Discussion of John Cochrane, "U.S. Federal Debt in the 21st Century"

John Y. Campbell

Harvard University

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What Is This Paper?

- This is a visionary reimagining of the Treasury's debt management function.
- Cochrane challenges not one but five shibboleths:
  - The Treasury issues debt, the Fed creates money
  - The Treasury relies on primary dealers to operate primary and secondary markets for Federal debt
  - The Treasury ensures predictable debt supply in the short run and does not respond to prices
  - The Treasury always makes its promised coupon and principal payments
  - The Treasury issues Federally taxable debt.

What Is This Paper?

- Cochrane's proposals:
  - ▶ Replace Treasury bills with divisible, electronically transferable, floating-rate, fixed-value instruments (electronic money, comparable to reserves at the Fed)
  - ▶ Disintermediate primary dealers by issuing permanent long-term debt instruments that can be traded on exchanges
  - ▶ Fix prices at the short end, giving up quantity control, and use swaps to manage Treasury interest-rate risk exposure
  - ▶ Allow the Treasury discretion over coupons, relying on reputation to limit abuse of this discretion
  - ▶ Issue both taxable and nontaxable debt, competing with municipal issuers.

Who Is the Author?

Moses?   Or Samson?

Treasury Electronic Money

- Technology is opening up new possibilities.
- Provision of money is a core function of government, but government may have to innovate to compete with high-tech private-sector alternatives (Bitcoin).
- If one could replace currency altogether, an even greater prize would be attainable
  - Elimination of the zero lower bound on the nominal interest rate
  - This would drastically simplify the operation of monetary policy in a low-inflation environment.

Perpetuities

- Cochrane wants to create a perpetuity such that new issues are indistinguishable from old ones.

  - I am sympathetic to this suggestion as a way to enhance liquidity.

- Britain's consols actually do not satisfy this condition, because they are redeemable at par so the coupon rate matters.

- A potential problem: perpetuity has modified duration $D^* = 1/Y$, which can be very high when yields are low.

- A potential solution: a perpetuity with coupons that grow geometrically at rate $G < 0$, and modified duration $D^* = 1/(Y - G)$.

Discretionary Coupons

- Cochrane wants to give Treasury discretion over coupons, "without triggering default."
- Problematic because
  - ▶ If bondholders expect Treasury to use this discretion, yields increase and borrowing becomes more expensive unless Treasury actually does cut coupons
  - ▶ If bondholders do not expect Treasury to use this discretion, any cut in coupons is a surprise and has the same reputational effects as default, regardless of the legal definition.
- In the current regime, the US benefits from its ability to borrow cheaply in bad states of the world.
  - ▶ This offsets the increase in the market value of long-term outstanding debt which occurs when long yields fall in bad states.
- I fear that this proposal pulls down the pillars of the temple rather than building better infrastructure.

Taxable and Nontaxable Debt

- Cochrane makes two arguments for Treasury nontaxable debt:
  - An efficient way to transform future tax revenues into current resources
  - Taxable TIPS are not safe long-term assets for taxable investors given the taxation of nominal interest.

- The first argument is not compelling:
  - One can always adjust the quantity of bonds sold to achieve the same intertemporal resource transfer with either type of debt
  - Progressive taxes create multiple classes of taxable investors, and nontaxable debt may benefit investors in the highest tax bracket if the marginal investor is in a lower tax bracket.

- The second argument is legitimate, but there are alternative fixes:
  - Tax-favored retirement accounts
  - Keep inflation under control
  - Tax reform to tax real not nominal interest income.