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Remarks at the Federal Reserve Bank of New York's Annual Primary Dealer Meeting

Brian Smith

U.S. DEPARTMENT OF THE TREASURY

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Brian Smith, Deputy Assistant Secretary for Federal Finance, U.S. Department of the Treasury

INTRODUCTION

Good afternoon and thank you for having me here today. I am Brian Smith, the Deputy Assistant Secretary for Federal Finance at the Treasury Department. In that role, I oversee Treasury's Office of Debt Management. We appreciate the opportunity each year to speak at this meeting and to share some of Treasury's priorities. While we meet bilaterally with primary dealer representatives as part of the quarterly refunding process, this meeting is a unique opportunity to engage with the entire primary dealer community all at once. These engagements are invaluable, whether in person or virtually, and I look forward to meeting with each of you again in person, when we're able to do so.

Primary dealers, as part of their relationship with the Federal Reserve Bank of New York, play a significant role in underwriting Treasury's securities issuance.

Primary dealers also provide liquidity to investors in the secondary market. We are always happy to reiterate that the Treasury market remains the deepest and most liquid market in the world. This is in no small part due to the important role that you, as primary dealers, play in intermediating flows between Treasury and investors. This model has been in place for decades, and we believe it remains as important as ever. In calendar year (CY) 2020, Treasury held more than 500 auctions for approximately $20 trillion of securities, raising more than $4 trillion of net new cash. Over 90 percent of the Treasury securities we auctioned were either awarded to primary dealers directly or facilitated by primary dealers through indirect awards. Even in the face of disruptions from the pandemic, including the unexpected shift to the work-from-home environment, you continued to support our auctions, allowing the process of raising unprecedented sums for the pandemic response to run smoothly.

As we continue in 2021 with record auction sizes to finance the government's response to COVID-19, your continued commitment to supporting the auction process and Treasury's robust financing mechanism is vital. In addition to your support for the auction process, we also appreciate the market intelligence and feedback about debt management issues that we receive from your organizations. Engagement with market participants, especially the primary dealers, is more critical than ever in this unprecedented environment.

Today, I want to discuss ongoing policy matters related to the Treasury market. It goes without saying that the COVID-19 outbreak was a tremendous shock to the global economy and financial markets. Even in the Treasury market, the deepest and most liquid market in the world, market functioning and liquidity were challenged. The Federal Reserve System responded swiftly and substantially to address those market stresses. In addition, the government's fiscal response to the outbreak dramatically increased the size and uncertainty of Treasury's borrowing needs. These events over the last year continue to affect our policy decisions today.

I would like to use our time together today to focus on two topics: (1) first, Treasury secondary market trading conditions following the COVID-19 outbreak, and (2) second, Treasury's response to increased borrowing needs due to the pandemic. For each of these topics, I will first review what happened and then discuss potential next steps.

(1) TREASURY MARKET CONDITIONS FOLLOWING COVID-19

Turning first to Treasury market conditions, the disruption to the Treasury market in March 2020 has been well-documented, including in the Financial Stability Oversight Council's (FSOC) 2020 annual report[1]. While I certainly hope the events of last year are unique, it is important that market participants, policymakers, and academics continue to study these events and consider ways to enhance the resilience of the Treasury market going forward. A well-functioning and liquid Treasury market reduces Treasury's borrowing costs and is critical to the broader financial system, given the many vital roles that Treasury securities play.

The sequence of events last year proved to be a "perfect storm" for the Treasury market and resulted in a notable disruption to market functioning and liquidity. Concerns about the spread of COVID-19 prompted flight-to-safety behavior, a sharp decline in Treasury yields, and a strong preference for cash and Treasury bills that temporarily drove bill yields negative. Investors also began selling their off-the-run Treasury holdings to raise liquidity. The selling was broad-based and continued over several days.

As this was happening, intermediaries had difficulty meeting the increased demand for liquidity. The massive increase in trading volumes and price volatility, combined with internal risk limits and potential balance sheet constraints, challenged broker-dealers' ability to respond to the "dash for cash." In addition, principal trading firms pulled back their provision of liquidity amid the elevated market volatility. As a result, bid-ask spreads widened and market depth dropped, with the greatest stress in long-maturity, off-the-run securities. It's worth noting that throughout the extraordinary volatility, the Treasury market was open and trading at record volumes.

In response to this perfect storm of events, the Federal Reserve System reacted swiftly and conducted record open-market operations to promote smooth market functioning[2].

This sequence of the events, which many of you helped us understand, has raised questions about the resilience of intermediation in the Treasury market during periods of market stress. As Secretary Yellen highlighted at the FSOC meeting last week, last year's disruption warrants a broad, interagency effort to analyze the key causes of the events and to consider ways to enhance Treasury market resilience. As part of this effort, Treasury, in conjunction with our Inter-Agency Working Group for Treasury Market Surveillance (IAWG) partners[3], has identified five primary areas for further study, and related questions that will inform our analysis:

(1) Improving data quality and availability. What data gaps still remain? Could improved data provide better insight into vulnerabilities or benefit assessment of future episodes of market stress?

(2) Improving resilience of market intermediation. Why did electronic order book liquidity deteriorate? Why was dealer liquidity provision not sufficient to intermediate customer flows? Could changes to regulation promote more resilient liquidity provision during future periods of market stress?

(3) Evaluating expanded central clearing. To what extent would expanded central clearing promote or inhibit liquidity provision and healthy market functioning in both normal and stress periods? How would different types of market participants react? Would central clearing lead to broader changes that could promote market liquidity? How would expanded central clearing affect systemic risk?

(4) Enhancing trading venue transparency and oversight. Are major government securities trading platforms appropriately regulated, and do market participants have sufficient information about their operations and policies? To what extent do practices such as circuit breakers and margin changes mitigate or exacerbate volatility?

(5) Examining effects of leverage and fund liquidity risk management practices. To what extent did sales by leveraged investors or open-end funds exacerbate market stress? What policies should be considered in light of the "dash for cash" dynamic?

These five areas of focus are multifaceted, and the IAWG plans to take a comprehensive and collaborative approach to exploring them and evaluating potential next steps. We hope that these efforts will complement the work of the FSOC on open-end mutual funds and hedge funds as well as align with the broad agenda laid out by the Financial Stability Board regarding core bond markets and nonbank financial intermediation.

(2) TREASURY'S RESPONSE TO INCREASED BORROWING NEEDS

Let me now turn to Treasury's financing decisions during the pandemic. The Federal Government's fiscal response to COVID-19 dramatically increased the size and uncertainty of Treasury's borrowing needs. In FY2020, the deficit increased over $2 trillion to around $3.1 trillion, and, based on your responses to our survey in February, the FY2021 deficit is expected to increase to $3.2 trillion. To meet these unprecedented borrowing needs, Treasury has dramatically increased bill issuance, consistent with our longstanding approach of using bills as a shock absorber to meet unexpected or seasonal fluctuations in borrowing needs.

From March to June 2020, the amount of bills outstanding nearly doubled from $2.6 to $5.1 trillion. This required increasing benchmark bill auction sizes to record levels and issuing a regular cadence of cash management bills (CMBs). The CMBs were auctioned weekly in conjunction with benchmark bills and had maturity cycles on either Tuesdays or Thursdays in order to minimize interest costs, improve bill liquidity, and smooth cash flows and maturity profiles. The benchmark bill and CMB auctions were met with robust demand, aided by the demand surge for bills, as I noted earlier.

While bill issuance met our initial borrowing needs, Treasury also increased auction sizes across all nominal coupon tenors and floating rate notes at the May, August, and November quarterly refundings in order to manage our maturity profile and to limit potential future issuance volatility. This approach of an initial surge in bill issuance followed by gradual terming out is consistent with the debt management response to the 2008 financial crisis. Despite the extreme volatility in the secondary market during the peak of the pandemic, coupon auctions went smoothly – many participants pointed to the predictability of auctions and liquidity of on-the-runs as the key drivers.

We also conducted our first auction of the re-introduced 20-year bond last May. While we announced our intention to issue the 20-year bond in January, prior to the crisis, the timing was fortuitous, and highlighted the important value of maintaining flexibility to expand financing if needed. Given our increased borrowing needs and efforts to term out, we auctioned $20 billion of the new issue in May, compared to market expectations of around $14 billion. The initial and subsequent auctions of the 20-year bond have gone smoothly, and we have been satisfied with the developing secondary market liquidity of this benchmark. We expect liquidity to continue to improve as the market further adopts the 20-year bond for a variety of uses, akin to our other benchmarks.

Turning to TIPS, we did not initially increase TIPS issuance last year, which was consistent with past practice for significant issuance increases. As a result, the share of TIPS outstanding as a percentage of total marketable debt outstanding fell from 9 to 7.5 percent over CY2020. At the November quarterly refunding, to continue the financing shift from bills to coupons and in light of healthy demand and liquidity, we announced plans to increase total gross issuance of TIPS by $10 to $20 billion in CY2021. Market participants generally agreed with our decision to begin increasing TIPS auction sizes because of the important role TIPS play in the Treasury product suite, the improvement in TIPS liquidity relative to the early days of the pandemic, and the economic rebound supporting TIPS demand.

The increases in auction sizes enabled us to meet Treasury's extraordinary borrowing needs and also helped build Treasury's cash balance during these highly uncertain times. To be clear, Treasury's cash balance policy, which was instituted in 2015 and dictates that Treasury hold a level of cash generally sufficient to cover one week of outflows subject to a $150 billion minimum, remains unchanged. This policy is motivated by prudent risk management and seeks to ensure that Treasury has sufficient cash to meet near-term obligations even if our market access is temporarily disrupted. While the events of 2020 did not disrupt our market access, they are certainly a reminder of the importance of being prepared for the unexpected.

Given the unprecedented size of near-term projected outflows and the critical importance of having funds immediately available for the government's response to the pandemic, we increased the cash balance to record levels in 2020. The size of the cash balance also reflected an abundance of caution due to the considerable uncertainty around the timing of substantial outflows. For instance, there has been significant uncertainty around the pace of outflows from certain programs (such as the Paycheck Protection Program), as well as around tax receipts given the economic environment and changes in tax filing deadlines. A higher cash balance also allowed Treasury to make more gradual adjustments to bill auction sizes, limiting unnecessary supply volatility.

Turning to our most recent policy decisions at the February quarterly refunding meeting and where we stand today: While Treasury continues to face significant and uncertain borrowing needs, the substantial increase in coupon auction sizes over the last year has created sufficient capacity to address near-term borrowing needs and flexibility to react to new developments. As a result, we kept nominal coupon auctions sizes unchanged this quarter, while continuing gradual increases in TIPS auction sizes.

These current coupon auction sizes have allowed us to gradually reduce bills as a percentage of Treasury debt outstanding in a manner that is consistent with recommendations made by the Treasury Borrowing Advisory Committee. In February, we modified our CMB issuance by ceasing two of the four regularly issued CMBs, while also noting we may increase the auction size of one or more of our remaining bill offerings to moderate the pace of the decline. Indeed, last month we partially offset the weekly decline in bill supply by modestly increasing the 6- and 17-week CMBs, as well as auction sizes across the weekly benchmark bills.

Going forward, changes in bill issuance and the size of the cash balance will continue to depend on the size and uncertainty of potential outflows. In recent months we have been able to reduce the level of the cash balance and make significant outlays related to the American Rescue Plan (ARP) and the relief programs enacted into law in December. In our February borrowing estimates, before we knew the final details regarding the size and timing of expenditures associated with the ARP, we assumed an end-of-March cash balance of $800 billion and end-of-June cash balance of $500 billion. We finished March with a cash balance of $1.1 trillion, highlighting the challenge of operating in an environment of such significant uncertainty. Despite the higher-than-assumed end-of-March cash balance, we still intend to gradually reduce the cash balance consistent with the guidance at the last quarterly refunding. In fact, since the end of March the cash balance has already fallen by about $200 billion. I would like to emphasize that we are highly attentive to how our bill issuance and cash balance decisions affect money market trading conditions, and we will take these sensitivities into account when making our decisions.

CONCLUSION

In conclusion, thank you again for all that you do to support the U.S. Treasury market. Your commitment in helping Treasury finance the government through the auction process is incredibly important during these unprecedented times. Let me stress that there is still a lot more work to do to understand potential vulnerabilities to Treasury market resilience, and we will continue to incorporate your input into our analysis. I look forward to our future discussions and I hope to meet again in person soon. Thank you.

[1] 2020 Annual Report, FSOC.

[2] Logan, Lorie K. (2020). The Federal Reserve's Market Functioning Purchases: From Supporting to Sustaining, speech delivered at the SIFMA webinar, July 15, 2020.

[3] The IAWG members are the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, the Federal Reserve Bank of New York, the Securities and Exchange Commission, and the U.S. Department of the Treasury.