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

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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?

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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.