Hamilton's debt reorganization

The infant U.S. government faced enormous debt problems in 1790, which were solved by Hamilton's brilliant approach.

In attempting to solve the budget problems of the United States government by cutting everything but debt service, President Reagan is ignoring one of the fundamental principles established by the first Treasury Secretary of this country, Alexander Hamilton.

It is true that Reagan is faced with a huge problem—a debt inflated by Federal Reserve chairman Paul Volcker to the gargantuan size of $165 billion in debt service per year, on top of a depleted real economy. Pressures on Reagan not to touch this $165 billion item are immense from the foreign, as well as domestic, banking community.

But the problem faced by Alexander Hamilton in taking over the Treasury in 1789 was even larger. At that time, the federal government had not paid any of its interest payments to foreigners, or domestic lenders, for seven years, much less principal!

As for the foreign debt—money which was owed in return for supplies or for salaries—it amounted to $11.7 million. The domestic debt, including arrears, amounted to $40.4 million—loaned for the war from individuals or private institutions. An additional $25 million was owed by the federal government to state governments.

The interest rate on most of these loans was 6%. Thus Hamilton calculated that the annual interest bill alone on just the foreign and domestic debt amounted to slightly more than $4.5 million. This sum literally dwarfed the size of the federal government's operating budget—which was a mere $600,000 a year!

What principles did Hamilton rely on to solve what appears to be an impossible problem?

First, he had to face the fact that the new Constitution committed the country to honor its debts. As the Constitution said, "All debts contracted and engagements entered into before the adoption of that Constitution shall be valid against the United States under it, as under the confederation."

Hamilton had no personal problems with this commitment. As he said in his 1790 *Report on Public Credit,* he believed that a stable and adequate means had to be found to pay the debt. But not all at once, on the creditors' terms! Hamilton rather proposed to turn the debt into long-term bonds, making provision for new lower interest rates and simultaneously creating a fund that could be used for the most important national objective—the promotion of the creation of wealth.

Hamilton's purposes in proposing to fund the debt demonstrate the objectives which he felt management of the Treasury should be guided by:

"First. Trade is extended by it; because there is a larger capital to carry it on, and the merchant can at the same time, afford to trade for smaller profits; as his stock, which, when unemployed, brings him in an interest from the government, serves him also as money, when he has a call for it in his commercial operations.

"Secondly. Agriculture and manufactures are also promoted by it: For the like reason, that more capital can be commanded to be employed in both; and because the merchant, whose enterprise in foreign trade, gives to them activity and extension, has greater means for enterprise.

"Thirdly. The interest of money will be lowered by it; for this is always in a ratio, to the quantity of money, and to the quickness of circulation. This circumstances will enable both the public and individuals to borrow on easer and cheaper term.

"And from the combination of these effects, addition aids will be furnished to labour, to industry, and to arts of every kind."

In other words, Hamilton argued that to pay all the debt, including arrears, as a priority would destroy the industrial and agricultural health of the nation!

Hamilton's alternative was straight forward. He first proposed that only the interest be paid, following the conversion of the debt into bonds.

Second, he insisted that the interest rate of 6% be reduced to 4%!

It was Hamilton's strong conviction that the "market" interest rate for the debt would eventually fall anyway. He was convinced of this because he was sure that his policies for improving the real wealth of the country through promoting industry and agriculture would make bidding for the bonds extremely competitive, and bring the rate down.

But Hamilton was not about to let the United States go bankrupt while waiting for this to happen. Rather, he unilaterally lowered the rate of interest to 4%!

The debt service per year was lowered to $2.2 million immediately.

To be continued.