployed where it is most productive. Financial repression may also shift innovation to opaque corners of the system. Examples include Regulation Q that, by capping the interest on bank deposits, led to the emergence of the money market fund industry and the associated financial stability challenges. Through most of the 2000s and 2010s, in addition to strict capital controls still in place, China capped interest rates to channel capital into government-favored sectors. This eventually gave way to the rise of China's monumental housing bubble and its very large shadow banking system.

Financial repression also masks fiscal risks and threatens financial stability by promoting leverage accumulation and seeding sovereign-bank feedback loops. SLR relaxation may encourage the buildup of additional leverage within the financial system if safe asset demand in arbitrage trading outpaces any additional supply freed up by the regulatory changes. Distorted incentives to purchase government debt may induce banks to take on excessive exposure to sovereign risk that can turn toxic if the government ever faces

liquidity or solvency problems, as the bank-sovereign doom loop of the European debt crisis vividly illustrated (see the IMF's Global Financial Stability Report).

There is also evidence that when banks are incentivized to purchase government-backed debt, government borrowing tends to crowd out lending to businesses, especially to smaller bank-dependent firms. Chakraborty et al. (2018, 2020) show how bank mortgage-backed security purchases stimulated mortgage origination activity that crowded out corporate credit provision. Onder et al. (2024) provides direct evidence that dealer banks' Treasury purchases cause them to reduce lending to firms. In practice, this means a higher cost of capital for all businesses, but particularly for small and medium-sized enterprises which are more bank dependent.

Is financial repression desirable?

Jeanne (2025) reports evidence suggesting that countries start to resort to financial repression when public debt exceeds 100% of GDP. Economic growth also tends to slow when public debt reaches these levels, making it difficult to simply "grow your way out" of high debt burdens (Reinhart et al., 2012). On the other hand, the academic literature has studied conditions under which defaulting, inflating away the debt, or adopting financial repression may be desirable. These conditions, however, hinge on not having access to alternative less distortive strategies to raise revenue, which is clearly not the case in the United States.

The risks to economic growth

The administration's financial regulation proposals have desirable goals, such as enhancing the existing macro-prudential framework, improving Treasury market functioning, and fostering responsible crypto innovation. However, the proposed changes will also boost demand for US debt at a time when global investor confidence in US assets is declining and yields are rising. While debt management is a standard tool used by every government facing high and rising debt servicing costs, the combination of regulatory reforms and the proposed use of unconventional sources of tax revenue raises the

question of whether the administration is about to embrace financial repression. Financial repression would dampen the growth potential of the US economy and make it much harder for the US corporate sector to access bank financing.

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