S. HRG. 107–163

BUDGET SURPLUSES AND DEBT REDUCTION

HEARING

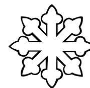
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

MARCH 29, 2001



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

75–131—PDF WASHINGTON : 2001

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON FINANCE

CHARLES E. GRASSLEY, Iowa, *Chairman*

ORRIN G. HATCH, Utah
FRANK H. MURKOWSKI, Alaska
DON NICKLES, Oklahoma
PHIL GRAMM, Texas
TRENT LOTT, Mississippi
JAMES M. JEFFORDS, Vermont
FRED THOMPSON, Tennessee
OLYMPIA J. SNOWE, Maine
JON KYL, Arizona

MAX BAUCUS, Montana
JOHN D. ROCKEFELLER IV, West Virginia
TOM DASCHLE, South Dakota
JOHN BREAUX, Louisiana
KENT CONRAD, North Dakota
BOB GRAHAM, Florida
JEFF BINGAMAN, New Mexico
JOHN F. KERRY, Massachusetts
ROBERT G. TORRICELLI, New Jersey
BLANCHE L. LINCOLN, Arkansas

KOLAN DAVIS, *Staff Director and Chief Counsel*
JOHN ANGELL, *Democratic Staff Director*

CONTENTS

OPENING STATEMENTS

	Page
Grassley, Hon. Charles E., a U.S. Senator from Iowa, chairman, Committee on Finance	1
Baucus, Hon. Max, a U.S. Senator from Montana	2

PUBLIC WITNESSES

Gensler, Dr. Gary, former Under Secretary of Treasury, Domestic Finance	3
Miller, Dr. James C., III, former Director, Office of Management and Budget	6

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Baucus, Hon. Max:	
Opening statement	2
Gensler, Dr. Gary:	
Testimony	3
Prepared statement	25
Grassley, Hon. Charles E.:	
Opening statement	1
Miller Dr. James C., III:	
Testimony	6
Prepared statement	31

COMMUNICATIONS

The Bond Market Association	33

BUDGET SURPLUSES AND DEBT REDUCTION

THURSDAY, MARCH 29, 2001

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:22 a.m., in room 215, Dirken Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Kyl, Baucus, Graham, Bingaman, and Lincoln

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. I would like to welcome everyone to this morning's hearing. And we are dealing with an issue of budget surpluses and debt reduction. And we are fortunate to have already at the table two very distinguished witnesses: Gary Gensler, who was Treasury Undersecretary, Domestic Finance, with President Clinton; and we have Jim Miller here, who was Director of the Office of Management and Budget under President Reagan.

The subject of today's hearing is especially timely as the Senate prepares to debate the latest Congressional budget resolution. One of the key issues we face is how to divide the budget surplus among competing priorities like tax cuts, debt reduction, Social Security and Medicare.

According to the Congressional Budget Office, Federal budget surpluses are projected to exceed $5.6 trillion over the next 10 years. Given the size of these surpluses, it should be possible to pay down all of the Federal debt held by the public and still have money left over. But, as today's hearing will show, getting to "zero" debt is not as simple as it seems.

The Federal debt held by the public consists of a variety of bills, notes and bonds that range in maturity from 3 months to 30 years. More than $500 billion of this debt will not come due within the next 10 years. Those who hold this debt may not be willing to sell it back, before it's due, at a price the government is willing to pay.

More than $170 billion of the outstanding debt is held in the form of U.S. savings bonds. These bonds provide a safe and affordable investment vehicle for millions of Americans. We might want to think twice before ending this popular and successful program.

Federal debt also plays a crucial role in our Nation's monetary policy, and it provides a benchmark for numerous financial transactions. There may be other alternatives, but the financial markets

will need time to implement these alternatives to avoid a costly and disruptive transition.

If we resolve those issues, we will face yet another problem. Given the size of the projected surpluses, the government will run out of debt before it runs out of surpluses. According to CBO, projected surpluses will exceed the amount of debt that can be repaid by 2006. Under the President's budget, surpluses will exceed the available debt by 2009.

Under the Senate Democrat's proposed budget—which would set aside the Social Security surplus, the Medicare HI surplus, and one-third of the on-budget surplus—surpluses will exceed the available debt by 2008.

Once the government runs out of debt, it will begin to accumulate enormous cash reserves. The government will have to invest these reserves in some type of financial assets, such as corporate stocks and bonds. Federal Reserve Chairman Alan Greenspan has warned that such investment could disrupt financial markets and reduce the efficiency of the economy. We cannot allow that to happen.

Even more troubling than the question of what happens when we run out of debt is the question of what happens when we run out of surpluses. The retirement of the baby boomers and the rising cost of health care will ultimately plunge the budget back into deficit. The taxpayers will not be impressed by our efforts to pay down the debt, if we simply turn around and run it back up again.

Reducing the debt is a worthy goal. But, getting to "zero" regardless of the cost and without regard to what happens thereafter seems foolish and shortsighted. Today's hearing provides us the opportunity to examine these important issues.I would like to once again welcome our witnesses and look forward to your testimony, and also the comments of the Senator from Montana.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you very much, Mr. Chairman. And welcome, Dr. Miller and Dr. Gensler.

To put things in perspective, the Federal Government is projected to run a large budget surplus over the next 10 years. And the Office of Management and Budget projects a surplus of about $5.6 trillion. And CBL uses the same numbers.

This, obviously, is good news. It is a long time coming, particularly given the period where we ran such large deficits. We face a new question. That is, what we do with these surpluses?

For many of us, the answer, as the Chairman alluded to, seem pretty simple. That is, we could use some of the surplus to provide a substantial tax cut. We could use some to meet the important public needs, like providing coverage for prescription drugs or Medicare. And, most important, we could use the surplus to pay off the $3.4 trillion of publicly held Federal debt.

But the answer used to seem easy; it's a little bit more difficult now.

A few months ago, Federal Reserve Chairman Greenspan explained that it is not possible or prudent to pay off the entire national debt over the next decade. The Office of Management and

Budget says that we can only get the debt down to about $1.2 trillion. The Congressional Budget Office says about $800 billion. Mr. Greenspan said $750 billion. Gary Gensler, who will testify today, said it is about $500 billion. Today's hearing gives us an opportunity to get to the heart of this.

To my mind, there are three issues. First, as a starting point, we should consider whether all this fuss about how much debt we can reduce really makes any difference. We should try to find out the benefits we get from saving our surpluses by retiring debt and we should consider whether there are other ways to save the surpluses, if we were not of debt, to retire.

Second, we should get to the important but complex question of how much we can really reduce the national debt, given the nature of the debt that is outstanding and the debt that will be issued in the future.

In this regard, I am eager to find out from Dr. Gensler just why he thinks that we can get the debt down below $500 billion in 10 years. And I want to find out why OMB and CBO have reached different conclusions; basically, what is going on here.

The third issue is the timing of decisions. Is this something we have to decide today or do we have time to figure out what to do before we make any serious decisions?

One final point: the material we are considering today may seem esoteric, focusing on things like basis points, yield curves, serial coupon bonds, et cetera, but it is critically important. Our decision about debt reduction will set the stage for our budget debate. It will also be our legacy to the next generation.

If we can get to the point where we could actually eliminate the national debt—and then we flinch—we may have squandered a golden opportunity to clear the books for our children and for our grandchildren.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Baucus.

And now we will start with Dr. Gensler and then Dr. Miller. And then proceed with your testimony. And then we will have 5-minute turns for questioning, according to how members showed up.

STATEMENT OF DR. GARY GENSLER, FORMER UNDER SECRETARY OF TREASURY, DOMESTIC FINANCE

Dr. GENSLER. Thank you, Chairman Grassley, Ranking Member Baucus, and members of the Committee. I would like to summarize my testimony, and with your permission submit the full text for the record.

Some of debt may be difficult to retire. I believe that less than $500 billion is truly unavailable to pay down through 2011; thus, leaving $2.9 trillion of currently outstanding debt available to be paid off without any significant premium or additional cost.

It may be helpful to walk through this, to turn to Table 1, which is stapled to the back of the testimony that you have from the full testimony. And on that table you can see that approximately 76 percent of the debt, or $2.6 trillion, actually matures by 2011, most of it marketable debt traded freely in the marketplace.

All of this debt can be repaid based upon its contractual terms simply by letting it come due when it comes due and paying it.

And, frankly, there is not something terribly esoteric about that portion of the debt. There are some issues around sound debt management that I will get to in a moment.

So that really leaves only $800 billion for further discussion and dialogue and debate.

First, as you can see on the chart, there are the other non-marketable debt of about $280 billion, or 8 percent of the Nation's publicly held debt. This is primarily savings bonds and some debt held by the Thrift Savings Plan, and foreign and other holders of zero coupon bonds.

This is probably amongst the hardest to redeem. And while it is likely to decline modestly over time for a variety of reasons, I estimate that it will be somewhere in the order of $250 billion 10 years from now.

The last category is the category that seems to have gotten the most discussion about, $500 billion of long-term maturity debt. I would note, this is simply 15 percent of the publicly available debt and yet it probably has 80 percent of the discussion on this topic.

Of this $520 billion, $60 billion is held by the Federal Reserve directly. And the Federal Reserve actually is already reviewing how to adjust for a period of declining Treasury debt. I believe Chairman Greenspan has testified in February and briefly noted that they would make the adjustments and felt that they could make such adjustments over time. So that really leaves $460 billion of debt, long maturity, in privately held hands.

I believe the Treasury can smoothly buy back one-half to possibly two-thirds of this debt. But let us call it $230 billion of debt, or approximately 7 percent of the outstanding publicly held debt.

In summary, that would leave approximately $500 billion: the $250 billion of non-marketable debt and a little less than $230 billion of long maturity debt outstanding.

Now there would be a number of things that Treasury would want to look at over time. But if Congress so directs it, Treasury does have available to it options in this new environment. Certainly one of their traditional tools to manage the debt is just changing the menu of issues that they put out there.

For example, the Treasury borrowing Advisory Committee informally voted at their last meeting to recommend elimination of the 30-year bond.

Another option was first recommended to the Congress by Alexander Hamilton in 1795, when as part of a plan to pay down the debt in 30 years, he recommended and got approval from Congress to start debt buy backs, which were actually started by Thomas Jefferson's first Secretary of the Treasury, Gallatin.

Debt buy backs have been used throughout our Nation's history during periods of sustained surpluses. And, in fact, Treasury successfully repurchased $30 billion of debt last year. And market analysts predict that $35 billion to $45 billion will be bought back this year, and it will be continued into the future in a smooth and predictable way.

Now there are questions about the buy backs. Legitimate questions have been raised. One question is: what about possible premiums? Might you pay in the marketplace something above its value?

Let me just first note that there are two different ways to think of premiums. One, which does not cost the government any long-term money, is if you are buying back a bond that has a high coupon and you are buying it back in our lower interest rate environment today.

The second is the question that Members and the public have focused on is, might there be a penalty premium, something in addition to this regular market premium?

Well, recent evidence suggests not. Let me just note two things: one, investment firms and the General Accounting Office have looked at the concept of concessions, might there be something being paid to the market for these purchases? And both investment firms and GAO have found that that has been negligible.

A second way to look at it is, how is Treasury's repurchases compare to where they can borrow money or issue new debt? And, in fact, consistently they have been saving about a quarter of a point, or 25 basis points, which today adds up to about $1.25 billion.

Now while these numbers may not persist for a full 10 years to reach the administration's estimates of between $50 billion and $150 billion in premiums or penalty premiums, the concessions would have to go up 1,000-fold. Or these savings to taxpayers would have to change from savings to dramatic losses of $11 to $33 per every $100 of bonds you purchase.

Now there is a second question that comes up: what about the future in terms of scarcity? What about bonds that become harder and harder to get as they become scarcer?

And economists talk about supply and demand curves. But there is one additional thing in this esoteric world of bonds. In fact, as supply increases, bonds become more attractive, particularly if they are from the U.S. Government, which is very much viewed as a very good credit.

Why is that? It is because of the concept of liquidity. And, in fact, there is ample evidence I present in my testimony whereby the smaller the market is, the higher the interest rate or, in other words, the smaller the market the cheaper the bonds.

It is hard to tell which influence will be greater: the scarcity or liquidity issue, or the traditional supply and demand issues. And that is why I have said that I think that about half to possibly two-thirds of the bonds could be repurchased, again, over 10 years.

Let me just mention one other thing that has been raised by the chairman and ranking members: the comparison to other estimates.

My estimate is different than CBO's and OMB's primarily because they were done for a different purpose. These reports generally were developed from baseline rather than policy assumptions.

In particular, the Clinton OMB estimate that was shared with Congress late in January was done in a way that did not change fundamental debt management approaches.

And, in fact, because of that approach OMB did not feel it necessary to consult with Treasury at the time, the same way they might not have consulted with the Education Department if they were not changing education policy.

In fact, if there was a difference of view, though, it probably comes down to the buy backs themselves. Which, again, only 15 percent of the debt matures after 2011. That is the marketable debt. And I am suggesting that half of that would stay outstanding. So the debate is really around 7 percent of the debt.

The last question that comes up is a very different question. Apart from the question of what can be paid down, another question comes up: what should be paid down? And that question can be looked at in many regards, but one aspect is as it relates to the financial markets themselves. Treasuries provide a certain function for the markets.

Well I would say this, a couple thoughts. One is, a transition period is already well underway. Treasuries now represent less than one-quarter of coupon debt in the market. Just a few years ago it was half of the market. So Treasuries are already a declining market share. One might think of cereal on a shelf in a department store. But Treasuries are taking up less shelf space in the bond market today.

I believe the U.S. capital markets, the most innovative and creative in the world, will surely adapt over time. And responding to this concern in recent congressional testimony, Chairman Greenspan said something similar when he said, Treasury securities are readily substitutable with other types of securities. And while, “It would be slightly less efficient than the risk with securities, the great advantage of reducing the debt effectively to zero, in my judgment, would overcome that.”

If I can just conclude and say, I believe that slightly less than $500 billion of debt is truly unavailable to be repaid over time, leaving the option for Congress and the administration to work with the other $2.9 trillion over the next 10 years.

I thank you.

The CHAIRMAN. Thank you, Dr. Gensler.

Now, Dr. Miller. Thank you.

STATEMENT OF DR. JAMES C. MILLER III, FORMER DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Dr. MILLER. Thank you, Chairman Grassley, and Senator Baucus, and Senator Kyl, and Senator Bingaman, and Senator Graham. I appreciate an opportunity to be here today to discuss this important issue.

You know, we had three decades, almost three decades of deficits. And I was a part of that. I was Budget Director during part of that period. But that period ended in 1998 and we have had a series of surpluses since then. And that surplus environment has raised a series of questions heretofore we really have not had to address, and that is the reason for this hearing today, it seems to me. And I congratulate you on addressing them.

The first threshold question, I guess, is how much could be paid down? If you went to extremes you could pay the debt down a lot. You could pay it down within the margins that Dr. Gensler is talking about.

The present, today, the National debt totals about $5.6 trillion. About $3.4 trillion of that is in the hands of the public. The rest

is in government accounts and Social Security, mainly in the trust funds.

If you suspended the issuance of longer-term debt immediately and you retrieved some other kinds of debt, you could get down to about $500 billion of debt by the year 2011. Of course, this would mean eliminating the Savings Bond program, eliminating state and local series, and other things.

But in any event, you could do it if you wanted to. You could get down to something like $500 billion. But the question is a policy one, I think, of whether you want to do that.

In any event, you could get down to what Chairman Greenspan called the "irreducible minimum debt." Now CBO and OMB taking more realistic assumptions, I think, both think that you could get down to maybe $1 trillion by the year 2011. You would keep the Savings Bond program; you would do some rolling over of longer-term debt, and so forth.

I do want, as a technical matter, respond to Dr. Gensler's argument that aside from the market premium, which we all agree about how that works, but that the hold back premium or the penalty premium, or however you referred to it, Gary, could be either negligible, even negative. I just do not buy that. I do not buy it as a theoretical matter or as an empirical matter.

As a theoretical matter, let me just ask you. If you hold some Treasuries of a certain variety and you hear that the Department of Treasury is going to go in for a big buy back of these things, are you happy or sad? You are going to be happy. The price rises.

Economists do not know a lot of things, and economists know a lot of things that may or may not be true. But if had to bet, I would bet on the laws of supply and demand. And supply slopes upward to the right. And if you buy back, and you continue to buy back, you are going to have to pay increasingly high premiums to buy back debt.

As an empirical matter, the amount of debt that we purchased so far has been very small as far as the total. So the evidence that there has not been a big rise in the hold back premium, I do not this is very dispositive on this matter.

Also, there is what economists call an "identification problem." Several things would happen at once. I mean these interest rates move up and down and so a lot of things are happening. And I do not think the evidence that Dr. Gensler finds compelling is compelling at all.

Now what do you do with a surplus once a debt has been paid? The government does hold accounts in banks. And you can imagine, CBO and OMB both estimate you would end up with something like $3 trillion. You can put them in bank accounts, but that is kind of silly, it seems to me.

So government purchasing assets would be the obvious answer. But here I am with Chairman Greenspan in his caution: "It would be exceptionally difficult to insulate the government's investment decisions from political pressures."

The prospects, to me, of harmful effects on the economy on the efficiency and the possibility of political chicanery seem chilling to me, the notion that somehow the government would end up owning $3 trillion. That is about 10 percent of total equity in the country.

Another thing you could do is create a system of personal savings accounts, I guess, or personal accounts, investment accounts. You would essentially use the Tax Code to collect money from people and then tell them that the money is theirs but they have to spend it a certain way. And I just do not think that is a good idea. Some people might think it is a good idea, but I think it is a very bad idea.

Now why should you run a surplus after the debt is paid off? Or do you get it down to what Chairman Greenspan calls "the irreducible minimum?"

Well, the only thing that strikes me is you could have some kind of rainy day fund, like some States have. You know, a rainy day fund in case—I do not think we are talking about the same kind of problem with the Federal Government that finds it much easier to issue debt and to accommodate these kinds of problems.

Moreover, I do not think you ought to end the system, even if you could. There are a couple of reasons here. One is, I know from being at OMB, some months you have more revenue coming in than outlays and some months more outlays. You need to have ability to issue debt for that purpose. You may need it in an emergency. Suppose we had a war or something, you might need to issue debt. So I do not think you ought to close down the system.

The bottom line is, it seems to me that we should not run these surpluses after we pay down the debt to an irreducible minimum level. And I agree here with Chairman Greenspan when he says it is far better that surpluses be lowered by tax reductions than by spending increases.

Now it struck me the other day that to watch this debate over what to do with the surpluses and people sitting around the table trying to grope with, "what do we do?" We have got this big problem coming up. And it reminded me of that commercial on television for Aflac. They keep talking about, what is this and what is that? And finally this duck quacks, "Aflac, Aflac."

It seems to me that what we ought we ought to do is to put the debt on a glide path down to the irreducible minimum. But we ought to turn the rest back to the people that paid it.

I would like to say it is like going in a McDonald's. And you order a Big Mac and fries. And you give them a $5 bill. You expect your change back. And you do not leave the store without it. And I think people ought to get their change back. And I urge you to reduce taxes and refund that surplus back to the people that paid it in the first place.

Thank you.

The CHAIRMAN. Before I start to ask questions, and people that succeed me, it will be in this order, whether people temporarily leave or not: Senator Baucus, as ranking member, and then Senator Kyl, and then Senator Bingaman, then Senator Graham, and then Mrs. Lincoln.

And another thing I would like to suggest: at 11:00, I am going to have to go to the Leader's office for a meeting on the budget. And, Senator Kyl, for me, and Senator Baucus, I hope that if I do not come back you can not only finish the meeting, but also at 11:30 be able to do what is hopefully is on everybody's schedule of voting out the nomination of Mr. Dam.

As background for my question for both of you, according to the CBO, the amount of Federal debt held by the public at the end of fiscal year 2000 was $3.4 trillion. And this amount will decline to $3.2 trillion this year. Thus, for the purposes of fiscal year 2002, we would have a starting point of $3.2 trillion as opposed to $3.4 trillion.

There are a couple rhetorical questions I hope we can agree on, and then my main question will be the third one.

If we stipulate that the government will reduce the debt from $3.4 trillion to $3.2 trillion this year, can we agree that the total amount of debt available to be repaid over the next 10 years is $3.2 trillion. And according to testimony, we can reduce the debt—well, this will be Dr. Gensler's testimony—$500 billion by the year 2011. That means over the next 10 years we would reduce the debt by $2.7 trillion. In other words, $3.2 trillion down to a half a trillion dollars. And I hope we could agree on that.

So a number of Senators have suggested that we use the Social Security surplus, the Medicare HI surplus, and one-third of the on-budget surplus for debt reduction. Those items would total $3.8 trillion over the next 10 years.

Since we have agreed that there can only be $2.7 trillion in debt reduction, what do you think will happen then to the remaining $1.1 trillion? And this is more towards your testimony, Dr. Gensler, than Dr. Miller. But if Dr. Miller wants to comment I would ask him to comment as well.

Dr. GENSLER. I appreciate that, Mr. Chairman.

Let me just briefly say something on the stipulated information. I have agreed exactly with your numbers and written the testimony as such. But I do note that recently Congress is also looking at possibly doing something accelerated on taxes, possibly in the neighborhood of $60 billion even this year. So that could change the starting point——

The CHAIRMAN. Sure.

Dr. GENSLER [continuing]. From $3.2 trillion to let us call it $3.3 trillion.

The CHAIRMAN. Sure. All right.

Dr. GENSLER. But in terms of the long period of time, the 10 years, I truly believe that that is a long period of time to adjust, whether it is adjusting debt management policies, which is the narrow point, or, more broadly, as you have raised the question of what to do with these additional surpluses. Whether it is to, as Dr. Miller has noted in terms of putting in banks or putting it in private accounts, or even the General Accounting Office is looking currently, I understand from the House side, General Accounting Office is looking at the possibility of even taking some monies and putting them aside to defease the remaining debt.

Now this is a very technical approach that might take some of this as well. But I think over this 10 years we could be on a glide path, and certainly somewhere in the next 3 to 6 years Congress and the administration can sort through that very important question that you have just raised.

I do not have a particular recommendation today, nor——

The CHAIRMAN. But at least we agree that that is the financial situation that we are in. That some of the suggestions that are on

the table now that will be debated next week would, in fact, bring that situation around that we have got to think in terms of what to do with $1.1 trillion dollars.

Dr. GENSLER. I think that is correct, over time. And that there are many, many things that can change over this period of time: the economy, the political situation, tax and spending policy as well. And that there are places to potentially take that money, whether it is a number of the things that Dr. Miller suggested or others, I think that that is available in the future.

The CHAIRMAN. Do you have anything to add to that?

Dr. MILLER. No, Mr. Chairman.

The CHAIRMAN. All right. Then I will go to the next question.

Last year, the Treasury Department instituted a buy back program for government bonds. And according to the GAO, the Treasury bought back—and this is a quote—bought back $30 billion par value in bonds for a total of $38.3 billion. That is a premium of $8.3 billion, or 28 percent.

If the government paid the same premium for the $523 billion in bonds that will not otherwise come due in the next 10 years, it would pay $668 billion, and that is a premium of $145 billion. Now you might question if that is a correct extrapolation, but at least quantifiably that is what it adds up to.

So, question, again, Dr. Gensler. Dealing with the issue of market premium that results from buying back bonds before they become due is merely a timing shift in which the government pays a premium now to avoid paying higher interest later. But what is to prevent bondholders from de-banding an even bigger premium? And could they not simply refuse to sell their bonds until the government agrees to even more of an exorbitant premium?

Dr. GENSLER. The good news is that these bonds are held by many participants in the marketplace and are freely traded in the marketplace. The evidence to date, of course, suggests that there has been negligible concessions, if at all.

I do believe, over time, that you could buy back at least half of it, recalling, again, you have 10 years, which would only be $23 billion a year without additional penalty premiums.

The CHAIRMAN. All right. Do you have anything to add to that, Dr. Miller?

Dr. MILLER. Yes, Mr. Chairman. The reason they are paying this market premium, of course, is that interest rates have fallen over time and those bonds are out there at higher coupon rates.

But the real issue here, I think, is the question that you got to at the end and the question of this hold back kind of premium. And I think here Dr. Gensler is in a very definite minority. Most of Wall Street is of the opinion that you are not going to be able to buy down the debt at that rapid a rate without paying humongous—that is a technical term—humongous rates of premiums of hold back or premiums of some sort, buy back premiums above market rates.

The CHAIRMAN. All right. I am going to go to Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

I would like to yield my time to the Senator from Florida, Senator Graham.

Senator GRAHAM. I want to thank Senator Baucus. And I would like to ask a couple of questions.

A great event in the history of mankind is going to occur on Saturday. My daughter's three triplet daughters are going to have their sixth birthday. Now if we were looking at those triplets on their sixth birthday as the Federal Government is looking at this issue, we would say that the only thing that counts is from 6 to 16 because that is the next 10-year time period.

The fact is that when they are 18 all three of them are going to be of college age. That is likely to impose a very significant financial cost on my daughter and son-in-law.

To me, that is analogous to the situation that we are looking at today. We are looking at a 10-year window, which happens to end in the year 2011. That also happens to be one of the first years that the first of the baby boomers will start to retire.

Those baby boomers born in the 1945–46 period will begin to retire around 2011. And every year after that, just like my triplet granddaughters, their costs are going to start to get significantly greater as more and more of that generation retires and becomes eligible for Social Security, Medicare and the other programs that are specifically oriented towards the older Americans.

So I would like to put this question of excess surplus in that context. Is it prudent, when we are going to be facing the enormous demands of the baby boom generation, just as this 10-year period ends, is it prudent for us to only look at this issue as if it were a 10-year issue and not think about how we should be preparing ourselves for those much greater expenses that we are going to have?

They are not rainy day expenses in the sense that they are something that you sort of vaguely know you might need. These are people who are in being, who are every day getting closer and closer to cashing in the contract that they have with the Federal Government on Social Security and Medicare. This is a known, highly quantifiable additional expense of the Federal Government.

So my question is, in the context of not a 10-year period but a 25-year period, a generational period, which would include this large retirement wave, what is the prudent thing to be doing with this "excess surplus?"

Dr. MILLER. Senator, your point is very well taken. And let me just, as an aside, say that when your triplets' grandchildren years from now they are going to be driving too. And that is a pretty scary thing.

I think the time frame does matter. And we sort of lull ourselves in when I was budget director in 5-year time frames and now you are looking at 10-year time frames, and it is appropriate to look beyond that. And what we know, of course, is they will be running big surpluses until about 2020, or whatever, and then we will be running deficits again.

It is not that we should ignore the years after that. I do not see how we can really come up with a scheme—and I do not mean that pejoratively—with a scheme that addresses the kind of problems I mention here of asset accumulation, or whatever, and then use those assets to defray the deficits that we would experience in the future.

It is just hard for me to see how you could insulate it from the political influence, et cetera.

I think a far better way to approach this is to address Social Security today along the lines that the President has suggested, that others have written about, and put together some individual retirement accounts so that when we get to this 10-year, 12-year, 20-year time frame we are not running those horrific—another technical term—horrific deficits that would then ensue.

I think we ought to look to address this problem that we are talking about here within the 10-year time frame, but also get underway to address that longer problem but to do it in a different way than what might be suggested by trying to hold the assets back and then having them ready to spend at that time. That is my opinion, sir.

Senator GRAHAM. Dr. Gensler.

Dr. GENSLER. Just briefly. I think that that is the great bipartisan support that came about in the last several years, is really to save as much of the surplus as possible, to contribute to National savings, similar to a family paying down a mortgage in their peak earning years, to prepare for their retirement, we prepare for their retirement of the baby boom generation, which I would say is my generation. And my little daughters, who are four, eight and ten, would fit into that other group.

I just wanted to note one thing just as a matter that was noted earlier by Dr. Miller. In fact, Merrill Lynch, Goldman Sachs, Solomon Brothers and Wrightson Associates, all four very well respected investment analysts and firms, have all said they think that buybacks will continue. And while they debate whether you could buy back a third of the total or half of the total or possibly more, Merrill Lynch was $245 billion, Goldman Sachs was $40 billion to $50 billion a year and growing after that, Solomon Brothers and Wrightson all have very significant numbers.

If they are off from mine they are off by orders of $50 billion or $100 billion dollars.

Senator GRAHAM. I have one follow up question of Dr. Miller.

You said that you felt the answer to this was to solve the Social Security system within the Social Security system.

Would it be prudent to do that first to assure ourselves that we have a solution to Social Security before we begin to cut off our options by things like turning back the “excess surplus”?

Dr. MILLER. No, sir. I think you ought to address them simultaneously. And interestingly, if you do the right thing here—I think the right thing; it will put pressure on Congress to do the right thing—on the Social Security reforms as well. This is an issue that I know that people have got to come together and reason together.

By addressing this issue correctly, I just do not see a way that you could do what you characterize as keep the options open, because I just think that if you try to keep your options open you just get in a morass here. And you don’t want to do that. So I think you ought to work on both simultaneously.

Senator GRAHAM. Well as an American, you should either be pleased or depressed at the fact that this is the committee that is going to have all of those on our plate because we are going to be

the ones responsible for Social Security and Medicare reform as well as tax policy, and management of the debt.

Dr. MILLER. I have great confidence in this.

Senator BAUCUS. Thank you, Senator.

I would like to focus a little bit on the premium question. As you have mentioned, Dr. Gensler, the various investment houses have recommended that the Treasury continue to buy back at certain rates and so forth.

It somewhat begs the question of whether those buy backs require a premium. And there are some who suggest that there are premiums, but there are others who point out that actually there are not, because you are comparing apples with oranges. That is, sometimes Treasuries are issued at certain amounts and interest rates and bought back at different amounts and interest rates.

Could you explain to us the degree to which Treasuries that have been bought back in short term, those presumably are in contemplation by, say, Merrill Lynch, will or will not have a premium, explained mechanically, why that is the case?

Dr. GENSLER. As I think we've all noted, much of this debt was issued in another interest rate environment. When interest rates were higher they fixed a coupon 8, 9, 10 percent. Fortunately, today, we are in a roughly 5-percent interest rate environment and, thus, buying something today that has this high fixed coupon in a 5-percent interest rate environment does engender what is called a "market premium."

But that is simply a timing shift: paying today to avoid a higher coupon in the future. And it was recognized by Congress a year ago, when OMB worked with Congress to make sure that the accounting for this did not go through the budget but it was treated in other means of financing.

In terms of any penalty premiums or hold out premiums, they have not been in evidence today. And while it may be true that there would be a hold out for the last bits, let me address a couple of things that have been in the popular press.

Foreign holdings. Ted Truman, who was a former senior Federal Reserve and Treasury official, testified a week ago at the Senate Budget Committee. And he noted that of foreign central banks probably less than 5 percent of their holdings were in this long maturity debt. Foreign central banks like to hold very short maturity debt, they like liquidity.

Foreign private holders. There is no reason to believe that foreign private holders would act any differently than domestic private holders. So that is one question that people have raised.

In terms of premiums there is a great deal of evidence that the smaller the stock on the shelf, the less value that debt has. In fact, Treasury has a core principle that it articulates publicly—has for years—that taxpayers would save money by having more liquid bonds; large liquid benchmark bonds. That is a core principle. It is in conflict to traditional supply and demand economics, but it is the nature of the bond market.

And less liquid, government backed securities trade 30 to 50 basis points. That is a quarter to a half a point interest rate cheaper than Treasuries today, and so there are going to be two influences. And I believe for the next 3 to 6 years you can continue a

pretty active buyback program and then you start to get back to the tail ends. And the future Treasury will have to make judgments at that time as to how to handle it.

Senator BAUCUS. Dr. Miller, could you respond to that, please?

Dr. MILLER. Yes. I think maybe that principle had some validity when the Treasuries dominated the market in ways that they do not today. So I think that the supply curve will run up much faster than Dr. Gensler believes.

And, again, that is supported by—I think most people on the street believe that the Federal Government is not going to pay down by the year 2011 more than a $1 trillion or so. Or, there will be a $1 trillion or so left out.

Let me just say that my own personal view here is that—and it goes back to, I think, what you raised, Senator Baucus, in your opening remarks—I do not think it matters a whole lot, because the surplus is going to overtake these events. Whether it is $500 or $1,000 or $500 billion or it is $1 trillion, is not nearly so important as the decisions you make today and tomorrow about what to do with this surplus.

And are you going to give it back? Are you going to pay down the debt in an orderly fashion, as I have recommended? Or are you going to something else with it: spend the money? Those are hard decisions to make, hard sometimes to respond to constituents, but I think it is a decision you ought to make. Pay it down to the irreducible minimum. And whether that is a $1 trillion or it is $500 billion, is not nearly so important as the algorithm you choose to address the problem.

Senator BAUCUS. Is it not, though, the question of premium somewhat dependent upon the development of other instruments? My guess is that markets being what they are and ingenuity being what it is, that when something looks like it is a little more scarce that something else is developed. It is like politics. This vacuum is going to be filled.

And I am just curious. Maybe, Dr. Gensler, if you could address that point.

Dr. GENSLER. In fact, Senator you are raising a point. It is already being addressed. Again, the Treasury market is taking up less shelf space in this grocery store called the bond market. And it is less than a quarter of the market today.

The market is adjusting. It uses derivatives or what is called "swaps," interest rate swaps. That is an $85 trillion market that dwarfs this. Congress worked successfully last year with the then Administration on new laws underpinning that derivatives marketplace. The marketplace also looks to agencies in corporate debt issuance, all of whom, by the way, are trying to have larger, more liquid issues because it lowers their borrowing cost.

So there is a great deal of adjustment that is already going on. And as long as that is smooth over time, over this 5- to 10-year period of time, the market will adjust. I believe Chairman Greenspan has spoken on that constructively as well.

Senator BAUCUS. One final question on that point. How less liquid, compared with Treasuries, would these new instruments be? Enough to make a difference?

Dr. GENSLER. Well, I think that the markets will adjust. And in some cases there might be some, if I may call them, micro-economic issues for the bond market. Those micro-economic issues, I think, are overwhelmed by the macro-economic issues of saving the national debt to prepare for the baby boom generation.

But in terms of liquidity, an $85 trillion interest rate swap market in many regards is already more liquid than the Treasury market. That is true in terms of 1- and 2-year derivatives. It may well be likely true for 10- and 30-year derivatives in the future.

Senator BAUCUS. What about security? A lot of people buy Treasuries because, you know, they are safe.

Dr. GENSLER. They are perceived as a risk-free asset. They are certainly less risk in them as we pay down the debt. I believe the markets are the most innovative and competitive and creative in the world and alternatives will be found over time and that the markets will adjust.

Senator BAUCUS. Thank you.

Senator Kyl.

Senator KYL. Thank you, Mr. Chairman.

I tend to agree with Dr. Miller that we are arguing here about something that is relatively less significant than the larger issue, than the big macro issue. Whether we can pay it down to $1 trillion or to $500 billion is probably going to be decided by factors other than those that have been discussed here this morning.

And, therefore, it seems to me since you cannot put the remaining over a trillion dollars in surplus, which we all agree is at least an order of magnitude number that is going to be available in a Federal mattress, the question is what do you do with it?

And Senator Graham says, “Gee. Is there not some way that we can save it for the baby boom generation, because we are going to be running a Social Security deficit at some point? Would that not be a good idea?”

People who talk about a lock box, of course, are trying to pull the wool over people’s eyes. There is no lock box. There is no Federal mattress that we keep money in.

I tried to figure out a way a year ago to create some kind of an instrument into which you could put the excess savings. And all of the people I talked to, including the Chairman of the Fed, said there just was not any.

So it seems to me that the real question here is which of the four options do you prefer? One of the options is to take all of this surplus and put it into very large bank accounts. And, as Dr. Miller said, I do not know of anybody that really believes that is a good idea.

The second is to take that surplus and then have the Government invest in the private market, in equities. Now, of course, we are encouraging third-world countries, Russia and China, to go exactly in the opposite direction, to quit owning the private industries in their country. And I do not know of anybody that really believes it would be a good idea for the U.S. Government to become a major investor in the private sector here in the United States.

So it seems like the only other two options are either to create the private investment accounts that would be the foundation for Social Security reform so that people would actually have their own

private Social Security account, which could be invested in the securities market, thereby obtaining a much higher rate of return and building up the accounts so that there really will be money to pay the benefits that mere tax revenues would not provide when they retire.

Or, for that $1 trillion plus over the next 10 years, to return it to the people or not collect it from them in the first instance, which is the notion of tax reductions.

I would like to ask each of you which of those four policy options do you believe represents the best public policy, starting with you, Dr. Miller.

Dr. MILLER. Senator, I think I was not listening sufficiently closely because I was making a note to myself. But the policy option of paying down the surplus in an orderly fashion and Dr. Gensler's shop at Treasury—they have all sorts of very sophisticated—or his former shop—computer programs, et cetera, how best to minimize the cost to the taxpayers by paying it down to some so-called irreducible minimum, to use Chairman Greenspan's phrase, is the way we ought to do.

And we ought to do it over 10 years or even, maybe, more. But 10 years. And that we ought to return the rest back to the people who have overpaid, because the surplus really reflects tax overpayments, and to steel yourselves against the temptation to spend the money. That is a real threat, I think, to this surplus.

Senator KYL. Thank you.

Dr. Gensler?

Dr. GENSLER. I think that there is a great deal of time to try to answer this question. I think it is at a core, as you say, Senator, a core public policy issue for the American people and Congress to look at.

There may be, actually, other alternatives, as I said earlier. The General Accounting Office is looking even for some portion of this to possibly put money aside to difease those bonds specifically tied to the bonds that stay outstanding.

But I think the overall comment I would have is, today you do not need to decide that. I do not think Congress or the American people need to decide that because of this irreducible debt issue, which is truly 9 or 10 years, or 11 years away, depending upon economics and political decisions that are made. That there is a great deal of time to sort through——

Senator KYL. Hold on just a second. Because we do have a decision that we have got to make very quickly. We find that we have about $98 billion in excess revenues before October 1st, before the end of this fiscal year. We have got to decide what to do with it. Everybody says, "Well, it would be a great idea to return $60 billion of that to the taxpayers, somehow or other." Democrats and Republicans have a different view of what to do with it.

But let us leave the other $38 billion for "contingencies," which obviously means spending. We are going to be spending about $158 billion, as I recall, in Social Security surplus to buy down debt. Would it be your view that the better public policy is to add that $38 billion to the $158 billion that is going to be paying down debt or to spend it or to return it to the taxpayers?

And then I will ask you, Dr. Miller, the same question.

Dr. GENSLER. In terms of this fiscal year, I think that paying down the debt is the path that the Nation is on, and I think it is also best in terms of to stay the course. I do not think that there are any irreducible debt issues there or, frankly, for anywhere in the next number of years. Out, again, 9 or 10 years from now one might hit some of these numbers.

The debt gets paid down weekly and daily by the mechanisms used professionally by Treasury and I think that that is a course that has well supported the Nation, recognizing that Congress is in a real debate about fiscal stimulus this year around that $60 billion that you just mentioned.

Senator KYL. But you would say either return $60 billion and use the other $38 billion to pay down the debt, but do not spend the money? Is that what you are saying?

Dr. GENSLER. Well I do not think that I would want to, here, try to supplant myself for what Congress does.

Senator KYL. Yes. Well that is what I am asking.

Dr. GENSLER. To decide what tax and spending issues are.

Senator KYL. Yes. My point is we are reaching that day of reckoning a little sooner than you suggest it would come, at least as to almost $100 billion.

Senator BAUCUS. Dr. Miller?

Dr. MILLER. Senator Kyl, I would pay the money back to the taxpayer, but I think how you pay it back is extremely important. If you simply write them a one-time check that gooses up—that is another technical term—gooses up their cash balances, perhaps, if they have not considered to spend it. But the real problem we face right now with the economy as being soft is that we have insufficient output. We have an especially insufficient investment right now. If you look at the investment numbers, they are way down.

What we need to do is to pass a—you need to pass a tax revision that is going to lower marginal rates and give people the incentive to invest in human capital as well as physical capital, to increase production, output, take advantage of the information technology revolution, and expand output through the years. And you do that by reducing marginal tax rates. And you do it with permanence.

That is the reason I oppose the notion of a trigger. Because if you have a trigger there, and a person making the decision of whether to invest realizes that there is some chance that Congress might spend too much, the surplus shrink below some path, and, therefore, our taxes are effectively raised again, that is a disincentive.

So it is really incumbent, I think, of you to think this longer term, the question asked by Senator Graham, you think of the longer term. You want to put in place a tax environment that is conducive to expansion of the economy.

And one other thing—if I just might, a point I want to make. And that is, you want to make sure you do it from the very beginning and you do not phase things in too long because people will have an incentive to postpone income producing activities and this will exacerbate the slowdown that we presently have.

I think in the early 1980's none of us really realized it quite at the time, but I think the fact that the Reagan tax cuts were phased in over time caused people to postpone income producing activities to take advantage of the lower tax rates years out, and that exacer-

bated or deepened the recession we experienced in 1981 and 1982. So Americans do not want to go through that again.

Senator BAUCUS. Thank you very much. Thank you, Senator Kyl. Senator Bingaman?

Senator BINGAMAN. Well, Mr. Chairman, this is most unusual hearing I can remember attending.

Senator Grassley said the problem is that we are going to run out of debt before we run out of surplus. That is a problem that I never thought I would see, and I still do not think I will ever see it.

So let me just go on record saying that this is a hearing about a problem we are never going to have, in my opinion.

And Dr. Miller says, "What will do with the surplus once the debt has been paid off?" I think that is a problem we are never going to have. And so I really do think we are sort of talking—we have lulled ourselves into this belief that we can see 10 years ahead, and that we can make decisions now and lock them in for 10 years as though Congress is leaving town this afternoon and are not likely to be back for 10 years.

The truth is, we are going to be here every year, we are going to be changing the law every year. The economy is going to be changing dramatically in ways we cannot anticipate.

Let me ask about a different aspect of this. The Concord Coalition has come out. Of course you are all familiar with the work they have done. There is a statement here by former Senators Warren Rudman, Sam Nunn, and also Pete Peterson, Bob Reuben, and Paul Volker. And it is a joint statement saying that the main thing to keep in mind right now is fiscal discipline.

We need to maintain fiscal discipline. We should not haul off and spend a lot of money or commit to spend a lot of money. We should not haul off and cut taxes dramatically or commit to cut taxes. That is the basic message.

And they say, as public debt is reduced to the low levels that are possible, other policies, such as retirement savings accounts, also play an important role. Household savings are nowhere near adequate to prepare for the every lengthening retirements.

And then they go on to say, "Consider establishing"—This is an action item that they recommend—"Consider establishing a system of mandatory, individually owned retirement accounts to help families build a more ample nest egg while alleviating concerns that future budget surpluses will result in either higher spending or in a large build up of government-owned private sector financial assets."

I would be interested in Dr. Gensler, first, and then Dr. Miller's comments about that as an appropriate thing for us to focus on here as we look ahead.

Dr. MILLER. I first would say, Senator, I want to associate myself with your remarks about whether we will really see this 10 years out. I think the main message of my testimony is the irreducible debt issue should not drive what Congress does in the year 2001.

You have many options within those red bar charts over on that chart, particularly if you can pay down $2.7 trillion over 10 years.

In terms of promoting National savings through individual accounts, which I think is the nature of your question, there are some

great benefits to that. We did study this closely as part of the Clinton administration and there were various proposals by various names: retirement savings accounts is one of them.

There are a number of issues even in that regard about the cost and how you get it out to well over 100 million working Americans. And they are very small accounts. And how you actually mechanically do this and do it in an efficient way so that they get the returns for their investments rather than just paying, frankly, Wall Street a lot of money to manage all these accounts. And that is a very difficult and challenging issue that if Congress were to take this up, which I think could be prudent, you would want to make sure to make sure it is very efficient and to keep the costs down.

Senator BINGAMAN. Now what I understand them to be talking about here is not the privatization of Social Security. It is something separate from the Social Security situation.

Is that your understanding?

Dr. GENSLER. I probably should have said that. That is how I took how you read that.

Senator BINGAMAN. Yes. That is what I mean.

Dr. GENSLER. And what I understand really is that it is something apart from and separate from Social Security because Social Security really is an insurance program that keeps so many elderly Americans out of poverty.

Senator BINGAMAN. Yes. That is my understanding also.

Dr. Miller?

Dr. MILLER. Well the Social Security system is not an insurance system; it is basically a retirement system.

But let me just say that I agree with the sentiments expressed. I have not read the Concord Coalition report that you referred to but I share those sentiments.

I think the real solution to the Social Security problem and the deficit reemergence problem that Senator Graham was referring to earlier is to establish these individual savings accounts.

But I think—and I hope that that is plain in my testimony—that the amount of money that we are talking about with the surplus is far in excess of what would be prudent, I think, to require people to hold for or invest for their retirement.

I would disagree with Dr. Gensler. I think the private sector is much more capable of maximizing value from those accounts than having the Government invest on behalf of individuals. And I noted there was a resolution, I think, in the Senate last year that was overwhelmingly opposed to that notion.

Senator BINGAMAN. Thank you very much, Senator.

Senator BAUCUS. Thank you very much.

Sarah Lincoln.

Senator LINCOLN. Thank you, Mr. Chairman.

I am so glad that Senator Bingaman brought that up, because this has been one of my focuses in terms of the issues that I have a great deal of concern about.

And, of course, being in the situation of having a great deal of surplus to spend, how we are going to use it—spending meaning are we going to direct it towards a savings, buying down the debt, how we are going to do it that—I do not know. And in Senator

Bingaman's comments, I hope that happens at my house. I hope that the surplus is incredible even after we pay out our debt.

But we would not be in this situation if we did not have a strong economy. And so one of the prudent things that we do need to do is to focus on how we continue to grow the economy at a time right now when the economy is not strong. Looking at being able to provide tax relief, and giving some of that money back to taxpayers in order to help grow that economy, I think we have to look at a reasonable way of how we can do that, providing tax relief across the board into the pockets of those that are going to spend it and help grow that economy, but also in terms of savings and how we might be willing to invest some of those surplus resources into programs that provide incentives.

And I was listening to some economists last month who made the comment—and this goes back to our debt—that international foreign investors who are investing in our debt have a real caution when they realize that this is the first year in the history of our country that we have had a negative savings rate.

Is there a correlation when you talk about the debt that we have in this Nation that foreign investors are going to invest in and the fact that we do have a negative savings rate? Is there a possibility that we are able to better manage that debt and the investment of foreigners in that debt if, in fact, we provide with some of the surplus incentives for savings?

Senator Baucus and Chairman Grassley are working on pension initiatives and other things that can encourage savings outside of Social Security and other arenas. And is there a correlation at all in terms of foreign investors in our debt and savings rates and what we do in this country?

Dr. MILLER. Again, I might refer to, I thought, very good testimony last week by Ted Truman that maybe if I could ask to be appended into the record.

But I think what you find is foreigners are willing to invest in this Nation. Not the Federal debt but in the Nation itself because of the strength of our economy, because of the strength of the American workforce, and the ingenuity of this economy. And that is the critical factor.

We are running significant trade deficits, as you know. The bulk of the foreign investment is not in the Treasury debt; the bulk of the investment is in plant and equipment in the stock market and corporate bonds. And that is why this issue about the Nation's debt and staying the course of fiscal discipline actually promotes the economy and keeps our market open for foreign investment here and those other assets, sort of a crowding in, so to speak, if that the term can be used.

I know that that is——

Senator LINCOLN. So you do not think there is a correlation?

Dr. GENSLER. I think the correlation is there that as long as our economy is strong we maintain an attractive investment. I think that is where the correlation is.

Senator LINCOLN. But the fact that also in 11 years, as Senator Graham brought up, that we are going to have an enormous amount of our population beginning to, not depend but have more of a dependence on the Government programs that are there, the

obligations and commitments that the Government has made to them, along with a negative savings rate.

Dr. GENSLER. I think that the better that we prepare for our future the better, in essence, the United States is for those foreign investors.

Senator LINCOLN. Yes.

Dr. GENSLER. They too are grappling with these issues. Those foreign countries are grappling.

I hope and I think we have the opportunity to better prepare. We had better be prepared by bringing this debt load down than many of those countries.

Senator LINCOLN. Thank you.

Dr. Miller, did you have anything?

Dr. MILLER. You know, for a couple of decades the portion of total debt outstanding that was held in foreign hands varied very little, and then it jumped up. And I think, in part, because sometimes they saw that this was a good place to put the money.

And, as Hon. Gary Gensler just said, we have a situation where the major foreign investment is not in Treasury bills but in real plant and equipment. That is very good. I mean, we ought to welcome that investment from abroad. It makes the economy go.

But I think, Senator Lincoln, you are right on the mark with the business about thinking about how these various programs and the approach that you take to these surplus and paying off the debt is going to affect real economic growth. That is the key.

Senator LINCOLN. Yes.

Thank you, Mr. Chairman.

Senator BAUCUS. Thank you, Senator.

One question that sort of nags me a little bit is this question of—it is not really directly relevant to this hearing—but it is the privatization of Social Security accounts. We are all very concerned about the baby boomer's retirement. And we do have an opportunity now with projected budget surpluses to maybe begin to do something about that.

The suggestion has been made by the President and others to take, say, 2 percentage points of the payroll tax that individuals could then use instead of paying that 2 percent and setting up a private savings account, which raises lots of questions. The basic question is is that going to really help ensure the future for a lot of Americans who will be retiring on down the road?

Now, I have seen an analysis of that, that is, namely of using 2 percentage points to set up a private account. And the analysis I saw is stunning. That on a net basis people would get a 20-percent reduction in benefits rather than—one would assume there would be an increase on the surface, intuitively, because of markets, rates of return in the private account as opposed to a lower rate of return that Social Security invests in.

But you have a huge transition problem. It is moving from the current system over to a system that includes private accounts. And the consequence of it is that the net reduction in benefits of 20 percent on average for those who are alive today up to those who are age 55 today, when they retire.

And I do not know. I am curious whether any of you have seen any analysis of that proposal and, if you have, whether that is ac-

curate. The estimate I saw is a very detailed analysis from a group that has no reason to try to, you know, have an axe to grind here.

If that is the case, then that is really a non-starter, that proposal. And it seems to me, that, therefore, the proposal has to be in addition to a Social Security trust fund rather than carving out a portion of the Social Security trust fund.

Dr. Gensler?

Dr. GENSLER. Senator Baucus, I do not know if I saw that specific analysis, but certainly I have read many analyses. And I think you have hit it on the head. There are two very real issues. One is, are these accounts in addition to that which we know of as Social Security today, or are they somehow carved out of that which we know as Social Security today?

I would certainly associate myself with the first and not the latter. But the Social Security as we know it today is fundamentally so important for all of us to plan for our future. And it could be disability; it could my 87-year-old aunt who would be in abject poverty if she did not have Social Security.

Now I know no one is suggesting to change it for my 87-year-old aunt, but I would like to plan for my future and my children's future.

If it is truly separate and in addition to Social Security and all that we know it today, there are separately a second issue of making it efficient and cost effective.

And when you take 2 percent of an average salary you are talking about, for most Americans, $600 to $800 a year, which then you add the cost of just running these accounts: the postage, the mailing, the account maintenance, and so forth. You find, actually, the returns get diminished greatly. And so the analysis you are talking about probably took some of that into account.

Senator BAUCUS. I would just caution all of us to look at whatever objective analyses we can before we leap. You know, it is to this conclusion that the carving out part of Social Security is going to actually help people, because I have very great reservations as to whether it will or not.

Dr. MILLER. Senator, you will not be surprised to hear me disagree with your premise.

Senator BAUCUS. You are right. I am not surprised.

Dr. MILLER. Number one, just as a threshold matter, when people have retirement accounts, of the retirement accounts in America today, companies, individual retirement accounts, how many of those are in Government bonds? Not many. Maybe we have a little bit in the portfolio, but not much.

Second, as an efficiency matter, the return that people realize from Social Security overall is much lower than the return they realize in the private marketplace. So if you did divert some of the Social Security FICA tax into personal, individual retirement accounts with constraints on the kinds of choices that people could make so they did not just play the market, broad based securities, they would realize a much higher return.

There is also an equity concern here. If you are Dr. Gensler's 82-year-old aunt you are doing very well under Social Security. But today if you are young, if you are black, Social Security is an awful deal. And we need to address it in such a way that people feel like

that when they pay this FICA tax they are going to get something, a return. And it is so important.

Let me just tell you a story. My wife was campaigning for Congress. And she talked to a group of young people who said that their aunt had died. And they went down to the Social Security office to get her inheritance. And there was, of course, nothing there. And they thought that was a bad deal. Of course, if you had private savings accounts there would be something to pass on to those nieces.

Senator BAUCUS. I appreciate that. I just urge you to look at some of these analyses. They are eye openers.

Senator KYL. Mr. Chairman?

Senator BAUCUS. Senator Kyl.

Senator KYL. Since you raised the subject, let me take about half the time you did to make the point that agrees with Dr. Miller in this further point. It is compared to what?

I do not know of any study that suggests that the current Social Security system will not result in at least 20 percent reduction of benefits. It cannot pay for itself. Everybody acknowledges that. Either benefits have to be substantially reduced or taxes have to be incredibly increased. That was the whole point of Senator Graham's question.

So it is not a question of whether we are going to retain the Social Security system as it is without a change. That is unacceptable to the younger people in our country today. No question about that. The question is, how are we going to get greater value for the money that we invest in Social Security so that we can pay those benefits? And, clearly, the private sector, at three or four times the rate of return, will provide a greater degree of investment opportunity than just leaving it in the status quo.

So I think the question is whether or not we are going to deal with the transition issue, which you correctly point out is the real difficulty here, by trying to take some of the surplus. If we are not willing to give it back to the American people, which would generate a stronger economy and provide greater tax revenues to the Treasury and enable us to be able to pay for it that way, if we are not going to do that, find a way to get this extra surplus, the amount that is not needed to pay down the Federal debt, into the hands of the people in the private Social Security accounts so it can begin earning money now.

You cannot rely just upon the 2 percent over the course of one's lifetime to generate enough money. But that additional amount of money might generate the 20-percent shortfall that the study that you refer to mentioned.

So I think it is important not to just assume that Social Security itself is going to be just hunky dory, as Dr. Miller pointed out. Especially if you are black, you are not going to get any benefit of this because you are not going to live long enough to beat the odds that Social Security has built into it in terms of when the pay out occurs vis-a-vis what people's life expectancy is.

Any comment by either one of you would be fine.

Dr. MILLER. I agree with your point. I mean, you know, to address Senator Baucus' concerns, I think we ought to take all of the Social Security FICA tax and use it to set up individual savings ac-

counts. The 2-percent solution proposal has been made as sort of a compromise. I think maybe that is a fair way of testing it. And I think when people see that they would latch on it. In fact, they would prefer it.

One of the things you might want to think about is essentially offering people their choice: stay in the present system, fine; or you get this choice of using some of the FICA tax and investing on your own. You have to do it for purposes of retirement, but let people make the choice. I mean it is a win-win proposition. Those that do not want it, they do not have to change. Those who like it, they get their choice.

Dr. GENSLER. I find myself here as a debt expert. But having been asked the question about Social Security I will at least state a personal view.I think it really is a remarkable program that has withstood the test of time. It has brought so many Americans out of poverty in their elderly years, brought so many Americans the comfort of if they are disabled or need other services that we do that as Americans and we look after all Americans in a way. And I think that we all have to remember that as we think about the very appropriate questions that Senator Kyl has raised about what to do for 20 years from now. Paying down the Nation's debt gives us more options as we enter that period of time, and as we have these debates. But I would hope that whatever we do does not strike at those core security issues that all Americans share in today.

Senator BAUCUS. Thank you very much, all of you. We are all obviously grappling with this problem of how we deal with baby boomers retiring so that they know there is some kind of security there, probably a combination of Social Security and other investment vehicles. But thank you all very much for your testimony.

[Whereupon, at 11:43 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Gary Gensler

INTRODUCTION

Chairman Grassley, Ranking Member Baucus, members of the committee, thank you for the opportunity to appear here today to discuss Treasury debt held by the public. Though questions related to the nation's debt are often technical and arcane, the relationship of this issue to larger budget debates requires that it now be subject to a more public airing. In particular, you. have asked how much of the $3.4 trillion in publicly held debt is available to be paid off through 2011. (Table 1 summarizes the currently outstanding publicly held debt.)

I recently had the honor to serve as Treasury Undersecretary for Domestic Finance. Amongst my duties as Undersecretary was the oversight of debt management during the time when Treasury made a smooth transition from financing a deficit to paying down over $400 billion in publicly held debt. Prior to this time, I was a partner of the international investment-banking firm Goldman, Sachs, and worked on Wall Street for 18 years.

Though some debt may be difficult to retire, I believe that less than $500 billion is truly unavailable to pay down through 2011. 1 believe that over $2.9 trillion of the currently outstanding $3.4 trillion in publicly held debt could be paid off without any significant cost or "premium."

More specifically, Treasury can pay off this debt without any significant cost or premium, by: (1) allowing the vast majority of this debt to mature as it comes due; (2) repurchasing the majority of Treasury's current long term marketable debt smoothly over time at market prices; and (3) making other changes as part of sound debt management, such as discontinuing issuance of the 30-year bond and certain other issues of securities. My analysis assumes that the $185 billion Savings Bond program would continue.

Separate and apart from the question of how much debt is available to be paid, some have raised a question about the economic and financial consequences of reducing the supply of Treasury securities. In other words, even if most of the debt was available to be paid down, would it harm the economy to remove Treasury securities from the marketplace?

The U.S. capital markets already have been adjusting to a declining role of Treasury securities and a transition period is well underway. Treasury securities, which once represented close to one-half of the U.S. bond market, now represent less than one-quarter. There are many other instruments currently competing for new roles in this changing environment. I believe that the U.S. capital markets, the most innovative and creative in the world, will surely adapt over time.

Responding to this concern in recent Congressional testimony, Chairman Greenspan said that Treasury securities are readily substitutable with other types of securities and that while ". . . it would be slightly less efficient than the riskless securities, the great advantage of reducing the debt effectively to zero, in my judgment, would overcome that."

REPAYING DEBT BY ALLOWING IT TO MATURE

In the past, when the government had deficits, it went to the public individuals, financial institutions, and local or foreign governments—and borrowed the money. Interest is currently being paid for these loans. Our recent commitment to fiscal discipline has allowed us to begin repaying that debt, thereby reducing interest costs for the taxpayers.

Over $400 billion in debt already has been paid off, primarily by simply using budget surpluses to pay off bonds as they mature—as opposed to rolling them over, and borrowing the same sum again. This method continues to be the most direct way to retire debt.

Nearly $2.5 trillion in marketable debt will mature or is callable by 2011. In addition, there is $150 billion in non-marketable debt held by state and local governments, 90% of which matures within five years. All of this combined $2.6 trillion in debt, representing 76% of the publicly held debt, can be repaid as it comes due with no premium or additional cost.

CHANGING TREASURY ISSUANCE

One of Treasury's traditional tools to manage the debt is to change the menu of new issues offered to the public. Treasury can initiate issuance of new securities when needed or discontinue issuance of specific securities during times of surpluses. For instance, Treasury initiated issuance of State & Local Government Securities in 1972, callable 30-year bonds in 1977 and non-callable 30-year bonds in 1985. In contrast, Treasury also has discontinued at least six different securities over the last 16 years: 20-year bonds and callable bonds in 1985; 4-year notes in 1991; 7-year notes in 1993; 3-year notes in 1998; and 52-week bills earlier this year.

Given projected surpluses and debt paydown, Treasury can use this traditional tool and stop issuing new long-term debt.

For example, the Treasury Borrowing Advisory Committee, a group of top outside financial experts, informally voted at their last meeting to recommend elimination of the 30-year bond. The Borrowing Advisory Committee meets quarterly to advise the Secretary of the Treasury, bringing together over 20 leaders of the bond market from commercial banks, investment banks and large investors. The history of the Committee dates back to at least the Truman Administration. Many other participants in the market also expect the Treasury to discontinue 30-year bonds later this year. In addition, the Treasury Borrowing Advisory Committee supported the elimination of the 30-year Treasury Inflation Protected Securities.

To ensure that all new offerings mature before 2011, Treasury also could consider eliminating issuance of new 10-year notes. While this action is not currently anticipated broadly in the markets, discussion of it has begun to appear in Wall Street research reports. In addition, both the Congressional Budget Office and the General Accounting Office have recently included discontinuance of 10-year notes within their analyses of future debt management actions.

DISCONTINUING STATE AND LOCAL GOVERNMENT SECURITIES

Treasury also has the authority to discontinue issuance of various series of non-marketable debt. In particular, they can stop issuing State and Local Government securities (SLGSs). Treasury initiated a review of this option last summer.

State and local governments currently invest $150 billion in Treasury securities with the proceeds of advanced refunding of their liabilities. Treasury has no statutory obligation to issue such securities. Just as other investors are, municipalities could adjust to a world of declining Treasury securities by investing in alternative debt instruments. They would still need to abide by anti-arbitrage rules related to the tax code and would likely change indenture agreements in their future offerings. This generally could be done, however, as most of this debt matures within 5 years, leaving a number of years prior to 2011 to make adjustments.

The General Accounting Office highlighted this possibility last month in their report to Congress, entitled "Debt Management Actions and Future Challenges." They said, "the Treasury ultimately may be forced to reassess its issuance of non-marketable securities, such as the state and local government series." In addition, some private sector forecasters assume that the program will be eliminated.

THE OTHER $800 BILLION IN DEBT

With at least $2.6 trillion in debt maturing by 2011, what about the other approximately $800 billion in debt? This includes approximately $280 billion in other non-marketable debt (excluding the SLGSs) and approximately $520 billion in marketable debt maturing after 2011.

NON-MARKETABLE DEBT

Some of this remaining debt is non-marketable debt such as savings bonds, long maturity zero-coupon bonds, and Treasury securities held by the Thrift Savings Plan. In combination, these total approximately $280 billion or 8% of the publicly held debt.

There are currently $185 billion in savings bonds outstanding. This program, while not growing for many years, still has broad public acceptance and is thought by many to be an important vehicle to promote private savings among small savers. While this debt is likely to decline modestly over time, it may be truly unavailable to be redeemed.

There also are $55 billion (face amount) in long maturity zero-coupon bonds. These were issued to foreign governments to back the Brady program ($25 billion) and to the REFCorp and FICO to back the resolution of the thrift crisis ($30 billion.) While these bonds are non-marketable and generally mature after 2011. foreign holders have been asking Treasury to redeem some of them. In particular. foreign governments have been refunding their Brady bonds and the underlying Treasury zero-coupon bonds have been redeemed. In total, over the last three years, $11 billion in zeros held by foreign governments have been redeemed. In addition, working with Congress, Treasury in the future could consider purchasing REFCorp and FICO bonds in the market and thereby effectively redeeming the underlying zeros. Therefore, the amount of non-marketable zeros will likely decline over the next ten years.

The Thrift Savings Plan holds $33 billion in Treasury debt to back Federal Government employees' selections of investing in the bond market. While the TSP invests directly in private sector bonds and equity securities, the arrangement with Treasury regarding Treasury bond investments was set up during the mid 1980's in a period of significant and growing fiscal deficits. All of these securities actually mature daily and are then rolled over into new securities. If desired, Congress, the Treasury and the TSP could consider alternatives for this program.

In summary, this $280 billion in various non-marketable securities are amongst the hardest Treasury securities to redeem. It is likely, however, that they will decline over the next ten years to less than $250 billion due to modest declines in savings bonds, foreign redemption of zeros, and possible changes related to other non-marketable debt.

LONG-MATURITY MARKETABLE DEBT AND DEBT BUYBACKS

There are currently about $520 billion in bonds (including inflation-indexed bonds) maturing after 2011 that trade freely in the market. The Federal Reserve holds about $60 billion, leaving only approximately $460 billion in private hands.

One of our founding fathers, Alexander Hamilton, first recommended one of the most basic and sound options at Treasury's disposal: debt buybacks. This is simply the government buying bonds in the secondary market prior to their maturity.

Hamilton. the first Secretary of the Treasury, submitted a plan to Congress in 1795 to extinguish the debt within thirty years. Albert Gallatin. appointed Secretary of the Treasury by Thomas Jefferson, conducted the first debt repurchases during the period from 1807 to 1812. Used subsequently throughout our nation's history during times of sustained surpluses, buybacks were once again employed last year.

Treasury successfully repurchased $30 billion par amount of long-maturity debt last year. To date, Treasury has successfully and efficiently conducted 24 buyback operations repurchasing $36.2 billion par amount of debt. The Treasury has received on average 4.1 offers for every bond repurchased. Because the average maturity of the redeemed issues has been long, 18.3 years on average, these buybacks have kept the average length of the marketable debt from extending by 3 months.

Debt buybacks have now become a regular and predictable part of the Treasury's debt management program. There is a regular schedule of two. operations per month with a practice of announcing a target buyback amount each quarter.

The financial markets anticipate that Treasury will repurchase between $35 billion and $45 billion in debt this year and continue this program well into the future. Many investment banks project significant continuing buybacks. For instance, Merrill Lynch recently projected approximately $245 billion in buybacks over the next 5 years. Last year, Goldman, Sachs projected the program growing to $40–50 billion this year and to higher levels going forward. Wrightson Associates forecasts that Treasury will continue buybacks at the current pace into the future. The General Accounting Office in their report to Congress last month also assumed that buybacks would continue into the future.

Over time Treasury can continue to smoothly repurchase substantial amounts of long-term debt at market-level prices. Moreover, foreign holders of long-term debt should not present an obstacle to this goal. Edwin Truman, a former senior official for international matters at the Federal Reserve and subsequently at the Treasury presented testimony in this regard last week stating; "Foreign holders do not present unique obstacles to programs directed at paying down Treasury's publicly

held debt prior to maturity on reasonable terms." With your permission, I would like to ask that such testimony also be included in the record of this hearing.

As mentioned earlier, the Federal Reserve holds about $60 billion of debt that matures after 2011 as part of its roughly $500 billion Treasury portfolio. The Federal Reserve System is undergoing an examination of how it would conduct monetary policy without this debt. Chairman Greenspan has testified that it would be "a little more difficult to do it that way, but the advantages of reducing the debt are such that that should be our first priority." In other words, the Federal Reserve holdings should not be an obstacle to paying down the debt.

In addition to buybacks, Treasury also could reinstitute debt exchanges, last used in 1972. Through this mechanism, Treasury could offer investors new short-maturity debt in exchange for their current longer-maturity debt. The Borrowing Advisory Committee has recommended use of these exchanges. In addition, debt exchanges are common practice for private sector and sovereign government issuers. For instance, the United Kingdom, Spain, and the Netherlands regularly use them as part of their debt management.

THE QUESTION OF POSSIBLE PREMIUMS

Some have suggested, however, that any efforts to buy back debt would involve expensive premiums. The Administration has suggested that it might cost between $50 and $150 billion in premiums to buy back long maturity debt. Experience and judgment suggest otherwise.

It might be best to start by defining two different types of premiums. The first is paid when the coupon interest rate on a bond is higher than the current prevailing interest rates. This so-called "market premium" equals the present value of the excess of the coupon rate over the current market interest rate. As this simply represents a timing shift of paying up front for avoiding above-market interest rates in the future, this "market premium" has no long-term cost to the government. The second question is whether Treasury might be required to pay more than the regular market premium to repurchase bonds in the market. It is this second question that has been discussed in policy circles during the last few weeks.

Wall Street firms and Treasury have reviewed two factors in their analyses to date that are pertinent to the overall questions related to possible premiums.

First, where has Treasury purchased bonds in relation to the market price? Investment firms have measured "concessions," which can be defined as the difference between the yield paid on repurchased bonds and the yield in the market place at the exact time of a particular buyback operation. Merrill Lynch and Goldman, Sachs both have consistently found that concessions have been negligible. The General Accounting Office concurred with these results when they reported to Congress last month, that "while there was variation across the 20 buyback operations, generally the average concession was small or negative."

Over the first 24 buyback operations, Treasury has paid a concession versus the market of only a fraction of one basis point (1/100th of one percent). For non-callable debt, there appears to be a concession to the market on average of only 1/10th to 2/10ths of a basis point. This equates to only $80,000 to $165,000 per billion dollars of buybacks or approximately $8 to $17 million per $100 billion in buybacks. To reach the Administration's estimates for premiums of between $50 and $150 billion, these concessions would have to expand over 1,000 fold.

Second, where has Treasury purchased bonds in relation to their ability to issue new long maturity securities? Treasury tracks the average yields of buybacks and compares it to new issue yields (interpolated yields on comparable maturity securities are based upon new issue 10-year notes and 30-year bonds). Consistently, Treasury has been able to purchase securities over 20 to 25 basis points cheaper than the interpolated new issue yield. This reflects how much Treasury gains by capturing the liquidity premium market participants are willing to pay for newly issued securities. Using a slightly different approach, Goldman, Sachs has found similar results. They have reported that the Treasury has saved taxpayers $1.25 billion through the first $36 billion in buybacks. This equates to roughly 25 basis points of savings or over three dollars in savings per every $100 of buybacks. To reach the Administration's estimates of premiums, these savings would not only have to turn into losses, but they would have to be of dramatic proportions. Losses on average would have to mount to between $11 and $33 dollars for every $100 in buybacks—the equivalent of approximately 70 to 250 basis points in yield loss.

To summarize, to date buybacks have lead to significant savings for taxpayers with only negligible concessions to the market. Furthermore, debt buybacks are a crucial tool for the nation to affect a smooth glide path to debt reduction.

THE QUESTION OF SCARCITY

Some have suggested, however, that when long-maturity bonds become scarcer, they will become more expensive, even possibly making them impossible to repurchase. While at first glance, this view seems to be consistent with traditional economic relationships of supply and demand; there is an important additional factor that affects the securities market—the importance of liquidity.

As supply declines, so too does the attractiveness of individual securities. The more of a security that exists, the more readily that security is tradable and generally the more liquid it is. The less of a security that exists, the less readily that security is tradable and generally the less liquid it is.

Investors generally value liquidity and are willing to pay more for large liquid issues. One of Treasury's five core principles of debt management, in fact, is to promote liquidity, so as to lower Treasury borrowing costs.

It is not entirely clear, then, what will happen to yields as the long-maturity Treasury market declines in size. There actually is relevant evidence from the market, however, that could suggest a decline in price and an increased willingness to sell to the Treasury.

First, it is interesting to look at securities that the market views as having the identical credit risk as Treasury securities, but with less tradable supply. There are a number of examples. In particular, REFCorp and FICO bonds were issued backed by the U.S. Government. (The principal is backed by zero coupon Treasury securities and the Treasury provides for any shortfall in interest.) REFCorp bonds, with only $22 billion outstanding, trade about 30 basis points cheaper than comparable Treasury securities. The smaller $8 billion pool of FICO bonds trade even cheaper, at about 50 basis points over Treasury yields. On the other hand, the larger, approximately $65 billion. callable Treasury market trades about 15 basis points over comparable noncallable securities on an option-adjusted basis.

Second, the recent buybacks provide some evidence. Since buybacks began on callable bonds, decreasing their supply, callable Treasury securities have cheapened by approximately 5 basis points. In addition, the most significantly repurchased noncallable bonds have not gotten more expensive. In fact, since the first buyback operation, the 3 most repurchased bonds have actually cheapened modestly, by 0.3 to 0.5 basis points, versus comparable maturity and coupon Treasuries.

Lastly, experience in other countries is interesting. A number of countries, including the United Kingdom, Spain, the Netherlands and New Zealand have recently conducted debt exchanges. This is a mechanism whereby newly issued debt is exchanged for currently outstanding debt. Evidence from these countries shows that debt has not gotten richer as it has gotten scarcer. To the contrary, bonds have increasingly cheapened as the amounts outstanding shrank.

To summarize, there is ample evidence that, as bonds become scarcer, they lose liquidity and generally become cheaper. While there may come a time eventually when it becomes difficult to repurchase long-maturity Treasury debt, this has not been the case to date and is not likely for some time to come. As buybacks continue and supply shrinks, those investors who value liquidity will be more willing to sell long-maturity Treasury bonds.

SUMMARY OF AVAILABLE DEBT TO BE REPAID

By discontinuing new issuance of long-maturity debt, using debt buybacks, and possibly reinitiating debt exchanges, Treasury could smoothly retire one-half, and possibly up to two-thirds, of its current long-term marketable debt in private hands over the next ten years. By continuing to work closely with the Federal Reserve regarding their holdings, this would leave less than $230 billion in marketable debt outstanding. If Treasury were to continue issuing 10-year notes for the next several years, they could later conduct buybacks of the majority of these securities as well. Moreover, Treasury will continue to have seasonal cash management needs and will periodically wish to address those needs by issuing and redeeming short-term cash management bills. In sum, the amount of truly unavailable debt should be thought of as less than $500 billion—the less than $230 billion in long-maturity marketable debt, plus the less than $250 billion in non-marketable debt previously discussed.

There is $3.4 trillion in publicly held debt currently outstanding. Approximately $200 billion of this will be paid off during the remainder of this year. This will leave $3.2 trillion in publicly held debt at the end of this year.

With less than $500 billion in debt truly unavailable to be redeemed, there remains $2.7 trillion in debt available to be paid off between 2002 and 2011.

COMPARISON TO OTHER ESTIMATES

Some have asked why this estimate differs from the one included in the last Clinton Office of Management and Budget report. That estimate was done for a different purpose. It was included in "baseline" estimates—numerical pictures of the budget that assume existing policies, including debt-management policies, continue unchanged. Given that approach, OMB did not feel it necessary to consult with Treasury in preparing those estimates.

The Congressional Budget Office recently estimated that $818 billion in debt might be unavailable to be redeemed over the next ten years. The principal differences from my estimate relate to assumptions about debt management. CBO's report is also a "baseline" estimate. In it, they did not discontinue the SLGSs program and they assumed that current Treasury policy had only a modest continuance of debt buybacks. Therefore, CBO was not suggesting or necessarily aware of possible changes in future Treasury debt management practices.

The new Administration suggests that $1.2 trillion of debt would be unavailable to be repaid. This was based upon a model that continued issuance of all long-term debt at current levels for at least 5 years; continued issuance of inflation indexed securities at current levels for at least 5 years; continued issuance of SLGSs; and discontinued the buyback program. One curious implication of the model, as reported in analyst reports, was the near-term elimination of the Treasury bill market, and the discontinuance of 2-year and 5-year notes while maintaining issuance of long maturity debt.

As the analysis in my testimony indicates and judgment and experience support, Treasury has ample alternatives available to manage the debt to a much lower amount than indicated by the OMB model.

CONCLUSION

With sound debt management Treasury can readily pay down the vast majority of the publicly held debt. Of the $3.4 trillion currently outstanding publicly held debt, over $2.9 trillion is available to be repaid through 2011. This would leave less than $500 billion in debt truly unavailable to be repaid in that timeframe.

TABLE 1.—PUBLICLY HELD DEBT

February 28, 2001
(Billions of dollars *)

Maturing Through 2011:			
Marketable Debt	$2,450		
Non-Marketable (SLGSs)	150		
Total		$2,600	76%
Other Non-Marketable Debt *:			
Savings Bonds	$185		
Long-term Zeros	55		
TSP & Other	40		
Total		280	8%
Marketable Debt Maturing After 2011:			
Federal Reserve Holdings	$60		
Privately Held	460		
Total		520	15%
Total Publicly Held Debt		$3,400	100%

Notes: Amounts rounded to nearest $5 billion.
Some of the other non-marketable debt also matures through 2011.

PREPARED STATEMENT OF JAMES C. MILLER III [1]

For nearly three decades, annual outlays of the U.S. government exceeded annual receipts, and the federal debt rose steadily—until 1998. Since then, the federal government has run significant annual surpluses, and paying off a major portion of the debt within a decade appears not only feasible but altogether likely.

This change in circumstance presents a set of questions heretofore not addressed. Among them:

- What proportion of the national debt could be paid off without incurring unreasonable costs?;
- Just what does the government do with the surplus once the debt has been paid down to some reasonable level?; and
- Is it even advisable to run a surplus once the debt has been curtailed?

Please let me address each in turn.

REDUCING DEBT AT REASONABLE COST

At present, the national debt totals approximately $5.6 trillion. Of that, approximately $3.4 trillion is in the hands of the public (including the Federal Reserve System), and $2.2 trillion is in government accounts (mostly as assets in various trust funds such as Social Security and Medicare). What is of interest, then, is the publicly-held debt, which could be paid down with that portion of the surplus not earmarked in some way.

Under current policy, the unencumbered surplus could eliminate the public debt entirely within a decade—but at what cost? In the extreme, Treasury could suspend the issuance of debt longer than 10 years, and shorter periods in the coming years. Only $500 billion or so of debt matures after 2011. To pay down more, Treasury would have to "call" that small portion of callable debt outstanding and engage in very aggressive "buy-back" strategies to get the rest.

This, of course, represents an extreme position. Do you really want to end the Savings Bonds program, which some people find of considerable intrinsic value? What about the state and local series, which those governments find handy in keeping their fiscal houses in order? Continuing such programs would add another $300 billion or so to what, in his January 25, 2001 testimony before the Senate Budget Committee, Chairman Greenspan called "irreducible minimum debt." Continued near-term debt issuance would push this figure even higher.

Both OMB and CBO claim that, under reasonable assumptions about policy as well as economics, roughly $1 trillion in debt would be unavailable for redemption in 2011. Former Treasury Under Secretary Gary Gensler, in his March 22, 2001 testimony before the Senate Budget Committee, concluded that the minimum figure is less than half that amount. Part of the difference is that Mr. Gensler believes Treasury can and should move much more aggressively to curtail long-term lending and to circumscribe other programs. He also believes an aggressive buy-back initiative would work rather costlessly. I find his argument about curtailing programs a value judgment and his argument about costless buy-backs unpersuasive. Let me address the latter.

Economists don't know a lot of things, and even some of the things they "know" may not be true. But of all the things economists know, I'd bet on the truth of the laws of supply and demand. Supply is upward-sloping, and demand is downward-sloping. If Treasury buys-back non-callable debt, it has to pay the "market premium," of course, but increasingly it will have to pay an additional premium associated with the holder's preference for this instrument compared with other instruments of similar risk.

As a matter of theory, the notion that with less volume of such debt there is less liquidity and thus the quality is lower and the non-market premium is lower or even negative makes little sense to me. Let me put it this way: if you are holding Treasury debt of a certain variety and hear an announcement that the Treasury will go in the market with a large buy-back of these instruments, will you be happy or sad? As a matter of evidence, I think the data Mr. Gensler cites is not compelling. In each case, the rate or price changes reflect the influence of more than just the buy-back initiative.

Even assuming away the various impediments to debt repayment just described, would it make sense to end the debt program completely? I think not. First, as a practical matter, the federal government needs an ability to borrow in order to cope with month-to-month variances in receipts and outlays. Furthermore, it needs to have the ability to borrow on a substantial scale in the event circumstances de-

---

[1] Former Director, Office of Management and Budget (1985–1988).

manded. To some extent, this access to debt should be viewed much like a fire extinguisher: you hope you don't need it, but it's best to have it in case you do. Businesses regularly maintain lines of credit they don't expect to use, just as individuals often do for personal emergencies. And third, unless substantial reforms are made in the Social Security, Medicare, and other entitlement programs, the surpluses eventually will turn into deficits, and an ability to issue debt would become a necessity.

How much debt it would be prudent to pay down is a matter over which experts can disagree, endlessly. Of much more importance, in my view, is what the federal government might do with the surplus once the debt is paid down to this "irreducible minimum."

WHAT TO DO WITH SURPLUS AFTER DEBT IS PAID?

There are really no good answers to this question. The federal government could place these hundreds of billions, or even trillions, of dollars in bank accounts. The government presently maintains bank accounts in order to facilitate thousands of transactions each and every day. But it doesn't load up these accounts with massive balances, nor should it.

Purchasing assets is the obvious answer. But here I stand with Chairman Greenspan in his caution that "it would be exceptionally difficult to insulate the government's investment decisions from political pressures." Moreover, here we are talking about such huge sums that to dispose of the surpluses in this fashion would mean government's controlling or outright owning substantial portions of the U.S. economy. Under CBO's and OMB's baselines, more than $3 trillion in such "excess surpluses or excess cash" are projected by 2011. If all were invested in equities, the U.S. government would be able to control roughly 10 percent of the total stock market in 2011. The prospects for harmful effects on economic efficiency, not to mention the potential for political chicanery, are chilling.

If surpluses were to continue after the debt is retired, another course of action would be to create a system of personal investment accounts. These could be for the purpose of augmenting individuals' retirement accounts, health care coverage, or even promoting other worthy goals such as education. In effect, the government would be forcing people to pay according to the cannons of the tax code and then guiding them with respect to their purchase decisions. Such a scheme doesn't appeal to me, but it would be preferable to socialism.

But the question has to be asked: why run a surplus once the debt is paid?

WHY RUN A SURPLUS AFTER DEBT IS PAID?

Why should the U.S. government, not to mention the American taxpayer, be put in such a bind? What reason is there for the government to accumulate substantial cash balances? The only reason that occurs to me is to create some sort of "rainy day fund," as some states have done. But surely the kinds of balances we are talking about far exceed any reasonable need along those lines. Moreover, the "rainy day" device is not so important for the national government, which is subject to far less swings in revenues and outlays, and which has a much easier time of issuing debt if warranted.

The obvious answer is to phase out the surplus in a thoughtful and cost-effective manner, and, here again, I side with Chairman Greenspan, who said in his recent testimony that "it is far better . . . that the surpluses be lowered by tax reductions than by spending increases." In fact, I would wager to avoid a return to deficits, you must take action to lower spending in the future. Recent reports on the outlook for Social Security and Medicare are more optimistic than in the recent past, but unless substantial reforms are made in these and other entitlement programs, outlays will explode and deficits will reappear.

CONCLUSION

To witness this debate over what to do with the surpluses is to be reminded of the current TV ad campaign for AFLAC—where the actors keep posing the question and the duck keeps quacking, "Alfac, Aflac."

The answer should be plain for all to see. The debt should be placed on a glide path to reach the "irreducible minimum," and the remaining surplus should be returned to whom it belongs. The American taxpayer deserves a break. He's bought his Big Mac and fries, and having paid with a $5 bill, he rightfully deserves his change.

COMMUNICATIONS

STATEMENT OF THE BOND MARKET ASSOCIATION

The Bond Market Association is pleased to comment on issues related to the management of the U.S. government's debt. The Association represents securities firms and banks that underwrite, trade and sell bonds in the international and domestic markets. Our membership includes all major dealers in U.S. government securities, including all 25 primary dealers as recognized by the Federal Reserve Bank of New York. We commend Chairman Grassley for calling this hearing and we appreciate the opportunity to present our views.

The issues currently faced by the Treasury Department in managing the government's debt are in many ways unprecedented. Over the next ten years, it is likely that trillions of dollars of government debt will be retired or bought back. Never before has the government faced such a massive retirement of outstanding debt securities. The retirement of the debt is welcome and laudable. Taking the federal government out of the financial markets as a borrower will free up much-needed capital for investment in job-producing assets such as factories, infrastructure, and schools. However, paying down the debt also raises questions about the efficiency of the capital markets in the absence of actively traded Treasury securities. An important question now for the Treasury Department and for the Congress is how to retire the debt in the most orderly way without threatening the efficiency and liquidity of the market. Two important issues related to maintaining the efficiency of the markets are the continuation of Treasury's buyback program and the continued issuance of 30-year securities.

THE GOVERNMENT SECURITIES MARKET

Despite its shrinking size, the U.S. government securities market is still widely acknowledged as the most liquid and efficient securities market in the world. Daily trading volume in Treasury securities totals in the hundreds of billions of dollars. Trading spreads secondary market dealer transaction costs—are razor thin. Treasury securities are held by a large and diverse group of investors, including individuals, state and local governments, corporations, pension funds, insurance companies, central banks, and others. The government securities market is the model of market efficiency around the world, and the market's efficiency and liquidity provide several important economic benefits.

Low-cost government financing—The market's efficiency allows the federal government to issue approximately $2 trillion per year in bills, notes and bonds at reasonable terms (most of which is simply a rollover of existing debt coming due). Considering that approximately $5.7 trillion of Treasury debt is outstanding, if the government incurred an overall cost of borrowing just 1/100th of a percentage point (1 basis point) higher, taxpayers would face an additional interest expense of $570 million per year. Clearly, maintaining an efficient new-issue market for Treasury securities is in the interest of taxpayers.

A "reference" interest rate market—The U.S. Treasury securities market is the interest rate benchmark for all the other U.S. debt markets. Corporate, municipal and federal agency bonds and mortgage- and asset-backed securities are all priced based on a spread over Treasuries, i.e., their yield above comparable government securities, which allows for much more efficient pricing. This "reference yield curve" allows borrowers other than the federal government—corporations, states and localities, government-sponsored enterprises and, indirectly, homebuyers and consumer borrowers—to access capital at the lowest possible cost. This is true because the liquidity of the Treasury market often permits market participants to hedge risk associated with positions in other types of bonds. Hedging can reduce risk and overall costs. Also, because Treasury securities are considered to be free from credit risk,

it is easier to evaluate debt instruments such as corporate bonds and mortgage-backed securities relative to the risk-free rates in the Treasury market.

A vehicle for implementing monetary policy—When the Federal Reserve seeks to adjust interest rates or the money supply, it acts principally through the government securities market. On an almost daily basis, the Federal Reserve Bank of New York buys or sells Treasury securities under repurchase agreement contracts. Less frequently, the Fed buys or sells Treasury securities outright. The Fed's counterparties are a network of securities dealers known as "primary dealers." Although the Fed has begun to use securities other than Treasuries in open-market operations, government securities are the preferred monetary policy tool principally because of the market's efficiency and liquidity.

The efficiency of the government securities market is best observed by examining "on-the-run" Treasury securities. On-the-run Treasuries are the most recently issued series of bonds in each regularly auctioned maturity. The vast majority of secondary market trading in government securities takes place in these benchmark issues. The on-the-run market is supported by a dependable and well-publicized schedule of Treasury Department auctions. This regular and predictable schedule is necessary because Treasury often sells tens of billions of dollars of bills, notes or bonds over short periods of time. Market participants depend on a regular auction schedule to plan for the efficient placement of large volumes of securities. The Treasury Department's financing is motivated by a single factor: the government's cash position. The Treasury Department must ensure that the government's cash on hand remains at levels high enough to ensure that obligations are met, but not so high that taxpayers incur needless interest expense. Much of the Treasury Department's new securities issuance is for the purpose of "rolling over," or refinancing, outstanding debt that comes due.

In recent years, as the fiscal budget deficit has shrunk and then disappeared altogether, the government's cash needs have diminished. Consequently, the Treasury Department has reduced the sizes of securities auctions and eliminated certain sales entirely. In addition, the Treasury Department has instituted a successful program of buybacks where the government retires outstanding debt before it comes due by purchasing securities in the open market. We believe that this strategy of combining adjustments to the auction schedule with carefully timed and executed buybacks has worked well for the Treasury and for market participants.

BUYBACK OPERATIONS

Last year, the Treasury Department implemented a practice of buying back outstanding Treasury securities in the open market as a debt management tool. The Bond Market Association supports the effective use of buybacks as a means of managing the government's debt position. We believe that buybacks have allowed Treasury to maintain sizable new auctions—thereby preserving liquidity in the "on-the-run" Treasury market while retiring outstanding debt in the most efficient manner possible.

Much attention has been paid to the benefits of buybacks in preserving the infrastructure of the Treasury securities market and the economic benefits that entail from a liquid and active secondary market in recently issued Treasury securities. However, buybacks also benefit the government and taxpayers by generating substantial interest-cost savings. This savings results from the difference in yield between older, "off-the-run" Treasury securities and newly issued "on-the-run" securities. Depending on market conditions and the volume of securities Treasury decides to buy back, the savings to taxpayers could total in the billions of dollars.

Any given Treasury security is on-the-run when first issued. It loses its on-the-run status when Treasury issues a newer security of the same maturity. On-the-run Treasury securities are traded more actively—and consequently carry a significantly lower yield-to-maturity, or rate of return earned by investors—than off-the-run securities. The interest savings available to the government is a result of this difference. The savings to taxpayers from buybacks comes about because the interest expense on newly issued securities sold to finance the buybacks of old securities is smaller than the interest expense on the older securities, even after accounting for the price premium that many older, high-interest rate bonds carry. This can be demonstrated on a variety of securities across the range of maturities that make up the Treasury "yield curve."

Market conditions may change in the future. Some market participants have suggested that as fewer and fewer Treasury securities are sold and traded, outstanding securities will begin to carry a "scarcity premium." At some point, buybacks may stop making sense from a cost-savings perspective. However, under current market

conditions and under the market conditions that have prevailed since Treasury initiated the buyback program, buybacks make good fiscal sense for American taxpayers.

THE FUTURE OF TREASURY'S 30-YEAR BOND

Market observers are beginning to examine whether it is justified for the government to continue selling bonds with 30-year maturities given current fiscal projections. After all, if, as some projections indicate, the Treasury will be able to stop selling new debt entirely by as early as 2007, does it make sense for Treasury to meet its current funding needs by issuing bonds which will not mature for 30 years? The Bond Market Association believes it would be premature for the Treasury Department to stop selling 30-year bonds at this time. We have recommended that the government continue selling 30-year bonds as long as practical. Moreover, we believe that if the sales of new 30-year bonds become impractical, Treasury should consider adopting a practice of exchange offers where investors who hold outstanding Treasury bonds would be permitted to offer them back to Treasury in exchange for new 30-year bonds.

As already stated, almost all the liquidity—the ready ability to buy and sell securities easily, efficiently and at the lowest possible transaction costs—in the Treasury market is in the market for newly issued, on-the-run securities. This is true for all Treasury securities, including the 30-year bond, for several reasons. Most important, a majority of outstanding securities of all types are held by investors in long-term portfolios rather than traded actively. As a new issue ages, an increasing portion of that issue finds its way into the hands of investors who intend to hold the security for an extended time, and the security trades less actively. Eventually, Treasury sells a new security of the same maturity and it replaces the older, increasingly less liquid security as the on-the-run issue for that maturity. The older issue loses some liquidity. If Treasury stops selling new 30-year bonds, trading in outstanding, long-maturity bonds will eventually slow significantly and there will no longer be a new, on-the-run 30-year issue. This would result in several negative effects for the government and the market:

- Eliminating the 30-year bond would eventually eliminate Treasury's ability to buy back outstanding securities before their maturity. Scarcity premiums, discussed above, would ensue quickly if new-issue supply were terminated, although this could be mitigated somewhat by lower prices due to the loss of liquidity.
- The capital markets would lose—some might argue they have already lost an important benchmark security. While there are alternative benchmark rates at short and medium maturities, there is no long-term pricing benchmark that compares to Treasuries. There is insufficient volume in the federal agency and swap markets to provide a reliable, 30-year benchmark. Eliminating long-dated Treasuries could make it difficult to price long-term debt issued by corporations, states and localities and others and could raise financing costs for those borrowers.
- 30-year bonds fill an important role in the portfolios of certain market investors such as insurance companies. There are few ready investment alternatives for investors who seek long-term assets of very high credit quality. The alternatives that may exist, such as high-quality corporate bonds, are priced relative to 30-year Treasury bonds and may become less attractive if they cannot be priced as efficiently in the absence of 30-year Treasuries.
- The surplus projections may not play out. It is very difficult to accurately project long-term budget surpluses. Over the years, projections have been notoriously off the mark. It may be necessary for Treasury to begin issuing 30-year bonds for fiscal reasons sooner than currently anticipated, and taxpayers could bear the cost of reopening the market.
- Maintaining the 30-year bond, as well as other coupon securities in Treasury's borrowing mix such as the ten-year note, will provide Treasury with the maximum flexibility in managing the government's debt.

SUMMARY

The federal government is in an enviable fiscal position. After decades of mounting public debt, it now appears that a substantial portion of outstanding securities can be retired or bought back over the next decade. It is wise and appropriate for Congress and the administration to conduct fiscal policy with the goal of retiring as much of the federal government's debt as is practical. However, we urge Congress to be mindful of the effects of debt retirement on the financial markets. Over the past three decades, capital markets participants around the world have come to depend on the government securities markets to fill some important needs. The pre-

eminent role of the U.S. government securities market is a significant reason why the dollar remains the world's exchange currency. We do not believe that fiscal policy decisions should be driven by capital markets concerns. However, we urge Congress to consider the effects of a shrinking Treasury securities market on the broader financial markets and the economy overall.

We again appreciate the opportunity to offer our views in the context of the Committee's hearing. We look forward to working with Committee members and staff as the debate over Treasury debt management continues.