Informed Budgeteer

DEBT LIMBO - HOW LOW CAN YOU GO?

- About 18 months ago, a few legislative staff met with a few executive branch staff regarding debt buybacks. What were they? Why was Treasury thinking of such a program? How should they be recorded in the federal budget? The answers are now history.

- That discussion focused on the concept of a minimum debt level within a 10-year budget projection window. The big question was "How do we tell our bosses, with surplus projections this large, that you can't reduce debt held by the public to zero?" After all, many of them were out there pledging to eliminate all of the nation's debt.

- Now it seems most people are comfortable with the concept of a minimum debt level. The new question is: How much can debt be reduced over the next ten years? or put another way, what is the minimum debt level at the end of 2011?

- CBO has prepared a table showing how the various estimates of minimum debt in 2011 were derived. The OMB and CBO estimates are within a range of reasonable assumptions; the Gensler (Clinton's Treasury Undersecretary for Domestic Finance) estimate is on the far end of the low scale and requires very aggressive assumptions.

Estimates of Debt Unavailable for Redemption
$ in Billions, End of Fiscal Year 2011

	OMB Clinton Jan. 2000	OMB Bush Feb. 2001	CBO Base.	Gensler*
Bills (1 yr or less)	0	0	0	0
Notes (2-10 yrs)	140	140	22	0
Bonds (over 10 yrs)[B]	575	537	364	180-260
Index Notes & Bonds	114	113	70	0
Savings Bonds	170	170	171	185
State & local securites	131	86	144	0
Other	108	112	47	55
Total	1238	1158	818	420-500

SOURCE: CBO; OMB; Treasury; Letter from Gensler to Rep. Spratt, 2/27/01. *These calculations do not address approximately $57 billion in outstanding 30-year inflation-indexed bonds and about $22 billion in agency debt. For zero coupon bonds included in "other", only the economic value ($25 billion) is counted as debt held by the public. Incorporating these adjustments would increase the Gensler estimated by $49 billion. [B]Includes effect of assumed buybacks.

- The differences between the projections are mainly due to different assumptions regarding the maturity structure of future debt issues and the future course of debt buybacks. For example, CBO assumes that no debt with maturity of five or more years will be issued after 2002. OMB (under Clinton and Bush) assumes that no debt with maturity of five or more years will be issued after 2005. Gensler assumes that from now on, no debt with maturity of five or more years is ever issued - - Treasury has not announced such policy.

- Gensler, in a letter to Congressman Spratt, noted that Treasury can decide to discontinue issuing long term debt. He also stated that the Treasury Borrowing Advisory Committee (TBAC) voted in January to advise Treasury to discontinue long term debt issues later this year. However, according to minutes of the meeting, the TBAC had an informal vote of 11-6 for elimination of only the 30-year bond. The minutes do not reflect discussion of intermediate term debt. The TBAC refrained from issuing a formal recommendation, not a clear policy statement on which Genlser can base his heroic assumption.

- In terms of debt buybacks, CBO assumes $35 billion in buybacks in 2001 and a total of $125 billion from 2002-2011. Both OMB figures assume $35 billion in buybacks in 2001 and none thereafter. Gensler assumes nearly $350 billion in buybacks over the next decade, much higher than his fellow colleagues assumed two months earlier.

- Treasury Secretary O'Neill has made it clear that OMB's assumption of zero future buybacks does not mean no more buybacks will occur. He stated that the administration will continue the buyback program, in a prudent, sensible and clear way. Treasury is expected to announce buybacks on a quarterly basis, and will evaluate future buybacks in terms of maintaining efficient capital markets in the most cost-effective manner.

- At this point it's important to review the two types of "premiums" that the federal government must pay bondholders in order to buy back debt prior to maturity.

- There is a "market" premium when the coupon rate for a bond targeted for buyback is above current interest rates. The market premium roughly equals the present value of coupon payments over and above the current interest rates the government will no longer have to make to the bondholder, so there is no long-term net cost to the federal government. There is also a "hold-out" premium, over and above market premium, which a bondholder could demand in order to sell back his bond, which would represent a cost to the federal government.

- There have been no hold-out premiums in the buybacks conducted since March 2000. However, many have suggested that hold-out premiums may begin to appear in the next few years. Chairman Greenspan alluded to this in his testimony before SBC in January:

  "Some holders of long-term Treasury securities may be reluctant to give them up, especially those who highly value the risk-free status of those issues. Inducing such holders, including foreign holders, to willingly sell their securities prior to maturity could require paying premiums that far exceed any realistic value of retiring the debt before maturity."

- It is unlikely that Gensler's assumption about future buybacks can be achieved without considerable cost to the federal government. The initial buyback participants were most likely the least risk-averse; as buybacks proceed, it is likely that a larger share of participants will be more risk-averse, and therefore demand a hold-out premium.

SENDING PREMIUMS ABROAD?

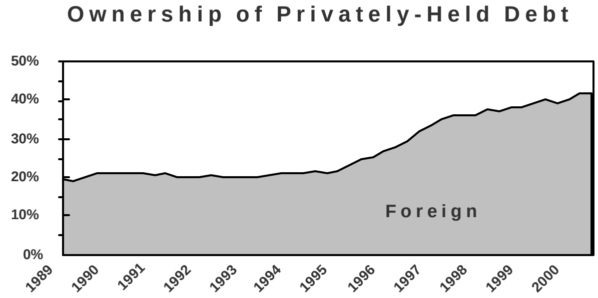
- At last week's hearing before the House Budget Committee, Federal Reserve Chairman Greenspan noted that a great deal of Treasury debt is owned by foreign central banks, foreign businesses and individuals who hold these assets because they are risk-free and dollar-denominated. Greenspan said many of these investors would be willing to hold Treasury securities at 3% annual interest or less even if they may be getting 5% interest at present. Getting them to discard these securities prior to maturity would be "extraordinarily expensive and obviously undesirable."

- As an example: an investor willing to hold a zero-coupon Treasury bond due in 10 years at 3% interest when the prevailing interest rate is 5% is, in effect, demanding a premium of at least 21%. (A zero-coupon bond with a face value of $1,000 that matures in 10 years and yields 5% per year will cost about $61. If that bond is yielding 3%, then the price is $74 -- a 21% increase.)

- Changes in the composition of privately-held debt since early 1998 show that foreign entities have held onto their Treasury securities more dearly than other bondholders. Since March 1998, privately-held debt owned by foreign investors has fallen only 2%. The domestic portion of the privately-held debt has fallen 22%.

- If foreign entities owned only a small portion of the privately-held debt this would not be a problem. However, foreign entities now own 42% of privately-held debt, up from 21% ten years ago.

Ownership of Privately-Held Debt



Source: Treasury Department

READY, FIRE, AIM

- Last week, SBC Ranking Member Conrad and his Democratic Staff rolled out "The President's Budget for FY 2002: Final Review and Analysis." Like other partisans, their "Analysis" is a stem to stern keelhauling of President Bush's 2002 budget. It leaves little room for bipartisanship. Not only is the harsh tone a disappointment; the analytical underpinnings are often deliberately fanciful.

- Much of the carping is already familiar, but this "analysis" now includes some new targets, including the President's request for National Defense, which they criticize on two fronts. The first is: "The Bush budget claims to provide a $14.2 billion increase in defense between 2001 and 2002. This is misleading, and takes credit for an increase approved during the previous administration...."(middle of page 24). Even half-asleep budgeteers will note there was no Clinton Administration budget request for 2002 – for National Defense or anything else.

- Before he left office, Secretary of Defense Cohen did write a new "Annual Report to the President and the Congress," which recommended $310 billion for the DoD in 2002. But no Presidential *budget* with these or other numbers was issued for 2002. The most recent Clinton request was submitted in January 2000; it was the 2001-2010 plan. In that, President Clinton requested $309 billion for 2002, $16 billion less than requested by President Bush.

- The creative writing exercise continues: "The President's request for overall defense in 2002 is $3.8 billion above the CBO baseline, but falls $6.3 billion below this level over the next four years." This, it is asserted, "cuts defense spending over the next four years below the level required to keep place with inflation" (page 25).

- The "proof" that the Bush National Defense budget fails to match inflation is that from 2003 to 2006 it supposedly falls below the CBO baseline. Skeptical budgeteers obviously would first want to compare the Bush defense discretionary budget to both the CBO and OMB baselines for **discretionary** spending. Such a comparison shows that in every year (2002-2006, and 2002-2011), the Bush budget **exceeds** both baselines (see table below.)

National Defense Budget Authority
$ in Billions

	Discretionary			
	Bush Budget	CBO Baseline		OMB Baseline
2001	311	311		311
2002	325	322		321
2003	333	330		330
2004	343	339		339
2005	352	347		349
2006	362	356		358
2007	372	365		368
2008	383	375		379
2009	394	385		389
2010	405	394		400
2011	416	405		412
	Total			
	Bush Budget	CBO Baseline*		OMB Baseline
		December	Interim	
2001	311	311	311	311
2002	325	321	321	321
2003	333	335	330	330
2004	342	344	339	339
2005	352	353	347	348
2006	362	363	356	358
2007	372	372	365	368
2008	382	382	375	378
2009	393	392	384	389
2010	404	403	394	400
2011	416	414	405	411

*CBO's December baseline reflected Tricare Mandatory costs in function 050, but CBO moved the costs to function 550 in the interim baseline following OMB's approach.

- In addition, the Bush defense budget exceeds the OMB baseline for total spending (discretionary plus mandatory), again in every year. Only in the case of the CBO baseline for total spending is there a difference; here the baseline is higher for the years 2003-2006. Thus, the Conrad "Analysis" selected the one of four baselines that would show President Bush's request lower, and it focused on the years in that baseline where the numbers showed the desired result.

- Inquisitive budgeteers would have questioned why the CBO baseline for total spending departed from the pattern of all the other evidence. The answer: this one baseline exceeded the Bush National Defense budget for reasons that had nothing to do with inflation. Basically, in December, CBO temporarily put into its defense baseline for the years 2003-2011 over $60 billion in direct spending for the "Tricare for Life" program enacted last fall for military retirees.

- This temporary functional presentation awaited OMB's official determination on where to display such spending. OMB has since decided it should be in the Health (550) budget function and moved it there in its own baseline and budget policy numbers. The authors of the "Final Review and Analysis" knew of this shift based on the scorekeeping meetings held in January that included CBO, OMB, and the majority and minority staff of the budget committees.

- As always, CBO will follow OMB on functional presentation, and CBO's baseline will be adjusted accordingly. It too will show the same thing as the other three baselines: that the Bush defense budget is **not** "below the level required to keep pace with inflation."

- Defense analysts jokingly refer to misdirected, reckless attacks as "ready, fire, aim." The assault on the Bush defense budget in the "Final Review and Analysis" would seem to merit this moniker.

BUDGET QUIZ

Question: Even though there is room under the FY 2001 discretionary spending limit, why will 60-votes still be necessary to pass any supplemental appropriations legislation this spring?

Answer: FY 2001 Foreign Operations and Related Agencies Appropriations Act set discretionary spending limits to $637 billion in BA and $613 billion in OT. The Foreign Operations bill also included a 0.5 % adjustment to BA for "rounding" -- $3.188 billion more in BA. The final OMB Sequestration Report for FY 2001 shows that appropriations to date are $6.545 billion under these final limits.

Total Discretionary Spending- FY2001
$ in billions

	BA
Total Discretionary Enacted	634.26
Final Sequestration Report Discretionary Limits*	640.80
Difference	-6.54

- However, discretionary spending is not just governed by the caps. It must also fit within the aggregates and allocations set out in the most recent budget resolution. Under the FY 2001 budget resolution, spending to date has already exceeded the 311 aggregates by $33.9 billion in BA. Although the caps were raised beyond the limits in the budget resolution, there is no authority for the 302(a) allocation to the Appropriations Committee to be increased beyond the resolution's limits.

- *Result:* supplemental appropriations for FY 2001 must be declared an "emergency" to avoid a 60-vote point of order under section 302 or 311 of the Budget Act. Remember also that the emergency designation for non-defense spending would have a 60-vote point of order under section 205 of the FY 2001 budget resolution.

Senate Budget Committee Hearing Schedule

March 14: Administration's FY 2002 Budget; Witness: Secretary of State, Colin Powell. Dirksen 608; 10 am.