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Professor outlines plan to cut deficit

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A solution to trimming part of the U.S. budget deficit while bringing a rosier tinge to the economy is so simple that it's surprising it hasn't been done already, according to Campbell R. Harvey, associate professor of finance at Duke University's Fuqua School of Business.

His answer: Restructure the federal debt the way business is restructuring its debt. Stop issuing so many long-term U.S. Treasury bonds that carry high interest costs. Switch, instead, to short-term, lower-interest T-bills and notes.

"The maturity structure of the $1.3 trillion in debt to be offered over the next 12 months should be dramatically tilted toward the short term," Harvey says.

This, he feels, would lead to direct savings of $12 billion a year. In turn, it would lead to sharply lower long-term interest rates, which 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 additional Gross Domestic Product over the next year, he predicts in a paper he prepared outlining his argument.

Harvey feels long-term interest rates are still high because investors believe that inflation will be rekindled in the future. But high long-term rates are bad for economic growth because they discourage capital investment, increase the cost of consumer credit, and make housing more expensive.

His thesis is based on the fact that three-month Treasury bills cost taxpayers 3.2%, while 30-year Treasury bonds carry 7.4% in interest.

"Why is the government financing part of its debt at high rates when it could finance using shorter maturity instruments at low rates?" he asks.

He notes that if the Federal Reserve's policy is to have sustained low inflation and the Treasury believes it will be successful, then it does not make sense to finance the government debt with more expensive, longer-maturity bonds.

"If the maturity structure of the debt was dramatically altered, it would signal to the market that the long-run control of inflation is indeed a feasible goal," he wrote.

Harvey feels that the overwhelming indirect effect of lower rates would be a spur to business formation. Consumers also would benefit, he says, because consumer loan rates (more closely linked to long-term than to short-term rates) would decrease and this could encourage additional spending.

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