Duke professor says restructuring federal debt could save $12 billion annually

Restructuring the federal debt could lead to a savings of $12 billion annually over the next few years and an extra $40 billion in economic growth next year, said Campbell Harvey, an associate professor of finance at Duke University's Fuqua School of Business.

"The current Treasury policy of long-term maturity financing just doesn't make sense," Harvey said, according to Duke.

The current yield curve (the difference between long-term and short-term interest rates) is more than 4 percent, he said. If the Treasury and Federal Reserve are serious about a policy of sustained low inflation, the federal deficit should be financed with shorter-term bills and bonds (currently yielding as low as 3.2 percent), as opposed to longer-term bonds (up to 7.4 percent), he said.

Harvey said the maturity structure of the $1.3 trillion in debt to be offered over the next 12 months should be tilted dramatically toward the short term. This, in turn, would lead to direct savings of $12 billion per year.

He explained: "If the Treasury continues its present maturity strategy, I estimate that they will float $700 billion in Treasury bills and $620 billion in notes and bonds. Suppose they change the maturity structure. I propose that the Treasury issue $850 billion in bills, $250 billion in one- to two-year notes and $220 billion in other notes and bonds.

"If the yield curve does not change shape over the next year, this new strategy would lead to direct savings of $12 billion a year due to lower interest costs.

"However, the yield curve will change shape. At the short term, an extra $150 billion in Treasury bills are being offered. Given the size of the market ($700 billion projected next year) and given the subscription interest in recent auctions, the increased supply of bills will probably have a small upward impact on short-term rates.

"More dramatic effects will occur at the longer-term portion of the curve. Supply of longer-term issues would be reduced by up to 50 percent. This would surely increase prices and lower rates, perhaps sharply. The net effect, slightly higher short-term rates and much lower longer-term rates, will be negligible on the cost of financing the government debt. Hence, $12 billion is a reasonable estimate of the direct savings involved in restructuring the maturity of the new federal debt.

"If the Federal Reserve's policy is to have sustained low inflation and the Treasury believes that they will be successful, then it does not make any sense to finance the government debt with longer-maturity bonds. It sends the wrong signal to the market."

Harvey said lower long-term rates would spur capital investment, lower the cost of consumer credit and reduce the cost of housing. The indirect effect could be as much as $40 billion in extra Gross Domestic Product over the next year.

Harvey said his plan is uncomplicated and can be easily implemented. The impact of the strategy would be the same as a tax cut; however, it would not increase the size of the deficit, he said.

Harvey is the author of ***The Harvey Forecast***, a quarterly newsletter. He said his economic model has identified the major turning points of all business cycles in the last 25 years, including a forecast of the last double-dip recession: 1981-1983.