THE GOVERNMENT: DEBT MANAGEMENT AND INTEREST RATES

by KARL R. BOPP

before the Institute of Investment Banking
sponsored by the Investment Bankers Association of America
and the Wharton School, University of Pennsylvania

Wharton School, University of Pennsylvania
Philadelphia, Pa. - April 17, 1957

* * * * *

Introduction

Pleasure to be here

(1) Tight money N.S.F. Not you - us!

(2) Pleasure - in part - because it is a period of relatively tight money

That means our economy is operating at high levels; surely that is what we want!

Of course, it creates some problems for you
But - when I see the volume of new issues, both corporate and municipal -

I have been asked to discuss:

Fiscal Policy)
Debt Management Policy) and Interest Rates
Monetary Policy)

I might state my conclusion at the outset:

If we want stable economic progress - we must expect flexible - that is unstable (not erratic)

I. Our Common Objective: Stable Economic Growth

A. We have a money economy: spending money is like casting votes for what we want produced - Role of Government and Central Bank

1. Want enough votes cast to utilize available resources

2. Freedom to choose
i.e., general, impersonal controls rather than direct or selective

B. Our money - with a fractional reserve system - is largely based on debt - a bank is a dealer in debts

C. So, the volume of money, the volume and character of debts, and the terms and conditions under which they may be exchanged play a large role in economic development

(A few words about fiscal policy before we go into debt management)

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

II. Fiscal Policy and Size of the Debt

A. Debt is primarily result of wars and depressions

U.S. Public Debt Outstanding

	($ millions)	
June 30, 1916	1,225	
" 1919	24,485	) 11 successive
" 1930	16,185	) annual reductions
" 1939	40,440	+ 5,451 Guaranteed
Feb. 28, 1946	279,214	
April 1949	251,530	
Feb. 28, 1957	276,400	

B. Old and newer ideas on fiscal policy

1. Old idea: Government concerned only with its <u>own</u> fiscal problems

   Government decided cost of what it wanted to do

   Passed taxes to pay

   Annual balance - except for extraordinary items

2. Newer idea:

   (a) Government has a general economic responsibility

   (b) Fiscal policy has important repercussions on the economy

      (1) Magnitude 70/400 billion G.N.P.

(Change in debt result of Congressional action)

C. Compensatory fiscal policy

1. The idea

2. Automatic stabilizers (see above)

3. Limits

   (a) The budget process

      (1) Agencies now working on budget for fiscal 1959

      (2) By September 1957 departmental estimates due for 1959

      (3) Budget Bureau review

      (4) President submits in January 1958

      (5) Budget year begins July 1, 1958

   (b) Projections - 18-24 months in advance

   (c) Applies to calendar year
   The more flexible you make it the harder for business to plan

   (d) Conclusion: powerful but not very flexible
   But <u>big</u> difference should not be vs. stabilization

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

D. Changes in debt - receipts and expenditures
Result of Congressional Action
Past commitments - e.g. Suez and J.M.F.

1. Automatic built in stabilizer
   (a) Nature of Federal tax system: receipts

	Calendar 1956
Direct on individuals . . .	37
On corporations	23
Social insurance	7
	67/82

   (b) Expenditures
   Social Security
   Support Program

   (c) Automatic economic stabilizers are automatic debt destabilizers

2. Discretionary
   Political aspects

E. At any rate debt managers are confronted with results of Congress and its own previous decisions (on maturities)

III. Debt Management

	End Feb. 1957
Total debt about	$276 billion
Non-market (incl. conv. - 10.6). .	115 "
YOUR INTEREST IS IN Marketables. .	$161 "

Alternative principles. No rabbits in the hat!

A. Lowest interest cost

1. Obviously don't make any issue "too sweet"

2. But if this is BASIC objective
   (a) Pressure on monetary authority - pre-Accord to make all credit cheap and plentiful
   (b) Also tends to rising interest structure so issue shorts - end with basket of quicksilver (Go into logic of rate structure)

3. Of course, it makes for ease of flotation

B. Tailor issues to investor demand

1. Nice sounding title
   Of course, need judgment as to available funds and investor groups

2. On supply of funds, "Investor demand" not absolute (Ownership Chart p. 32-33)
   Depends on relative attractiveness of issues
   e.g. corporate purchases of bills

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

3. On demand for funds, what it comes down to is - other borrowers would get what they want and Treasury would get what is left, i.e. short-terms in boom and long-terms in depression

4. Aggravate the business cycle

C. Counter - cyclical (compensatory)

1. Intellectual appeal
Vary liquidity to suit requirements of the economy

2. Some problems - need to predict economic future

(a) When do you issue long terms?

(1) In prosperity! - But

(i) Risk of failure - other demands are then strong

(ii) Means when rates are high: successive issues at higher rates. Also late prosperity issues will go to premium

(whip-sawed over-the-barrel)

(iii) Hard to explain to unsophisticated audience

(2) In depression? No

(i) For fear of aggravating depression but funds are plentiful then

(b) What about economic conditions when bonds mature?

(1) Make callable - but not for nothing

(c) Illustrate with problem of savings bonds - economy would best be served if people bought during inflation - but is individual?

3. Some hope if cycles remain moderate in amplitude

D. Balanced debt structure

1. Various meanings

(a) Chicago idea of only cash + consols

(b) Have funds flowing thru market in orderly way
Regular maturities - say quarterly

(c) Need of the economy for liquidity

E. Debt management can make a modest contribution

F. Has to manage in market as fixed by central bank

IV. Monetary Policy and Interest Rates

A. Alternative extremes

1. Pegged rates
- lose control over supply and availability of money and reserves

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

2. A predetermined supply of money
   - lose control over cost or rates

3. Pegged market

   "Free" market - part of it is market's expectation of what the F.R.S. and Treasury will do!

   Flexible market

   Orderly market

B. Flexible interest rates

1. Principles

   (a) Objective is not to achieve any <u>given</u> rate of interest or any <u>given</u> quantity of money

   (b) Influence supply, availability and cost so that "the supply and flow of credit is neither so large as to induce destructive inflationary forces nor so small as to stifle our great and growing economy."
   (W. McC. Martin, April 9, 1954, Pullman, Wash.)

   (c) Open market operations) availability
   Discounting)
   Reserve requirements

   (d) Basically not structural but general except Reg. T and U

2. Recent illustrations

V. <u>Government Policy as a Market Factor</u>

A. Based on estimates by policy officials of economic prospects

1. Important to keep informed of what they say; e.g. Martin

2. Changes are usually moderate: a little more, a little less. Yet don't have precise control. Resolve doubts on side of ease or restraint.

B. Reflected currently in what is happening: Regular releases (Wednesday data released Thursday 3:30-4:00 p.m.)

1. Is the Fed. in the market?

   (a) There are times and areas when and where this is important; e.g. the May 1953 purchases after the April speech of Martin.

   Watch "other than bills" <u>but</u> note refundings!

   Annual Report for 1954, p. 68, gives holdings by issues.

   (b) Ordinarily, however, mere change in portfolio in and of itself not so important

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

2. Why is the Fed. in the market?
   - (a) Non-controllable factors
     Currency
     Treasury deposits
     Float
   - (b) Reserve balance
     Total - a growing economy needs more unless reserve requirements are reduced
     Margins not totals
     Excess - avail. to expand
     Borrowings - must be repaid
     "Free" - net avail. for expansion
     Question of distribution; e.g. Chicago in April 1
   - (c) Money rates
   - (d) Availability (attitudes of market)

3. From policy to principles to operations

(Columbus)

   - (a) Projections of the non-controllable factors
   - (b) Inevitable errors in projections
   - (c) How correct for errors
     - (i) Bring average in line?
       What happens to subsequent days? - and weeks?
   - (d) Regular way transactions
   - (e) Cash transactions
   - (f) Repurchase agreements
   - (g) Changes in level over a longer period

C. Conclusions on

Stable growth

Employment

Prices

Stable economic growth means flexible-consistent policy but variable-fiscal debt management and monetary operations

On projections: Sometimes lucky
" unlucky
Never as lucky as Columbus

Review in The Economist, 12/8/56, of Christopher Columbus, Mariner by Samuel Eliot Morison:

"...A mathematician who underestimated the distance to Japan by 8,000 miles, a geographer who could not tell what he had found, a colonial governor who could not keep order (and who nevertheless) became a central figure in history because, as Jung said, 'by using subjective assumptions, a false hypothesis and a route abandoned by modern navigation he nevertheless discovered America.'"

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis