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The bottomless government market

The decline of the government bond market is now self-feeding.

None of the Carter administration's talk of budget cuts, credit controls, and other last ditch "anti-inflation" measures can do a thing to stem the collapse of U.S. government bond prices in the estimation of veteran analysts.

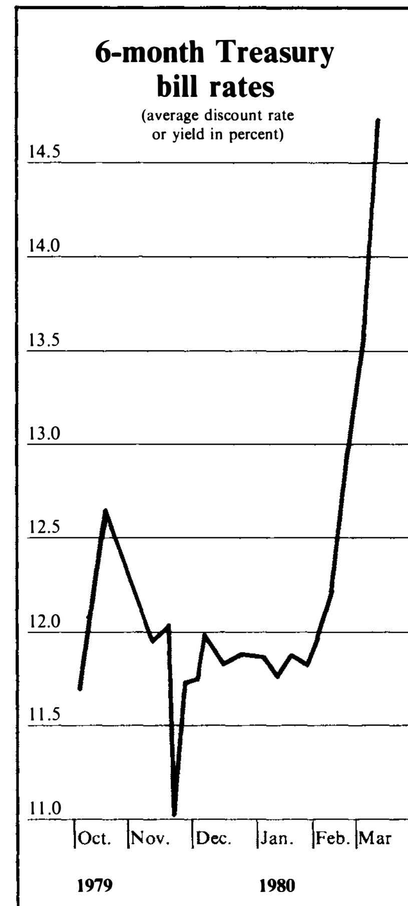
In a recent interview Joseph Bench, economist for First Pennsylvania Bank, pointed out that for every one percent increase in the Treasury bill rate, the Treasury's interest costs rise $4 billion, given that around half of the Treasury's debt must be refinanced over the next year. Bench pointed out that the interest rate assumptions programmed into the fiscal 1981 budget are four percent below current Treasury bill rates, which means that an additional deficit of $16 billion lies hidden in that budget.

The current round of turmoil in the government debt market,which produced yields in excess of 15 percent on three-month Treasury bills on March 3, was triggered by the release of the fiscal 1981 budget by President Carter in late January. Subsequent news that the inflation rate is now running at 19 percent annually has fueled the collapse in bond prices. Every economic initiative adopted by the administration—high interest rates, the hike in defense spending, and disincentives for oil, gas and nuclear energy production—has aggravated the interest rates-chasing-inflation spiral.

Last October, following Volcker's credit tightening measures, Treasury bill rates broke through 10 percent for the first time in U.S. financial history. In late February, they reached 13 percent and, at the March 3 auction, six-month Treasury bills were sold at an average discount of 14.792 percent and three-month bills at a rate of 15.136 percent.

The yields on U.S. government debt have served to attract international capital back to the U.S. dollar, which has led to the recent strengthening of the U.S. currency out of all proportion to U.S. economic "fundamentals." But the relative firming of the dollar has in turn placed the Treasury in a no-win situation.

The major new factor in the collapse of U.S. government bond prices was the liquidation of Treasury bills by foreign central banks. On March 3 and 4, the Federal Reserve sold $1 billion per day for customer accounts, reportedly of the central banks of Japan, West Germany, Switzerland, and Britain, all of whom were conducting large support operations for their currencies. These foreign Treasury bill sales coincided with an especially large sale of new bills by the Treasury—$11.6 billion within two days—and caused rates to jump into the 15 percent area. The further rise in Treasury yields in turn put more pressure on the yen and other foreign currencies, forcing a further liquidation of Treasury bills by the foreign central banks and so the cycle continues.



Dr. Griggs, economist of Schröder Bank in New York, noted in an interview that though the liquidation of Treasury bills by foreigners was large in recent days, they were noticeably smaller than the size of the currency support operations. On March 3 and 4 the support operations were averaging in the $1.5 to $2 billion per day. This led Dr. Griggs to suspect either the Fed was absorbing bills for its own account or the Bank of Japan was already drawing very heavily on its $5 billion swap line with the U.S. Treasury, which was activated in emergency meetings on March 2. Of course, this process also boosts the world supply of dollars, the implication being more inflation and yet higher U.S. interest rates.

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