

## Week 5 Learning Objectives

- Understand the US Treasury Market
- Understand the market for State and local debt and the differences from Federal debt.
- Understand the differences between US debt and the debt of other nations.



## Week 5 Lecture - Government Debt

This week we discuss the markets for government debt. There is no doubt that these markets will be saturated with new issues as both federal and state governments are running deficits that will need to be financed. We will separate this discussion into two parts; the first is federal debt, the second municipal debt.

### Part One Federal Debt



UNITED STATES  
DEPARTMENT OF  
THE TREASURY



The US treasury market is formed by bills, notes and bonds and is the benchmark for interest rates for all other securities. They are issued on a competitive auction basis and their secondary market is over the counter (OTC). Agency securities are issued by both federally sponsored and federally owned agencies, which issue their own debt to obtain financing from the Federal Financing Bank. It should be noted that securities issued by government sponsored agencies are not the same as federally owned agencies. The sponsored agencies are not “guaranteed” by the federal government. However because it is extremely unlikely that the government will abandon these agencies when problems arise, they still command a high price and provide low yields.



Treasury securities are back by the “full faith and credit of the US Government.” This means in essence that they are “guaranteed.” But it is wise to recognize they are only as good as our government and its position in the world. Another way to look at this is the events that would cause our Government to default on the debt would be so catastrophic any worries about loss of principal that is invested in treasuries would be moot.

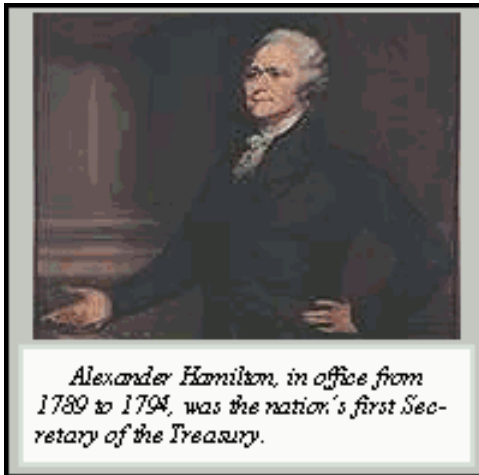
But having no credit risk, doesn't mean they don't have risk. There is certainly the risk of interest rate changes and inflation losses. The interest rates could rise after a purchase causing the selling price to be lower than what was originally paid. Also,



holding long term bonds at relatively low rates of return provides for the potential of not keeping up with inflation.

Having said that US Treasuries are very prevalent in the world. The US Government is the largest issuer of debt in the world so the volume and liquidity is high. Interest income is subject to federal taxes but exempt from state and local taxes.

There are four types of Treasuries as your text points out. They are T-Bills, notes, bonds and TIPS. The difference in the first three is basically the term. TIPS (Treasury Inflation Protected Securities) were developed to offset the risk associated with not keeping pace with inflation.



*Alexander Hamilton, in office from 1789 to 1794, was the nation's first Secretary of the Treasury.*

Your text covers the Primary and Secondary market, bid and offer quotes, repo's and regulation of the secondary market. Also it mentions Strips. The Stripping process separates the coupon from the principal payment resulting in coupon strips and principal strips.

Other agencies can offer securities as well. Sallie Mae is an example of a federally sponsored enterprise (student loans) that issue securities. There is some credit risk with these type of securities resulting in a higher yield. But since it is widely thought that the government will rescue the enterprise in the event of financial troubles, the risk

premium is very low.

Federally related agencies that are government owned borrow from the Federal Finance Bank, which consolidates their issues and in turn borrows from the US Treasury.

Finally the US Government isn't the only government to issue debt. Other nations also issue debt backed by their own government's "full faith and credit." Of course other less credit worthy government also borrow money as we have seen a number of government defaults. This weeks discussion question will go further into this using Brazil as an example.



## Part Two Municipal Debt

Municipal securities are called Munies and are issued by state and local governments. There are several types and several risk associated with municipal bonds. Your text

provides a solid overview of this sector of the financial markets. Obviously, one of the significant differences between Munies and Treasuries is the credit rating of the insurer. The federal government is considered to be just about “risk free” where as Munies have credit risk and ratings. There have been defaults in some Munies but they are rare.

Munies are sold originally in a primary market through investment or commercial banks and then can be resold in the secondary market. They provide tax savings to investors and no final value to a given investor can be determined without taking into account the tax savings.