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John Cochrane thinks Treasury can get a free lunch. Treasury disagrees.

By: Dylan Matthews – March 5, 2013

University of Chicago professorJohn Cochrane alerted readers of the *Wall Street Journal*Monday to an intriguing possibility: could the Treasury be ensuring lower deficits in years to come, with no spending cuts and not tax increases? The key to the plan is that interest rates on U.S. debt are still very low. But they won't be for long. So Cochrane wants the Treasury to take advantage of this, and lock in the rates for the long-term — to, as he puts it, "seize its once-in-a lifetime opportunity to go long."

What would seizing that look like? The obvious answer is "sell more long bonds." The Treasury sells a mix of securities, ranging from Treasury bills that pay off within a year to Treasury bonds that can mature over as many as 30 years. Currently, it's enjoying very low interest rates across the board, so if it were to start issuing more long-term debt and less short-term debt, then we could reap the benefits of those rates for a much longer period of time, lowering interest payments and, in turn, the deficit.

What's more, it means that when the Fed raises rates (as everyone assumes will happen in 2015 or 2016), that won't have the effect of raising interest rates on most U.S. government debt, and thus increasing interest payments and, in turn, the budget deficit going forward. Because the low rates have been locked in already, the budget is insured against any changes in Fed policy.

So why not, Cochrane asked? Well, a number of reasons, bond experts respond. Nancy Vanden Houten, a bond market analyst at Stone McCarthy, explains that the Treasury Department doesn't — and argues that they shouldn't — engage in this kind of "opportunistic" bond issuance. "Many financial markets are structured around the Treasury markets, so you can't make those opportunistic decisions," she says. What would likely happen, she continues, is that bond markets would be startled and

concerned about what this means for the government's fiscal situation, and react by charging more interest, counteracting any benefits to buying more long bonds.

That concern is echoed in recent Treasuryminutes. In those minutes, domestic finance officials in the Treasury Department discuss the possibility of extending the "weighted average maturity" (WAM) of government debt — basically what Cochrane's proposing. But the officials weren't too keen on the idea. "A more rapid extension would only result in a two percent decline in the amount of debt maturing each year, and would not create any net interest-cost savings (assuming CBO interest rate forecast is realized)," the minutes recount one member surmising. They agreed with Vanden Houten that the risks of interest rates increasing were high.

What's more, the Treasury Department is *already* extending the maturity of its debt. The average maturity of U.S. government debt increased 34 percent from October 2008 to the end of last year, and the share of Treasury bill — the shortest-term instruments — has been cut in half. So the department could sensibly argue that Cochrane just wants a speeding up of what's already happening ."We have had the fastest maturity extension in a compressed period of time [in modern Treasury finance]."Matthew Rutherford, Assistant Secretary for Financial Markets, told me.

Not quite, Cochrane says. For one thing, he notes that the editing process resulted in his op-ed leaving off an important wrinkle. He doesn't necessarily want the debt maturity to increase straightforwardly but rather would support the government arranging swaps (a kind of derivative commonly sold by major banks) of its short-term debt and long-term debt held by others. That, he says, would amount to a similar deal as extending the debt maturity without the disruptions to financial markets.

Cochrane dismisses the concerns of Treasury officials and Vanden Houten about raising interest rates. "Investors don't care all that much about the maturity structure," he says. "That's what the Fed's running up against." And in any case, he thinks it a poor excuse for not taking better advantage of today's preposterously low interest rates. "I can't understand why anyone's lending the Treasury money at 2.8 percent," he says. "Paul Krugman's saying we should take them up on it and blow it on defenses for an alien invasion or something. I'm saying we should use it to retire some short-term debt and buy insurance against an interest rate spike."

Ultimately, the dispute is about exactly that: insurance. Cochrane wants some insurance that the federal deficit will not balloon going forward. Vanden Houten and the Treasury want the stability of the Treasury bond system to hold so that investors can insure themselves in case riskier ventures fail. The question, then, is, “What is the bigger threat: an increase in the budget deficit or a rattling of the financial system?” It’s hardly a nice choice to face but at the moment, the administration appears to consider the latter a bigger concern.