THE WALL STREET JOURNAL.
WSJ.com

OPINION | March 3, 2013, 5:39 p.m. ET

Treasury Needs a Better Long Game

Today's low interest rates are a rare opportunity to buy time for a fiscal housecleaning.

By JOHN H. COCHRANE

Sooner or later, the Federal Reserve will want to raise interest rates. Maybe next year. Maybe when unemployment declines below 6.5%. Maybe when inflation creeps up to 3%. But it will happen.

Can the Fed tighten without shedding much of the record $3 trillion of Treasury bonds and mortgage-backed securities on its balance sheet, and soaking up $2 trillion of excess reserves? Yes. The Fed can easily raise short-term interest rates by changing the rate it pays banks on reserves and the discount rate at which it lends.

But this comforting thought leaves out a vital consideration: Monetary policy depends on fiscal policy in an era of large debts and deficits. Suppose that the Fed raises interest rates to 5% over the next few years. This is a reversion to normal, not a big tightening. Yet with $18 trillion of debt outstanding, the federal government will have to pay $900 billion more in annual interest.

Will Congress and the public really agree to spend $900 billion a year for monetary tightening? Or will Congress simply command the Fed to keep down interest payments, as it did after World War II, reasoning that "Fed independence" isn't worth that huge sum of money?

Martin Kozlowsi

This additional expenditure would double the deficit, which tempts a tipping point. Bond markets can accept fairly big temporary deficits without charging higher interest rates—buyers understand that bigger deficits for a few years can be made up by slightly larger tax revenues or spending cuts over decades to follow. But once markets sense that deficits may be unsustainable, and that bond buyers may face default, restructuring or inflation, they will demand still-higher interest rates. Higher rates mean higher deficits—leading to a fiscal death spiral.

Many economists think the tipping point starts when total government debt (federal, state and local) exceeds 90% of GDP. We are past that value, with large state and local debts, continuing sclerotic growth and a looming entitlements crisis to boot. This, not the "balance sheet" or other monetary or institutional constraints, will be the Fed's quandary—can the monetary authority really dare to risk a fiscal crisis?

The obvious answer is to fix the long-run deficit problem, with the reform of runaway spending, entitlement programs and a pro-growth tax policy. So far that is not happening.

Still, the Fed and the Treasury can buy a lot of time by lengthening the maturity of U.S. debt. Suppose all U.S. debt were converted to 30-year bonds. Then, if interest rates rose, Treasury would pay no more on its outstanding debt for 30 years. And if the country couldn't solve its fiscal problems by that time, it would deserve a Greek crisis.

Alas, the maturity structure of U.S. debt is quite short. I estimate that our government rolls over 40% of its debt every year, and 65% within three years. (I account for Federal Reserve holdings, coupon payments and use market values.) Thus the fiscal impact of higher interest rates will come quickly.

Mr. and Mrs. Smith shopping for a mortgage understand this trade-off. Mr. Smith: "Let's get the adjustable rate, we only have to pay 1%." Mrs. Smith: "No, honey, that is just the teaser rate. If we get the 30-year fixed at 3%, then we won't get kicked out of the house if rates go up."

Amazingly, nobody in the federal government is thinking about this trade-off. Instead, each agency thinks only for itself.

The Fed is still buying long-term bonds in an effort to temporarily drive down long-term interest rates by a few basis points. It has concluded it can survive the loss in mark-to-market value of its bond portfolio that higher interest rates will imply, when they come, by suspending its customary interest-rebate payments to the Treasury. If the Treasury was counting on that roughly $80 billion per year, that is Treasury's problem. If higher rates cost the Treasury $900 billion a year, that is Congress's problem.

The Treasury's Bureau of Public Debt controls the maturity of federal debt issues. It has been gently borrowing longer in response to low long-term rates, but not enough to substantially alter the government's interest-rate risk. The bureau also views its job narrowly—which is to finance whatever deficits Congress determines, not to take actions that mitigate future deficits. Congress and the administration are busy with other matters.

Ironically, the Fed's buying and the Treasury bureau's selling have neatly offset, leaving very little change in the maturity structure of debt in private hands.

What to do? First, the Treasury and Fed need a new "accord" to decide who is in charge of interest-rate risk, most likely the Treasury, and then grant it clear legal authority to manage that risk. The Fed should then swap its portfolio of long-term bonds for a portfolio of short-term Treasuries and forswear meddling in the maturity structure again.

Second, the Treasury should seize its once-in-a lifetime opportunity to go long. Thirty-year interest rates are at 2.8%, a 60-year low. Many corporations and homeowners are borrowing long to lock in low funding costs. So should the Treasury.

You may complain that if the Treasury borrows long, then long-term rates will rise. If so, it is better that everyone knows that now. It means that markets aren't really willing to buy long-term government debt, that the 2.8% yield is only a fiction of the Fed's current buying, and that it won't last long anyway. Better fix the fiscal hole, fast.

You also may argue that 2.8% long term-debt is more expensive than 0.16% one-year debt. There are two fallacies here. First, the 2.8% long-term yield reflects an expectation that short rates will rise in the future, so the expected cost over 30 years, as well as the true annual cost, are much closer to the same. Second, to the extent that long-term bonds really do pay more interest over their life span, this is the premium for insurance. Sure, running a restaurant is cheaper if you don't pay fire insurance. Until there is a fire.

A much longer maturity structure for government debt will buy a lot of insurance at a very low premium. It will buy the Fed control over monetary policy and preserve its independence. If Fed officials realized the risks, they would be screaming for longer maturities now.

But we don't have long to act. All forecasts say long-term rates will rise soon. As the car dealer says, this is a great deal, but only for today.

Mr. Cochrane is a professor of finance at the University of Chicago Booth School of Business, a senior fellow of the Hoover Institution and adjunct scholar of the Cato Institute.