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## **The Long-Bond Decision - Boondoggle or Smart Policy**

The 30-year bond was established in 1977 and since that time it has been a staple of United States debt financing. On October 31, 2001 Treasury Undersecretary Peter Fisher announced that the United States Government would suspend the sale of 30-year bonds (also known as the long-bond). Mr. Fisher stated, “We do not need the 30-year bond to meet the government’s current financing needs, nor those that we expect to face in coming years.”<sup>1</sup>

But why would the Treasury make such a move in uncertain economic times and with the United States in an armed conflict? The financial markets and many economists have reacted strongly to this decision. There are numerous theories and discussions that have developed out of this suspension. For the most part they have been against the Treasury.

### **History is Against Long-term Debt Manipulation**

The discussion of altering the long-term debt structure of the United States dates back to the 1960’s. President Kennedy’s administration attempted to control interest rates by instituting, what is called, operation twist. This was an attempt by Treasury to alter the interest rates by issuing a larger amount of short-term debt and then working with the Fed to make long-term debt to become scarcer. It has been generally decided that operation twist was unable to do what it was designed to do.

Fed Chairman Alan Greenspan is quoted in the December 17, 1991 FOMC Transcripts as saying “Now, what is interesting here is that there has been extensive literature on Operation Twist, and my recollection is that it is pretty mixed.”<sup>2</sup>

In fact in 1991, then Treasury Secretary Brady proposed reducing the reliance on the long bond. After a strong financial markets reaction, he retracted this idea as unreasonable. This was followed by discussion at the December 17 FOMC meeting where it was stated by Fed Governor Wayne Angell that, “... any time public officials make comments about taking away the supply of an instrument that the markets have been accustomed to using... it does seem to me a but dangerous to destroy in a sense an entire market system... That is, I think moderating supply is quite different from any discussion of taking the instrument away.”<sup>3</sup>

Yet on October 31, 2001 the Treasury did exactly that, they took away the 30-year bond. The reasons given officially by the Treasury are:

- The cost to tax payers was too high due to the high interest rates of 30-year bonds
- The Treasury does not need the funds

### **Politics in the Decision**

While the Treasury has been moving away from reliance on the 30-year bond it has not tried to manipulate markets. Based on the Treasury's suspension of the long bond, along with the emergency reopening of the 10-year bond in September, it seems pretty obvious that we are now dealing with a new era of a more activist approach to debt management.<sup>4</sup> Over the last ten years the Treasury has gone from issuing 30 year bonds from four times a year to three times to two times per year to one big issue with a small reopening to now none. Or another way too look at it, the Treasury went from using the long-bond to fund over 30% of its offering in 1986 to 9% in 1992 to a steady 5% from 1995 to present.

<b>YEAR</b>	<b>Total Notes and Bonds Issued (in \$ billions)</b>	<b>Total amount of 30-year bonds issued (in \$ billions)</b>	<b>30-year bonds as a percent of total issuance</b>
2001	273.6	15.0	5.48%
2000	269.4	15.2	5.64%
1999	362.8	20.1	5.54%
1998	437.0	30.0	6.86%
1997	537.4	30.0	5.58%
1996	571.2	32.0	5.60%
1995	497.5	11.0	2.21%
1994	503.4	22.1	4.39%
1993	486.6	28.6	5.88%
1992	465.3	40.5	8.70%
1991	427.9	46.9	10.96%
1990	310.5	41.2	13.27%
1989	277.7	38.9	14.01%
1988	243.1	26.3	10.82%
1987	147.0	32.4	22.04%
1986	109.8	34.3	31.24%

Source: Wrightson.com<sup>5</sup>

Additionally, so far this year, Treasury bought back \$32.25 billion in long-term debt (they plan on buying an additional \$1.75 billion in December) in a reverse auction and issued \$15 billion new so that net net there will be \$19 billion less debt. But as the economy soured and after the attacks on September 11<sup>th</sup>, even the Office of Management and Budget has even predicted that there would be a deficit for the next three fiscal years. The Treasury has even stated that after December 2001 it would suspend buy backs of debt until further notice.<sup>6</sup>

The thoughts of many experts are that the Treasury cut the long bond for political reasons. The Fed was lowering short-term rates but long-term rates lagged. While short-term rates may be low, to get the economy really going, you need lower low long-term rates. Simply put, the Treasury is trying to manipulate interest rates. President Bush is also well aware of the need to get the economy moving before the attention of the nation leaves the Middle East. He is all too aware that a poor economy hurt his father's presidency only ten years ago. As Bloomberg L.P. put it "Want to get those stubbornly high long-term interest rates to come down quickly? No problem. Stop selling 30-year bonds."<sup>7</sup>

But was this idea of getting interest rates down shortsighted? The answer is yes. First, there is the Pure Expectations Hypothesis that states that a multi-year bond's interest rate is the

geometric average of a series of one-year bonds over the same period of time. Thus the 5% interest on a 30-year bond today is actually the same as 30 one-year bonds averaged out for thirty years.<sup>8</sup> If this theory is true, then the cost reasoning employed in the Treasury's decision was misguided.

Further, if you look at the interest rates on the 30-year bond before and after this decision by Treasury, there was only an initial significant drop in long-term interest rates and within one month rates were actually higher than pre-announcement levels.

<b>A Look at 30-year Bond Prices and Yields Before October 30<sup>th</sup> and After</b>								
date	10/30/01		10/31/01		11/6/01		11/28/01	
	Price	Yield	Price	Yield	Price	Yield	Price	Yield
2 year	100.174	2.468	100.2	2.428	100.266	2.315	99.14	3.053
5 year	104.082	3.6	104.196	3.515	100.024	3.483	96.124	4.316
10 year	104.184	4.418	105.251	4.268	106.12	4.197	100.124	4.948
30 year	102.124	5.214	107.2	4.882	109.007	4.798	100.064	5.361
2yr/5yr spread	113.2		108.8		116.8		126.3	
5yr/10yr spread	81.8		75.3		71.4		63.2	
10yr/30yr spread	79.6		61.4		60.1		41.3	
2yr/30yr spread	274.6		245.5		248.3		230.8	

source: Dresdner, Kleinwort & Wasserstein

Technically the Treasury did accomplish the lowering of the spread between the long bond and other instruments, while the spread between the other instruments and themselves has remained fairly constant. The problem is that interest rates have gotten higher thus the Treasury's move has had the exact opposite effect from what was intended.

Is the 30-year bond's interest rate too high? Is it costing taxpayers money? According to Mr. Tony Farren, Sr VP - Dresdner, Kleinwort & Wasserstein, "Sure in a high interest rate environment there may be some validation to those statements, but these are the lowest rates in years. We haven't seen rates like these in 40 years if at all."<sup>9</sup>

What effect will this move by Treasury will have on the market? The 30-year bond only accounts for 14% of the total outstanding debt of the United States (roughly \$450 billion). The typical holders of this instrument are institutions looking to lock up capital in a risk free environment. The main reason you invest in a treasury bond is because it's a guaranteed instrument. According to Mr. Farren, "It is not that long-term rates are high, it is that short-term rates are so low. This shows the flaw in the treasury's theory because at 5% over 30 years, it is not exactly tickling any investor's fancy."

While the United States Treasury is worrying about rates that are "too high", corporate America is issuing record amounts of debt at higher rates than the long-bond. Also, from November 26 to 30, there were record amounts of short-term debt issued by the treasury \$73 billion, \$21 billion of two-year debt alone.<sup>10</sup> Most of this debt will have to be refinanced in a few months and even the two-year debt will not get to the point when the Budget Office says the next surplus will be.

## **The Real Effects on the Market**

The most peculiar point made about dropping the 30-year bond, and probably the most short sighted, is that “The 30-year bond no longer maintains a position of significance in the financial markets. Its role and its liquidity have been significantly impaired by the substantial reduction of the issuance that has occurred over the last decade. But the markets have functioned smoothly during this period while both activity and attention have shifted...”<sup>11</sup> This statement by Treasury goes back to the December 17, 1991 FOMC meeting and the comment from Fed Governor Angell that it is one thing to moderate supply and an entirely different matter to eliminate an instrument.

Additionally, \$450 billion is not an insignificant amount of money (amount of outstanding long bonds) and there is a significant market for this risk free investment.

The risk free investment provided by a 30-year bond is now in jeopardy. Every “textbook” starts with a 30-year Treasury, a risk free investment, and then adds risk for every other security. So the elimination of the 30-year bond takes away a huge risk free opportunity.<sup>12</sup> All long-term debt instruments around the world and in corporate finance are priced off the long bond. Many companies, foreign governments, insurance companies, and pension funds need long-term instruments with no risk.

When an investor is looking at long-term debt, they ask ‘where are they at spread off the long bond?’ What Mr. Fisher has done is take an established market and put a large dent in it. As Mr. Farren put it, “Even if Fisher is correct, there has been a reliable market since 1977 and Fisher is now removing it. If the US wants to be the top dog it is our RESPONSIBILITY and our OBLIGATION to provide a benchmark that the 30-year bond provides.”<sup>13</sup>

The point is that Mr. Fisher and the United States Treasury took a very narrow view in its decision to suspend the 30-year bond. If rates are so high, then why is corporate America issuing so much long-term debt of its own? Basically it is a political gimmick for the Treasury to “save the taxpayers money” by issuing short term-debt over long-term debt. Even if Mr. Fisher is correct and the cost to tax payers will be cut with the long-bonds elimination, what about the insurance companies and pension funds who utilize the long-bond to stabilize their portfolios. After September 11<sup>th</sup> there should be an even larger impetus to keep these institutions healthy. Finally, after 34 years, the United States has the responsibility to set a benchmark for others to follow. Eliminating this benchmark will only serve to hurt the United States as a financial leader.

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**ENDNOTES**

<sup>1</sup> K.N. Sundarajan, “U.S. to Stop Selling 30-year Treasury Bonds”, Bear Stearns, October 31, 2001

<sup>2</sup> Financial Markets Center – Fed Archives (FED), “FOMC Meeting Transcript 12/17/91”, [www.fmcenter.org](http://www.fmcenter.org), p.4

<sup>3</sup> Fed, p. 5

<sup>4</sup> David Greenlaw, “Bye, Bye Bond”, Morgan Stanley, New York

<sup>5</sup> Wrightson.com Treasury Notes and Bonds Issuance Summary, November 29, 2001, [www.wrightson.com/NPC/tsyauctionhist/TsySummary.htm](http://www.wrightson.com/NPC/tsyauctionhist/TsySummary.htm)

<sup>6</sup> Treasury News, “Under Secretary of the Treasury for Domestic Finance, Peter Fisher, Remarks at the November 2001 Quarterly Refunding” October 31, 2001, [www.treas.gov/press/releases/po749.htm](http://www.treas.gov/press/releases/po749.htm), p.3

<sup>7</sup> Carol Baum, “Another in a Long History of Yield Curve Fixes”, Bloomberg L.P., October 31, 2001 p. 1

<sup>8</sup> Robert Auerbach, Class notes from November 16, 2001

<sup>9</sup> Anthony T. Farren, Sr. Vice President, Dresdner, Kleinwort & Wasserstein, phone interview December 5, 2001

<sup>10</sup> Farren

<sup>11</sup> Treasury, p. 2

<sup>12</sup> Auerbach

<sup>13</sup> Farren