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The Disappearance of U.S. Treasury Securities: Should We Care?

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As the outstanding level of U.S. Treasury debt falls, some people in the financial markets are experiencing a mild sense of panic. Until very recently, U.S. Treasury securities play a myriad of roles for bankers, securities dealers, and investors. I will list just a few. The Treasury yield has been a gauge of the interest rate for a bond that was free of the risk of default as well as a standard on which to base the pricing of risky debt – that is to say, corporate debt would be priced at a spread over the Treasury issue of an equivalent maturity. The Federal Reserve continues to conduct monetary policy using Treasuries (they currently hold around $575 billion, which is roughly 10% debt outstanding), and a number of local governments in the U.S. are required by statute to hold their operating cash in this form. Finally, the market for U.S. Treasuries was a place where financial firms with inventories of corporate issues could hedge the interest-rate risk in the portfolios.

But over the past few months, it has become clear that we have shifted from an era of expanding federal debt to one in which the outstanding quantity of publicly held U.S. Treasury issues will be shrinking. The dread in the financial community arises from the realization that even today, the prices of Treasury bonds are so profoundly affected by perceptions of future scarcity that they are no longer capable of serving the same functions they did are recently as one year ago.

As a result of all this, a competition has ensued to take the place of Treasuries and become what, in the markets, is know as the “benchmark” bond. Competitors for this prize include Federal Government Agency securities, the bonds issued the most creditworthy corporations like Ford, World Bank debt and interest rate swaps (which are used by financial institutions to trade interest-rate risk among themselves). Becoming the benchmark issue will likely reduce borrowing costs, and carries a certain amount of prestige.

But before we advocate anointing a new benchmark, it is worth stepping back and asking whether there is a need for one. Have Treasury bond yields really played an indispensable role in fixed-income markets? Looking first to official uses, I see no reason for concern. The Federal Reserve is a small player in these markets anyway – remember that the money stock measured by

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M2 now stands around $4700 billion, more than 8 times the Fed's balance sheet. But at a purely operational level, the U.S. is unusual in restricting its central bank holdings to the debt issued by its own government, and so the move to holding small quantities of other issues poses no real difficulty.

What about Treasury yields as a base for pricing corporate debt and their function as a hedge for interest-rate risk? The benchmark's usefulness here has been in the signal it has provided about the movements in market perceptions of future inflation and real growth. But over the last five years or so, inflation has been very stable (remaining in the range of 2 to 3%), and the volatility of growth has decline markedly. On the latter point, Federal Reserve Bank of New York economists Margaret Mary McConnell and Gabriel Perez Quiros have shown convincingly that U.S. output volatility has fell dramatically since the mid-1980s. Interest rates, which experience large swings in the 1970s and 1980s, are now more stabile as well.

All of this suggests that the importance of the interest-rate signal embodied in Treasuries is no longer as valuable as it once was. While in the past, corporate debt was risky mainly because of interest-rate risk arising from fluctuations in the portion of the yield attributable to benchmark, we are now entering a time when the primary risk inherent in owning privately issued debt is the fluctuations in the spread arises from changes in perceptions about credit risk of the issuer. Investment bankers may now actually have to earn their keep, as they will not be able to rely solely on rating agencies to tell them the credit-worthiness of a corporation, and then use a formula to price the bonds they underwrite. Instead, it will be their skill at credit-risk evaluation and management that will be rewarded, and Treasuries will be of little help here.

What about the use of Treasury yields to gauge the risk-free rate of interest? Here too, things are no longer what they used to be. Beginning at least in the fall of 1998 if not earlier, yields on Treasuries began to fluctuation for a number of reasons that had more to do with conditions in the rest of the world than anything else. There are times when the full faith and credit of the U.S. Government is extremely valuable. More recently, yields have fallen as news has come out about supply reductions. Liquidity and flight-to-quality considerations mask the usefulness of Treasury bond yields for other things.

Where does this leave us? First, the fiscal consolidation that has led to the reduction in U.S. government borrowing is surely a good thing. I hope that no one would advocate an increase in government spending or a decrease in taxes solely for the purpose of issuing more federal debt. Beyond that, I believe that worries about the disappearance of Treasury bonds are misplaced and that the search for a single security that will take all of their past roles is unnecessary. The Federal Reserve will find securities to buy, investment bankers spend more time evaluating the creditworthiness of private borrows, and the measurement of the risk-less rate will be teased from the instruments that remain. Interest-rate risk will be traded in swap markets, and credit-risk will be traded in derivative markets based on various private bonds. But the most important thing is that people will invent instruments to perform the tasks they demand. Financial markets exist as a place to price and trade risk, regardless of whether U.S. Treasury securities exist or not.