How a Shift in Treasury Debt Management Might Juice the Economy

New York, Aug. 4 (Bloomberg) -- The Bush administration, fumbling to juice the economy in this election year, has the answer right at its fingertips. At least that's what a Duke University professor says.

All George Bush needs to do is command the Treasury to slash the amount of its long-term borrowings and load up the debt in short-term bills and notes, according to a study released by the professor today.

If the Treasury shifted $150 billion in borrowings into bills and notes during the next year, Uncle Sam could save $12 billion in interest costs each of the next few years and add as much as $40 billion to the gross domestic product, said Campbell Harvey, associate professor of finance at Duke's Fuqua School of Business.

"One thing about this plan is it's very quick," said Harvey. "As soon as you announce this, you're going to see long-term rates fall."

Few Wall Street economists buy Harvey's scheme but he said this shift in debt management would cause bond yields to drop to 6.4% from 7.4% while the bond-equivalent yield on three-month bills would rise only 70 basis points to 4%. What's more, inflation expectations would drop because the Treasury, along with the Federal Reserve, would be sending the signal that inflation isn't to be feared anymore, he said.

Harvey estimates the Treasury will sell $1.3 trillion in new securities in the next 12 months. Under the Treasury's current strategy, about $700 billion of that will be short-term bills and $620 billion in notes and bonds maturing in two years or more.

Treasury ought to sell $850 billion in bills, $250 billion in one-year to two-year paper and only $220 billion in other notes and bonds, Harvey said. The subsequent drop in long-term rates would spur capital investment, lower the cost of consumer credit and reduce the cost of housing, all benefitting the economy, he said.

Wall Street's economists challenged this contribution from academia on two fronts: reinvestment risk and supply and demand.

The more short-term debt an issuer sells, the sooner he has to refinance it. If interest rates suddenly shot up, the Treasury would be paying a higher rate on a larger amount of debt than if it had issued debt at the current ratio, the economists said.

Harvey's plan "seems to preclude the possibility of the need to raise short-term rates," said F. Ward McCarthy Jr. of the economic consulting firm Stone & McCarthy Research Associates.

Higher short-term rates would cost the Treasury money not just on the new money it raises each year but on the debt it has to refinance, said Kevin Logan, chief economist at Swiss Bank.

Harvey answers that the government can partially control this risk. Through the Federal Reserve's management of the money supply, short-term rates can be kept low so long as the Fed maintains a constrictive monetary policy. That in turn would squash inflation expectations.

A shift to shorter maturities by the Treasury would reinforce the Fed's commitment to check inflation since the cost of doing otherwise could be severe, Harvey said.

By selling 30-year bonds at all -- and reducing its own investment risk -- the Treasury is in effect saying that it doesn't believe the Fed can achieve its stated policy, Harvey said.

Wall Street's economists also argue that the normal laws of supply and demand don't always work with 30-year bonds. The Harvey study "assumes that by changing the location of borrowing you can change the level of the yields," Logan said.

Whether $1 million or $1 billion exist isn't the point, Logan said. What matters in setting the yield is whether the buyer of a bond thinks inflation will eat away at the value of the security. Changing the debt burden to bills from bonds doesn't affect that.

Harvey, of course, sees it another way. "I just can't believe any trader in the bond market would say a 50% reduction of any commodity wouldn't move the price," he said. Even aof course, sees it another wa
any trader in the bond market would say a 50% reduction of any commodity wouldn't move the price," he said. Even assuming no price change initially, the signal sent on inflation by a move toward shorter maturities eventually would push rates down, Harvey said.

No matter the merits of Harvey's proposal, it still has to get past the Treasury. "I cannot envision a bureaucracy like the Treasury being as brazen as that," McCarthy said of the chances that Treasury will do as Harvey advises. "Look at the prodding it took to make the Treasury cut the bond auction in February."

In February, under pressure to get rates down, the Treasury issued only $10 billion in bonds rather than the $12 billion sold in November. At the time, the market was rife with speculation of such a move, and talk of more reductions comes up every time another auction is due. The next bond auction is next week, the details of which will be announced tomorrow. Most economists expect another $10 billion bond sale.

Harvey is all for more bond reductions. "The cuts in short-term rates have done nothing for economic growth," he said. "To me, the obvious thing to do is work on long-term rates."

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