Hutchins Center
on Fiscal & Monetary Policy
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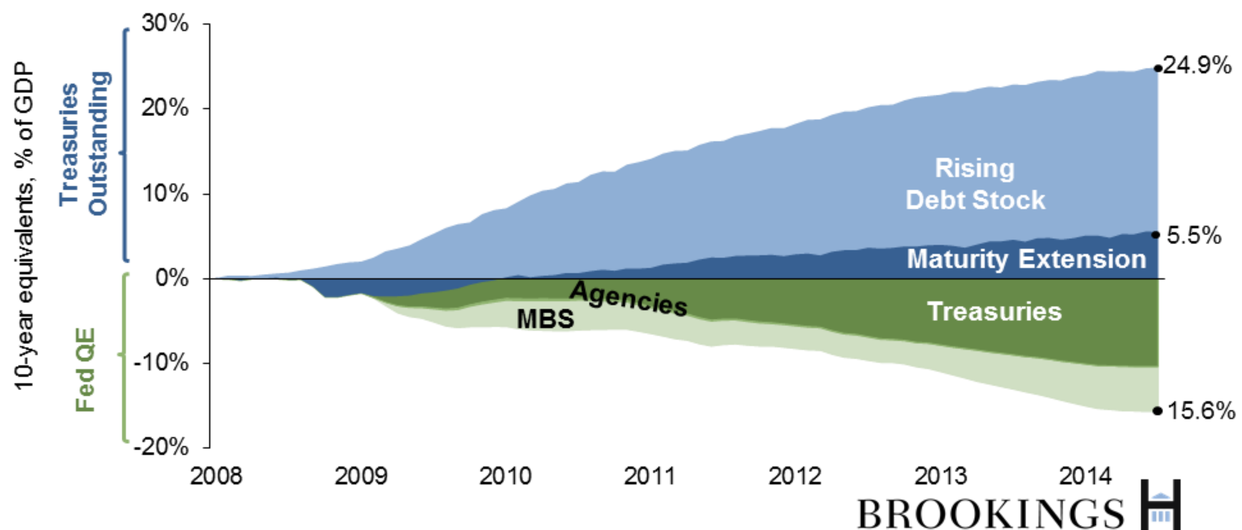
Quick Read: Government Debt Management at the Zero Lower Bound

Before the Great Recession, the U.S. Treasury handled decisions about the maturity of the federal debt and the Federal Reserve handled decisions about short-term interest rates. Once the Fed pushed short-term rates to zero in 2008 and began buying huge amounts of long-term Treasuries ("quantitative easing") the line became blurred. Indeed, while the Fed was buying long-term Treasuries to push down long-term interest rates, the Treasury was selling more of them, and not only because it had bigger budget deficits to finance. The Treasury made a decision to continue to lengthen the average maturities of the government's debt. The Treasury and the Fed were rowing in opposite directions. The net result, Harvard's Robin Greenwood, Sam Hanson, Josh Rudolph, and Lawrence Summers find, was that roughly one-third of the decline in long-term rates engineered by the Fed's quantitative easing was undone by the Treasury's decision to sell more long-term bonds.



The authors also say the traditional case for the Treasury issuing long-term bonds is overstated. The benefits to relying more on short-term borrowing, they say, include that it's cheaper for the Treasury because investor demand is so strong, it enhances financial stability by increasing the supply of safe, government-provided short-term assets, and it helps the Federal Reserve when interest rates drop to zero. These outweigh the major benefit of issuing long-term bonds, namely limiting the fluctuation in government borrowing costs.

The Harvard authors say the Fed and Treasury should release an annual joint statement on the strategy for managing the federal government's debt to avoid the two arms of the government working against each other for long periods. In ordinary times, when rates are above zero, the Fed can easily offset the effect of Treasury debt management decisions by moving interest rates. But in bad times when rates fall to zero, more coordination is needed. The Treasury needs to respond to the Fed's move to nudge investors to hold less long-term debt and the Fed needs to respond to the Treasury's interest in stabilizing the cost of government borrowing. The Treasury would propose that in ordinary economic times, when interest rates are not near zero, the Treasury should be the primary player in debt management policy, but with the Federal Reserve mitigating the aggregate demand impact as necessary. However, with interest rates near zero, a greater level of emphasis should be placed on the aggregate demand impacts of debt management policy.