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OP-ED

The National Debt Is a Bigger Problem Than You Think

By Lawrence Goodman
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The U.S. debt situation is worse than commonly realized. Unaddressed, the surge in Treasury borrowing over the last 10 years represents an accident in the offing.

Fortunately, a few debt management policy tweaks can yield great benefit with limited costs.

In 1971, when the Bretton Woods exchange rate system and U.S. dollar were under severe strain and ready to collapse, Treasury Secretary John Connally remarked at a G-10 meeting in Rome, “The dollar is our currency, but it’s your problem.” Despite the wording, the dilemma was indeed shared.

Today, it’s our debt, and it’s our problem. Public debt is now 107 percent of GDP up from 62 percent a decade ago. But, the amount of debt is only part of the problem. More pressing challenges lurk beneath the surface:

First, the Federal Reserve stands ready to reduce the size of its $4.5 trillion balance sheet, including $2.5 trillion in U.S. Treasury holdings. The impact of this unwind is complex and multi-pronged. What we know for sure is that gigantic purchases of Treasuries debt kept yields artificially low over the last several years. Fed purchases of Treasury bonds subsidized the U.S. budget deficit.

So, as the portfolio is unwound, yields will face upward pressure. This becomes a fairly daunting challenge as budget deficits are also destined to widen.

Second, Treasury debt maturities are abnormally skewed to the short term. This presents a problem, especially with expanding deficits on the horizon.

Many suggest that current debt levels are not a burden, as U.S. debt has been higher. This is naïve. Yes, debt reached a peak of 120 percent of GDP in the immediate aftermath of World War II. But, more pressingly, large refinancing requirements represent an enormous jump in the U.S. government’s “reliance on capital markets.”

Treasury will need to roll or refinance 18 percent of GDP to private investors in 2017 alone, relative to an average of 10 percent of GDP per year between 1973 and 2008. Add another 3 percent of GDP for borrowing associated with our fiscal deficit and Treasury's "reliance on capital markets" — domestic and international — is 21 percent of GDP.

It is even worse if the Fed allows its holdings of Treasury debt to mature over the next year. At that point, Treasury's reliance on capital markets will jump to 23 percent of GDP.

In the old days, public officials paid much more careful attention to liability management. For instance, after World War II, Treasury issued more evenly across the yield curve. For instance, in 1946, only 41 percent of the total debt held by private investors fell due over the next five years.

Today, a stunning 70 percent of Treasury debt held by private investors will need to be refunded in the next five years.

Third, liquidity in the U.S. Treasury market is already a concern. The flash crash on October 15, 2014 — when the yield on the 10 year U.S. Treasury bond plunged by 37 basis points in a mere two hours —represented statistically a once in over 500-million-day occurrence. Even now, the causes of the flash crash are not fully known and actively debated.

Treasury Secretary Steven Mnuchin is to be applauded for finally prioritizing, reviewing and, hopefully, revising the maturity structure of U.S. debt. However, issuance of new long-dated instruments such as a 50-and 100-year bond would be a mistake.

New long-dated bonds would do little to smooth our principal repayment profile beyond more actively tapping preexisting maturities. Issuance would simply create new buckets of illiquid securities at a time when market liquidity remains questionable. Limited liquidity — due in large part to the impact of financial regulation — diminishes the willingness of financial institutions to hold bonds in inventory and raises the risk of potentially damaging price swings.

Lastly, the inevitable normalization of monetary policy or higher federal funds rates would likely strain Treasury debt markets. New longer-dated instruments – such as 50-or 100-year bonds – would be especially vulnerable. Illiquidity would undoubtedly exacerbate price swings. Under these circumstances, the new bonds would quickly lose value and become a potential public relations problem.

So, in an environment of growing public deficits and unrelenting debt maturities, what should be done?

First, the Office of Management and Budget (OMB) and Congressional Budget Office (CBO) must formally create and publicly release a "reliance on capital markets" measure. It is essential to incorporate maturing debt obligations over the next 30 years into the analysis of the U.S. financial position. Transparency will motivate better debt and fiscal management.

Second, Treasury should extend U.S. sovereign debt into longer-dated maturities.

Lastly, the budget deficit should be kept below 3 to 4 percent of GDP into the foreseeable future.

Why take any more chances?

It's our debt. It's our problem. Let's fix it.

Lawrence Goodman is the president of the Center for Financial Stability and previously served at the U.S. Treasury.