The Heritage Foundation

ISSUE BRIEF

No. 4474 | OCTOBER 23, 2015

U.S. Treasury Debt Is Not the Foundation of the Global Economy

Norbert J. Michel, PhD

Congress is once again facing a decision on the debt limit. If lawmakers do not raise the $18.1 trillion limit by the end of October, the U.S. Treasury may not have enough cash on hand to meet all of its obligations as they come due.[1] If they do raise the limit, the Treasury will borrow more money by offering new debt—Treasury securities—for sale.

For many in Congress, issuing more debt is the preferred solution because it prevents difficult choices. Without the new securities, the U.S. Treasury will have to prioritize payments, and Congress will face more pressure to finally address its long-term spending and debt problems. Adding to the atmosphere of panic, some policymakers are pressuring Congress on the basis of the faulty notion that the world is functionally dependent on U.S. debt.

U.S. Treasuries Not Irreplaceable

Recently, the American Action Forum released a video which claims that the "U.S. Treasury Market is the Foundation of the World Economy."[2] There is no doubt that Treasuries are widely used throughout the world, principally because they are one of the safest investments available. To assign such importance to U.S. debt, however, is an overstatement. The world economy has ebbed and flowed for centuries, even making it through the industrial revolution, without anything like the current Treasury market.

Such drastic claims also serve to further the notion that the government "runs" the economy, as well as the idea that the current level of government spending is necessary. Neither premise is correct. The free enterprise system can function—and, more often than not, has done so—without trillions in federal bonds.

Still, the notion that we need government debt at all times is not new. Similar arguments surfaced in the late 1990s and early 2000s, for instance, when the U.S. government found itself running budget surpluses. Some did not want to use the surpluses to pay down debt, and others argued that only a limited amount of the debt should be repaid. Others worried that the Federal Reserve would be unable to conduct monetary policy without Treasuries, the main item bought and sold to conduct open market operations.

Greenspan's Voice of Reason

In 2001, Alan Greenspan noted that "the elimination of Treasury debt does remove something of economic value, and it will require that significant adjustments be made by market participants."[3] However, he was quick to add that "the loss of Treasury securities as benchmarks seems unlikely to result in major difficulties for market participants because alternative benchmarks are easy to envision."[4] Thus, Greenspan did not go so far as to say the entire world economy was built on U.S. Treasuries, and he recognized that financial markets would adjust to a Treasury-free world because that is what financial markets do—they find ways to allocate capital.

This paper, in its entirety, can be found at
http://report.heritage.org/ib4474

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

In fact, Greenspan also pointed out that markets were already adjusting.

> 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.[5]

Monetary Policy Without Treasuries

For decades, the Fed has conducted open market operations by purchasing and selling Treasuries. That is, the Fed regularly maintains system-wide liquidity via the buying and selling of Treasury securities. Thus, the rapid decline in outstanding Treasuries during the late 1990s pushed the Greenspan Fed to study alternative methods for conducting monetary policy. In 2002, the Fed published its report but failed to implement any substantive policy changes, partly because budget surpluses soon turned to deficits.[6]

Nonetheless, the study suggested that an auction-based lending facility, instead of open market operations or traditional discount window lending, would be a viable method for providing liquidity to the banking system. Under such an alternative, the Fed would simply auction off fully collateralized credit to all sound banks. The Fed temporarily used this type of auction facility between 2007 and 2010, when both open market operations and the discount window failed as monetary policy tools.

Formally, the Fed introduced the Term Auction Facility (TAF) in December 2007, a lending program that combined aspects of open market operations and discount window lending. By the Fed's account, the auction facility worked well during the crisis, and there is no obvious reason they could not rely on these types of auctions to provide system-wide liquidity. The TAF even seems to have avoided the well-known stigma that long ago relegated the discount window to a minor monetary policy tool. According to Donald Kohn, former Vice Chairman of the Federal Reserve Board of Governors:

> The legal form of the TAF is the same as that of regular discount window loans. But by providing funds through an auction mechanism rather than through a standing facility, the TAF resembles open market operations rather than the standard discount window and, partly as a result, it appears to have largely avoided the stigma problem that limited the effectiveness of the discount window.[7]

Conclusion

Congress will soon have to decide whether to raise the $18.1 trillion debt limit, or face the possibility that the U.S. Treasury may have to prioritize its obligations. There are many factors to consider, but bringing the world economy to its knees because the U.S. fails to issue Treasury securities is not one of them. Free enterprise, in the U.S. and abroad—can function—and has functioned—without massive amounts of government debt and spending. Markets will ultimately function better without massive amounts of government debt because there will be fewer distortions and more private capital available.

For these reasons, Congress should focus on its long-term spending and debt problems. The right approach would be to eliminate waste wherever

1. U.S. Government Accountability Office, Office of General Counsel, "Question Concerning Secretary of the Treasury's Authority," B-138524, October 9, 1985, http://www.gao.gov/products/449522 (accessed October 22, 2015).
2. See American Action Forum video, "#Eakinomics: Why Congress Should Raise the Debt Limit," October 5, 2015, http://americanactionforum.org/videos/eakinomics-why-congress-should-raise-the-debt-limit (accessed October 21, 2015).
3. Alan Greenspan, "The Paydown of Federal Debt," speech given to the Bond Market Association, White Sulphur Springs, West Virginia, April 27, 2001, http://www.federalreserve.gov/BOARDDOCS/Speeches/2001/20010427/default.htm (accessed October 21, 2015)..
4. Ibid.
5. Ibid.
6. Federal Reserve System Study Group on Alternative Instruments for System Operations, "Alternative Instruments for Open Market and Discount Window Operations," Board of Governors of the Federal Reserve System, December 2002, http://www.federalreserve.gov/boarddocs/surveys/soma/alt_instrmnts.pdf (accessed October 21, 2015).
7. Donald L. Kohn, "Policy Challenges for the Federal Reserve," speech at the Kellogg School of Management, Northwestern University, Evanston, IL, November 16, 2009, http://www.federalreserve.gov/newsevents/speech/kohn20091116a.htm (accessed June 15, 2015).

possible and make commonsense reforms that modernize outdated entitlement programs. Congress should address the key drivers of spending growth and put the budget on a path to balance—before raising the debt limit. The Heritage Foundation's blueprint for congressional action[8] lays out that path in detail.

*—**Norbert J. Michel, PhD,** is a Research Fellow in Financial Regulations in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom and Opportunity, at The Heritage Foundation.*

8. Paul Winfree, Romina Boccia, Curtis S. Dubay, and Michael Sargent, "Blueprint for Congressional Fiscal Action in the Remainder of 2015," Heritage Foundation *Backgrounder* No. 3052, September 2, 2015, http://www.heritage.org/research/reports/2015/09/blueprint-for-congressional-fiscal-action-in-the-remainder-of-2015.