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Remarks by
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Chairman
Board of Governors of the Federal Reserve System
before
The Bond Market Association
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I am pleased to be with you this morning and note the Bond Market Association's twenty-fifth anniversary. Over the years I have enjoyed being associated with many of you in this audience. My very best wishes to Heather Ruth on the last day of her tenure as president and congratulations to Micah Green upon his appointment.

Today I want to address a subject in which your group and the Federal Reserve share a keen interest--the paydown of the federal debt and its implications for the economy and financial markets. While the magnitudes of future federal unified budget surpluses are uncertain, they are highly likely to remain sizable for some time. The dramatic improvement in projections of the budget balance in recent years reflects, in large part, the pickup in underlying productivity growth in the U.S. economy, which has boosted corporate profits and household incomes and thereby tax receipts. In effect, we built a tax structure on the assumption that the economy would grow over time at rates around those seen from the early 1970s to the mid-1990s, and this structure has generated considerably more revenue as the economy's underlying growth rate has risen. Restraint on expenditures also has contributed to the brighter outlook. Tight limits on spending were imposed in response to the large deficits of the 1980s and early 1990s, and defense spending was reduced following the end of the Cold War.

Both the Office of Management and Budget and the Congressional Budget Office have assumed that much of the accelerated productivity growth of the late 1990s is likely to be sustained through the next decade. No doubt, a period of weakness in measured productivity is likely to accompany the current slowdown in economic activity. However, there is little in the recent data to suggest that any significant alterations in these agencies' longer-term projections of structural productivity growth might be required.

Should we infer from these positive budget developments that unified budget deficits are no longer conceivable? Hardly. The substantial surpluses in retirement programs (especially social security) in recent years and in the nearer-term budget projections are on a cash basis. Were we fully accruing the benefit liabilities inferable from existing law, these retirement programs would currently be in deficit, and contingent liabilities amounting to about \$10 trillion for social security alone would have been added to the current debt to the public.

When the baby boom generation retires, and as the population subsequently ages further, these contingent liabilities will come due and--barring an offsetting surplus in the remainder of the government's budget--will be met by the issuance of Treasury securities, shifting much of total federal liabilities from contingent liability to debt to the public. At that point, of course, the unified budget will be in deficit.

Of more relevance for the nearer term, current forecasts suggest that under a reasonably wide variety of possible tax and spending policies, the resulting surpluses will allow the Treasury debt held by the public to be paid off. Moreover, well before the debt is eliminated--indeed, possibly within a relatively few years--it may become difficult to further reduce outstanding debt to the public because the remaining obligations will mostly consist of savings bonds, well-entrenched holdings of long-term marketable debt, and perhaps other types of debt that could prove difficult to reduce. Whether economic developments and tax and budget choices will, in the end, produce surpluses of the order of magnitude currently projected is open to debate. But the probability of substantial continuing surpluses is sufficiently high to require that, at a minimum, we begin to address their potential implications for fiscal policy decisionmakers, financial markets, and the Federal Reserve.

I have long argued that paying down the national debt is beneficial for the economy: It keeps interest rates lower than they otherwise would be and frees savings to finance increases in the capital stock, thereby boosting productivity and real incomes. But the current budget projections are such that we need to consider what path of debt reduction is best for the economy.

The issue is complicated: On the one hand, higher national saving, by raising the nation's capital stock, leaves the country better prepared to cope with the economic effects of the aging of the U.S. population--and one way to achieve that higher saving is to run budget surpluses. On the other hand, after a point, this increase in national saving comes at a cost. Once Treasury debt reaches its irreducible minimum, additional surpluses will, of necessity, lead to the accumulation of substantial private--that is to say, non-federal--assets either in the Treasury's general fund or in government trust funds. The decisions on how such funds should be invested by the government would necessarily be political ones, and would lead to efforts by some groups to obtain via the political process funding that they could not obtain, at least at the same price, in private markets.

These efforts would likely result in distortions in the allocation of capital that must be balanced against the benefit to the nation of the increase in saving. In fact, it is the market-driven allocation of capital and labor to their most productive uses that has fostered our recent impressive gains in productivity and encouraged inflows of capital that have enabled us to build an extraordinarily efficient capital stock despite quite modest levels of domestic savings. The effectiveness of our markets in allocating capital is one of our nation's most valuable assets. We need to be careful not to impair their functioning.

It is, regrettably, too easy to envision political pressure being exerted to use government financing of investments to offset perceived capital market imperfections. Experience suggests that in such cases the resulting returns earned on the investments are likely to fall short of market standards. Moreover, the social benefits of investment are likely to be very difficult to measure in practice, opening the door to political interference in the allocation of funds.

It is difficult, for example, to envision effective constraints being placed on politically attractive investments by defined-benefit trust funds, such as the social security trust fund. Benefits are guaranteed by government, irrespective of any losses to the fund. Thus, one must presume that even if our social security trust funds were to be so seriously impaired by mismanaged government investment that they dried up, full benefits would be highly likely to be forthcoming despite the fact that under current law the social security trust fund has limited borrowing authority. As a result, prospective beneficiaries would have no incentive to police the investment policies of the trust fund.

To be sure, we do have about \$3 trillion of assets administered in the defined-benefit plans of state and local governments. While research in this area has been limited, it does indicate that state and local pension funds have tended to underperform private pension funds if required to direct a portion of their investment within the state or to make “economically targeted investments.” Some recent work has suggested that the negative effects of such requirements may have been less important in recent years than they were in the past, but that conclusion remains speculative. Along the same lines, there is some evidence suggesting that returns on state pension funds have been lower where the proportion of trustees who are political appointees is higher.

Some have argued that methods could be devised to insulate government investment decisions from the political process even in defined-benefit funds, perhaps by limiting such investments to index funds. Even if such methods were successful, the government would be investing only in publicly traded securities, and so its investment might have an adverse effect on the relative financing costs of smaller, often quite productive, non-publicly-traded firms. Over time, these effects would presumably be arbitrated away. But such a process likely takes time, and capital market imperfections, in any event, are likely to impede full arbitrage.

Arguably, defined-*contribution* funds, even if administered by a federal agency, could insulate investment policy from political interference, as well as potentially freeing investment from the straightjacket of holding only index funds. It is highly unlikely that the beneficiaries of such funds would countenance politically convenient investments in their retirement funds. Indeed, the \$100 billion federally managed Thrift Savings Fund has been operated without such interference. I should note, however, that conversion of social security from a defined benefit plan to a defined contribution plan would fundamentally alter its nature.

One way to employ unified budget surpluses to finance increased investment would be to convert such funds into individual retirement accounts owned and administered by beneficiaries, with the presumption that the funds would be fully dedicated to retirement. In such an instance, the resulting reduction in government saving would be offset by a rise in private saving, so that total domestic saving would be maintained, though the availability of newly owned private assets could reduce the propensity to save out of income somewhat.

Given concerns about the potential distorting effects of asset accumulation by the Treasury or in government defined-benefit plans, we need to carefully consider the appropriate

path of debt paydowns. By addressing this issue now, we can avoid an abrupt and potentially disruptive change in fiscal policy as the level of Treasury debt reaches its irreducible minimum.

Despite the clear advantages of paying down the federal debt, I recognize that doing so has some potential adverse consequences even before the difficulties associated with government accumulation of private assets arise. The Treasury market serves a number of useful purposes (in addition to providing many of you with profitable employment). Most obviously, Treasury debt provides an asset that is free of credit risk--a characteristic that is desirable for many investors, especially in times of economic or financial turbulence. Treasury yields also provide a benchmark for the quoting and pricing of risky debt. In addition, the size and liquidity of the Treasury market allow market participants to hedge interest rate risks easily and at low cost. Moreover, the liquidity of these securities enables participants to make rapid adjustments to their portfolios in times of market volatility.

Thus, the elimination of Treasury debt does remove something of economic value, and it will require that significant adjustments be made by market participants. Indeed, with marketable Treasury debt held by the public--that is, excluding the Federal Reserve but including foreign central banks--having declined about 20 percent in recent years, to less than \$2.5 trillion, some of these adjustments have already begun. Reportedly, firms have increasingly turned to swaps, agency securities, and even larger corporate debt issues to do their hedging. After a period of transition, such shifts arguably should not have any significant adverse effect on risk management. As hedging activity moves from the shrinking Treasury market to alternative markets, the liquidity of those markets should improve. Yields on the alternative hedging

instruments likely will track at least as closely with those on instruments commonly being hedged as do Treasury yields.

Similarly, the loss of Treasury securities as benchmarks seems unlikely to result in major difficulties for market participants because alternative benchmarks are easy to envision. For example, in European bond markets, swaps are already the most common benchmark. Even in the United States, the Treasury bill market has lost its “benchmark status” in recent years, and has been replaced in that role by the eurodollar and eurodollar futures markets, with no evident adverse effects on the operation of short-term credit markets.

All of these alternative assets, of course, involve some degree of credit risk. However, given sufficient demand, it seems likely to me that you or your colleagues could produce a nearly riskless security. For example, this could be accomplished with a very senior tranche of a collateralized debt obligation backed by high-grade corporate debt.

In short, I am confident that U.S. financial markets, which are the most innovative and efficient in the world, can readily adapt to a paydown of Treasury debt by creating private alternatives with many of the attributes that market participants value in Treasury securities. Of course, the resulting adjustments will not be perfect and, in some cases, will impose costs on financial market participants, especially during the period of transition to new products and procedures. However, I believe that these costs are very likely to be outweighed by the benefits to the country of a higher capital stock and the resulting increases in productivity and income that appear to be the consequence of debt reduction. Moreover, competitive pressures and profit opportunities will provide a strong incentive for you and your colleagues in the financial industry to devise ways to minimize such costs.

Still, the lack of Treasury securities might be a bigger problem for international investors than for domestic investors, because they may be less well informed about U.S. corporations. As a result, international investors--especially official ones--may have a strong preference for U.S. government instruments. In such circumstances, foreign investors may reduce, on net, their holdings of overall dollar assets as Treasury securities are paid down. By itself, such diminution in the demand for U.S. dollar assets would tend to raise interest rates for U.S. borrowers and, conceivably, put downward pressure on the dollar's exchange rate. However, the evidence of the past year and a half gives little support to this notion: Foreign private investors, on net, have run off their holdings of U.S. Treasury securities, while they have built up their holdings of private dollar assets by an even larger amount, and the foreign exchange value of the dollar has appreciated.

A final valuable feature of the Treasury market is that it is a remarkably efficient system for funding federal government deficits. Because demographic and other factors are surely likely to lead to the re-emergence of deficits in the future, one might argue that it would be best to continue to borrow at least limited amounts from time to time in order to keep the market operating, so that it will be available when it is needed again. While that is clearly an alternative, we should also keep in mind that re-establishing the Treasury security market likely would not be all that difficult. Borrowing needs, in all likelihood, would start out small, so the market would have time to develop. Moreover, I have great confidence in your ability--or that of your successors--to initiate a new market for Treasury debt when that becomes necessary.

Like other financial market participants, the Federal Reserve will also have to adjust to the loss of Treasury debt. Currently, Treasury securities are the "permanent" assets that

correspond to the currency that is the Federal Reserve's main liability. Treasury securities have several features that make them particularly attractive assets for the Federal Reserve. First, the liquidity of the market allows the Federal Reserve to make substantial changes in reserves in a short period of time, if necessary. Second, the size of the market has meant that the effects of the Federal Reserve's purchases on the prices of Treasury securities have been minimal. Third, Treasury securities are free of credit risk. Thus, the Federal Reserve does not itself take on such risk when it holds them. I should point out that we do not eschew risk because we fear becoming insolvent. Rather, we believe that the effects of Federal Reserve operations on the allocation of private capital are likely to be minimized when Federal Reserve intermediation involves primarily the substitution in the public's portfolio of one type of instrument that is free of credit risk--currency--for another--Treasury securities. As I discussed earlier, it is important that government holdings of assets not distort the private allocation of capital, and this goal applies to the Federal Reserve System as well as to the Treasury.

However, if the Treasury debt is paid down, as I trust it will be, then the Federal Reserve will have to find alternative assets that still provide substantial liquidity and minimize distortions to the private allocation of capital. Even before that time, the Treasury market may become less liquid, making it more difficult for the Fed to make purchases without affecting market prices. Moreover, declining Treasury debt presumably would, at some point, reduce the liquidity of the Treasury repurchase agreement (RP) market, complicating the use of such operations in adjusting the short-term supply of reserves.

In the short run, the Federal Reserve will continue to purchase a substantial volume of Treasury securities. In order to minimize the effects of its purchases on the market, however, it

has established limits on the fraction of individual issues that it will hold going forward. The Federal Open Market Committee (FOMC), as you know, has also decided, on a temporary basis, to allow the Open Market Desk at the Federal Reserve Bank of New York to conduct RP operations with agency mortgage-backed securities as collateral as well as with Treasuries and direct agency debt.

Other changes that are already allowed under current statutes could be implemented to substitute, to a limited extent, for our holdings of Treasury securities. For example, the Federal Reserve could purchase, outright, Ginnie Mae securities, which are fully backed by the Treasury. It could also further broaden the types of collateral allowed for RP operations, perhaps including certain municipal obligations or those of foreign governments. Such an expansion could reduce the effects of Federal Reserve operations in the market for any particular type of collateral. The FOMC has asked staff to explore all of these short-run alternatives.

Over a longer time horizon, more fundamental changes could be considered. One possibility is to expand the use of the discount window by auctioning such credit to financially sound depository institutions. Such auctions would enhance our ability to adjust the supply of reserves as needed, and because these loans would be fully collateralized, they would offer considerable protection against credit risk.

Another possibility is to add new assets to those the Fed is currently allowed by law to buy for its portfolio. These assets could be used to provide a broader range of RP collateral, a process similar in concept to the expanded use of the discount window, as well as ultimately being added to our permanent portfolio. One would hope that such additions would help to limit the distortions to particular markets caused by Federal Reserve purchases.

Of course, what adjustments we make to our procedures--and when we make them--depend on how rapidly the supply of Treasury securities dwindles and on how long the Treasury market is not available. As I noted earlier, demographic forces are likely to cause unified budget deficits to re-emerge at some point in the future and fresh supplies of Treasury securities to be issued. At that time, the Federal Reserve presumably would begin to shift our portfolio back toward the Treasury market.

The timing and extent of the re-emergence of Treasury issuance will depend on underlying productivity growth and, of course, on the degree of fiscal discipline exercised by future American governments.

Finally, in the period ahead, the Federal Reserve will be seeking active consultations and discussions with you and other market participants, as well as with the Congress, before significant changes are made to Federal Reserve procedures and methods. While the prospective paydown of Treasury debt presents us with challenges, I am confident that, with your help, the Federal Reserve can make the needed adjustments and will be able to continue to implement monetary policy in the national interest. The benefits of reducing our federal debt make the associated challenges well worth meeting.