How U.S. could save millions

You might think that an outfit like the U.S. Treasury would try to do a bit of economizing, but not the U.S. Treasury. The Treasury is wasting tens of billions of tax dollars by paying higher interest rates than it needs to pay when it borrows.

The silliness is evident in this week's "refunding" by the Treasury. This is one of the few times each year when the government must pay off billions of dollars worth of maturing securities by auctioning off even larger chunks of IOUs. The Treasury has sold $35 billion in notes and bonds, in addition to its usual weekly sale of $23.3 billion in three- and six-month bills.

The interest the Treasury is paying to borrow this $35 billion ranges from 3.2 percent on the three-month bills to 7.2 percent on 30-year bonds. Your average person, being unsophisticated about finance, would choose to pay lower rates. The Treasury chooses to pay the higher rates so much of the money it borrows.

A range of rates

This week, for example, the Treasury sold $18 billion in three-year notes, on which it (we taxpayers) will pay 6.1 percent annual interest. It borrowed $13 billion on 10-year bills, on which we will pay 7.8 percent interest. And it borrowed $10 billion for 30 years, on which we will pay 7.6 percent interest.

What are they doing with the taxpayers' money? says Campbell R. Harvey, a finance professor at Duke University's business school. Harvey is one of several experts who think the Treasury is foolish in the way it finances the nation's debt.

If the Treasury had borrowed the $10 billion for three years instead of 30, we taxpayers would be paying about $475 million a year in interest, a savings of about $760 million over the next three years. "What are they doing with the taxpayers' money?" says Campbell R. Harvey, a finance professor at Duke University's business school. Harvey is one of several experts who think the Treasury is foolish in the way it finances the nation's debt.

If the Treasury had borrowed the $30 billion on long-term bonds and sold to short-term Treasury bills, it could save $12 billion a year in interest expense, Harvey calculates.

The benefit to the overall economy would exceed the $12 billion the government saves, Harvey says. He reckons that the smaller supply would cause yields on long-term bonds to drop by as much as 100 basis points, or a full percentage point.

A boost for business

This would translate into lower rates on home-mortgage loans, thus stimulating sales and construction of houses. It would also spur business investment, because businesses focus on long-term interest rates when deciding on new investments. The lower the cost of borrowing, the more projects that businesses are willing to undertake.

In all, Harvey estimates, a percentage-point drop in long-term interest rates would cause the nation's economic activity to grow by an extra 0.8 percent, or $60 billion a year.

David Wyss, chief financial economist at DRI/McGraw-Hill, the Lexington, Mass., consulting firm, thinks Harvey's estimate of increased economic activity is probably a little high. But he estimates that such a lower interest rate by the Treasury could result in housing sales of 900,000 more homes being built each year and an increase of $15 billion or so in economic activity.

"Which isn't trivial," Wyss said.

Over the last 15 years, the Treasury has lengthened the average maturity of its borrowing. In 1977, the Treasury's securities had an average maturity of 3.5 years. Now the average maturity is about six years.

Since interest rates normally rise with the length of a security's term, this means the Treasury has been financing an ever-larger part of its debt with high-rate securities, moving away from lower-rate, shorter-term securities.

Less red ink

Wyss said that if the Treasury had kept the average maturity of its debt at 3.5 years, it would have paid half the $200 billion we pay. That, in turn, would cut the budget deficit by about 25 percent.

The Treasury's strategy makes as much sense as a home buyer paying up 8 percent mortgage money to use a credit card that charges 18 percent.

The risk in switching some borrowing from long to short-term is that inflation and short-term interest rates would cause federal borrowing costs to shoot up. But the Treasury and the Federal Reserve Board keep telling the public that they are determined to keep inflation low, which should keep interest rates from rising much.

"Maybe the Treasury really believes inflation is going to go up," Harvey said. "If they really believe it is going to be lower, they've got to be moving to shorter maturities. It would make their policies much more credible."