Running Out of Debt?

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Is It Really Good Policy to Payoff the
Publicly Held Treasury Debt?

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Who would have thought, at any time in the last seventy years, that the government would run continuous budget surpluses and undertake massive retirements of public debt? Not since a previous Pittsburgher, Andrew Mellon, ran the Treasury has there been a sustained effort to reduce the debt.

Our concern today has two parts. First are analytic issues about what debt retirement would do to the economy. Debt retirement, like debt issuance, must be financed. The way in which it is financed matters; it matters how the surplus is used. Second is the practical issue of whether debt retirement is likely to be large enough, long enough to raise the first set of issues.

I will start with some comments on the second set of issues. Again, there are two parts. First is the estimated size of future surpluses. This is an issue about whether the economy, other things unchanged, can produce the projected surpluses. Second, is the political question: will the political process allow surpluses of this magnitude to occur? The answer to the political question is speculative, but it is a speculation that most risk-averse investors should willingly take. Nothing in our history suggests that there is even a remote possibility that successive Congresses and administrations would be disciplined enough to allow actual surpluses of $5 to $6 trillion in the next ten years, as projected by the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB). Setting the social security surplus aside leaves $2.5 trillion according to OMB and $3.2 trillion (CBO) for the eleven years 2001 through 2011.
We will not see these projected surpluses, so we do not have to deal extensively with issues about the size of the projections. I want to make two quick points, however, because the discussion in the press confuses more than it clarifies public awareness of the size of surpluses.

First, the surplus projections are so-called baseline projections. They do not tell Congress what programs the Congress will decide to expand or contract or what tax rates Congress will change. The estimates assume that programs continue on their present path. Second, much has been made about the uncertainty of future estimates by those who want to emphasize that future surpluses may be overestimated by very large amounts. True enough, but it is no less true that the estimates of future baseline surpluses may be too low.

In statistical jargon, the baseline estimates are unbiased. They are subject to large errors, particularly as we look ahead ten years. Rational decision-makers do not ignore these uncertainties, but they base their actions on unbiased estimates of the surpluses.

Stripped of all the subterfuges and clever stratagems, at issue is not the size of future surpluses but how they will be used. Politics is, first and foremost, about who pays and who receives. Those who oppose tax cuts most vigorously usually want to spend the money on projects that suit their tastes or benefit their constituents. Those who favor tax cuts usually want to limit government spending. Without a doubt, the baseline estimates of future surpluses overestimate the surplus because the surplus will be spent or returned, probably both, but not kept in a lock box.

Let me turn for the rest of my time to some analytic issues about debt retirement. I will assume here, for purposes of the analysis, that government realizes the projected surpluses. What can it do as Treasury balances accumulate?
There are only three possibilities. The government can either (1) retire outstanding debt, (2) reduce the monetary base, or its growth rate; the monetary base consists of the government's monetary liabilities, currency and bank reserves, or (3) purchase foreign assets. This is arithmetic. It describes the consolidated statement of any economic system. After we consolidate accounts of the Treasury and the Federal Reserve, on one side we have the government's deficit or surplus, the difference between government's total outlays and its total receipts plus the current account surplus. On the other side are the uses of the surplus, how the surplus affects the government's liabilities. A budget surplus means that the government receives cash (net) from the public. I will ignore the current account deficit or surplus through most of the discussion because it is irrelevant for these purposes in an economy with a floating exchange rate. It enters only, if at all, when we consider purchases of foreign exchange, as I will do presently.

The basic equation is then:

\[ D = \Delta B + \Delta S \]

where \( D \) is the budget deficit or surplus (-D)
\( \Delta B \) is the change in the monetary base, and
\( \Delta S \) is the change in the stock of government debt.

A surplus means that the Treasury spends less in the economy for goods, services, and interest than the public pays to the Treasury. Since the Treasury has a surplus, Treasury cash balances pile up either in the banking system or at the Federal Reserve. Given that it has a surplus, the most the Treasury can do is pay back what it has received by (1) retiring debt, (2) retiring base money, or (3) buying foreign assets, if we include international assets. Let's consider each one.
Retiring Debt

There are limits to debt retirement. Government debt available to retire is less than the projected (non-social security) surplus. The government cannot retire savings bonds and other non-marketable debt unless the owner chooses to sell. Further, the marketable debt has an average maturity of more than five years. About $800 billion has more than five years to maturity. The government can buy up the long-term debt only by offering a premium. As the outstanding amount shrinks, the premium would rise. The same is true of much of the agency debt and the liabilities of the various public mortgage institutions.

Financial institutions and the public hold about $1 trillion in government debt with 1-year or less to maturity. There is, in addition, about $800 to $900 billion that will come due in years 1 to 5. After that, there is not much more to retire annually. We have to look elsewhere to use the remaining surplus.

Does it make sense to retire as much debt as we can now? In a growing economy, incomes rise. Retiring debt now means that we tax the poorer current taxpayers so that future taxpayers are debt free and can enjoy lower tax rates. This is inter-generationally regressive. It would be better, for them and for us, if we reduced tax rates now, encouraged investment now, so that we would have a larger capital stock and higher incomes. They, too, would have a larger capital stock that would produce income that could be used to retire the debt that they inherit from us along with the larger capital stock.

Reducing the Monetary Base

The monetary base has its name because it is the base of the financial system. The approximately $550 billion takes the form mainly of currency held by the public. The rest is bank reserves.
If the Treasury deposits its surplus at the Federal Reserve banks, the monetary base falls. The reason is that the surplus drains money from the public. Banks lose deposits. They pay the Treasury by reducing their reserve accounts at the Federal Reserve.

Reducing the base would shrink the financial system, appreciate the dollar, and deflate the economy. The price level would fall. The transitional costs of deflation can be very large, as we learned in the 1930s and as the Japanese continue to learn.

Deflation would depress the economy and eliminate the budget surplus. This is a costly way to reduce the surplus. Reducing tax rates is much better.

The Federal Reserve could offset any deflationary effect by purchasing private securities in exchange for monetary base. It would pay for these assets by creating bank reserves, just as it does now when it buys Treasury bills. To provide for a 4% to 5% annual average rate of increase in the base, consistent with assumed economic growth and low inflation, it would have to purchase a total of $300 to $400 billion of private debt in the eleven years 2001 to 2011 inclusive.

Traditional central banks bought mainly gold, foreign exchange, and bills of exchange, and rediscounted commercial and agricultural loans. If Treasury bills no longer existed, the Fed would have to return to something more like its original procedures. Until 1932, it could not use government securities to back the currency. Treasury bills were not issued in the 1920s, and the Reserve banks held very little debt. The Federal Reserve discounted eligible paper offered by banks, purchased bankers acceptances and gold because the U.S. was on the gold standard. For illustration, at the end of 1926, government securities were less than one-fourth of all Reserve Bank credit outstanding, member bank discounts were about one-half, and the remainder was bankers acceptances. But the principal asset was gold, $4.2 billion compared to $1.4 billion of Reserve bank credit.
To operate in a more classic way, the Federal Reserve would have to make rules for eligible paper to prevent the central bank from taking on excessive credit risk and to avoid the importunings of government officials and private citizens who want their projects financed by the central bank. The Federal Reserve could restrict its operations to purchases and sales of prime commercial paper issued by financial institutions and corporations with the highest credit ratings.

Outstanding commercial paper now totals several hundred billion dollars, more than enough to serve as a market in which to conduct policy operations. Markets exist also for bankers acceptances and bundles of loans. Federal Reserve purchases and sales in these markets would strengthen the markets and contribute to more active trading.

Initially, I was concerned that Federal Reserve purchases would be large enough to cause commercial paper to go to a substantial premium relative to longer-term instruments. This, in turn, would encourage more offerings, perhaps shortening the duration of corporate liabilities. The stock of commercial paper outstanding is so large relative to the Federal Reserve's required current net purchases of about $20 to $25 billion annually (or $30 to $40 billion on average for the next eleven years) that any effect would be small.

**Purchasing Foreign Assets**

The third, and last, option is to buy foreign assets—for example Japanese or Euro Treasury bills. This is entirely feasible and has a long tradition in central banking. Foreign central banks and governments own large stocks of U.S. government securities, more than $1-1/4 trillion, 40% of the amount held by the public.

Again, there is a disturbing side effect. Purchases of foreign exchange would depreciate the dollar unless offset, or sterilized, by other monetary actions.
Such pressures would affect the current account and, thus, future foreign exchange or capital movements. Dollar depreciation would increase the price of imports and partly offset the deflationary effect of the surplus.

A Bit of History

We have some 20th century experience. In the 1920s, the government budget remained in surplus. The surpluses averaged 20% of tax revenues from 1921 to 1929. During the decade, the Treasury retired 30% of the debt outstanding in 1921. Tax rates were reduced in 1922, 1923, 1924, 1925, 1928 and 1929, the last a temporary reduction. The maximum tax rate on an income of $1 million declined from 66% to 23%; the tax rate on incomes of $2000 to $3000 fell from 2% to 0.1%.

The economy ended in depression because of deflationary monetary policies in France and the U.S. The gold standard spread these policies around the world. Tax cuts worked to maintain expansion, but they did not overcome deflationary monetary policies.

There is nothing to fear about sustained budget surpluses, were they to occur. The main concern must be to avoid deflation. This requires the Federal Reserve to act independently of fiscal policy, a stance it should take in any case. Its job is to provide for money growth at a non-inflationary and non-deflationary rate.

Some Final Comments

The organizers asked us to comment on the effects on foreign governments. The U.S. has a current account deficit and a fluctuating exchange rate. I assume that will continue. (This assumes that we do not use the surplus to buy foreign exchange and do not shrink the monetary base.) If so, the main effect on
foreigners is that the world capital market would, over time, hold fewer U.S. government securities. At given saving rates and wealth, the market would hold more equities and more foreign and corporate debt, if foreigners and corporations use the opportunity to issue more debt and more equities. If we assume that issuance of debt and equity remain unchanged everywhere, the world real interest rate would be lower.

A concern for some is the loss of a benchmark yield for pricing other securities. Unless the Treasury offered a premium, Treasury bonds would remain outstanding for thirty years. Their duration would decline, and they might have scarcity value for certain, risk-averse asset owners.

Many countries do not have long-term debt outstanding. The U.S. government had very little long-term debt as recently as the 1950s and in the 1920s. Markets functioned, so we have reason to believe they would do so in the hypothetical future.

Market participants can solve the benchmark problem by offering synthetic securities. A bank could agree to accept today the libor rate for 10 years on a fully collateralized contract. This is a marketable, ten year, low risk yield. It could buy or sell 10 year Euro-bonds protected against exchange risk. In these, and other ways, the market can produce synthetic securities that come close to the benchmarks that would disappear.

Let me close as I began. I find it hard to take this problem seriously. Those who do should demand a big tax rate reduction---NOW.