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Karthik Ramanathan

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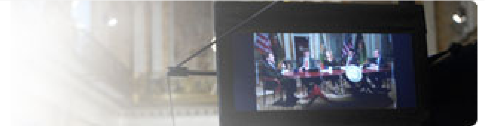

Acting Assistant Secretary for Financial Markets Karthik Ramanathan Update on Financial Markets and Treasury Fiscal Outlook

12/10/2008

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New York - Good afternoon. I'd like to thank you for this opportunity to discuss financial markets, the fiscal outlook, and what recent trends may mean for debt management. The Treasury market is the deepest, most liquid market in the world, and to maintain this status, we act in a highly transparent manner and in a way that avoids disruptions to the financial markets. As major participants in the market for Treasury securities, you need to understand our objectives and constraints as you evaluate the investment outlook. As a result, I believe our discussion will be mutually beneficial.

Without a doubt, the economic and financial landscape is evolving rapidly. In just the past four months, events have come to pass that few could have anticipated or even imagined. The Treasury began investing in Agency MBS and making investments in financial institutions. The Federal Housing Finance Agency, a newly formed and better equipped regulator, placed Freddie Mac and Fannie Mae under conservatorship. The Federal Reserve introduced a series of innovative lending and asset purchase programs while aggressively easing monetary policy. The last remaining investment banks have become bank holding companies. And, the FDIC has initiated a temporary liquidity guarantee for new bank-issued debt. Together, these events have resulted in the provision of various explicit and "effective" government guarantees for a large cross section of the United States domestic debt market.

These developments have directly affected Treasury's borrowing needs as well. The fiscal stimulus payments distributed earlier this year along with other actions to aid credit markets and promote economic recovery have added to our borrowing needs in a compressed period of time. In addition, the slowing economy and potential responses to this downturn will cause the government's borrowing needs to increase further.

The Office of Management and Budget (OMB) deficit estimate for fiscal year 2009 was $488 billion in mid-July, very similar to private sector estimates at the time. In February 2009, OMB will release the Annual Budget with the Administration's revised fiscal year 2009 deficit forecast as well as the five year outlook. In the meantime, private sector estimates of the budget deficit have risen given the possibility of further economic deterioration and subsequent spending on economic recovery programs.

While there is generally variation in market participants' deficit estimates, this year the range is wider than in recent years. At this point, most estimates fall within a $500 billion range – nearly the size of last year's entire deficit. More importantly to investors, estimates of net marketable borrowing vary commensurately. Recent market estimates have suggested $1.5 trillion in net marketable borrowing in fiscal year 2009, with some raising the possibility of net marketable borrowing in excess of $2 trillion. While this uncertainty remains, it is our responsibility as debt managers to as transparently as possible meet these borrowing needs in the least disruptive manner.

We have responded to the increases in the government's borrowing needs in a traditional yet aggressive manner, following our principles of first increasing issuance sizes, then considering changes in frequency, and finally, considering additions to the auction calendar. This past year, we significantly increased issuance sizes of regular bills and coupons and increased issuance of cash management bills, some long-dated, to bridge low points in our cash balance. In June, we resumed issuing a monthly 52-week bill.

In addition, to address evolving challenges in a clear yet timely manner, we have issued statements regarding debt management decisions between quarterly refundings. For example, in early October, after passage of the Emergency Economic Stabilization Act, we alerted the market that we were considering significant changes to the offering calendar, including a reintroduction of the 3-year note in November.

Just two days later, Treasury took the extraordinary step of announcing the unexpected, off-cycle reopening of four off-the-run 10-year notes. This action provided needed funds while also helping to clear the unprecedented volume of settlement fails in the Treasury financing market. The subsequent November quarterly refunding statement made clear that unscheduled reopenings would remain the exception, as they are in general contrary to Treasury's policy of regular and predictable issuance.

The statement also made evident that further improvements in resolving settlement fails would have to derive from private sector changes to trading conventions; otherwise, regulatory measures would need to be considered. Since that time, fails to deliver have declined from nearly $800 billion to less than $150 billion – a massive reduction in a very short period of time and another sign of increased efficiencies in our debt markets.

At the November refunding, we reintroduced the 3-year note to be issued on a monthly basis, added a regular second reopening of the 10-year note, and switched to quarterly new issue 30-year bonds. We also stated that we would continue to monitor projected financing needs and make adjustments as necessary, including, but not limited to, the reintroduction or establishment of other benchmark securities.

Marketable borrowing needs of $1.5 trillion can be managed with traditional approaches: increasing issuance sizes and frequencies, issuing cash management bills to bridge low points in our cash balance, and adding or reintroducing securities as necessary. Nonetheless, given the broad range of deficit estimates, Treasury needs to be prepared to meet additional financing needs if necessary. This challenge may require novel approaches to debt management. Should new approaches be adopted, Treasury would continue to strive for transparency and predictability, communicating any changes in as cogent and unambiguous a way as possible.

Market participants have proposed several ideas for addressing significant growth in net marketable borrowing needs. Some of the more conventional approaches include issuing a 7-year note on either a quarterly or monthly basis, potentially as early as February, and reopening the quarterly new issue 30-year bonds. More generally, extending the average length of the debt, given the current cyclical and future secular shifts in borrowing needs, has been suggested. While proposals such as the introduction of longer dated bonds have been raised, we need to be cognizant of the limited capacity to raise funds from such instruments and the ability of the market to effectively digest the risk inherent in the types of securities.

Other ideas that have been suggested to Treasury include introducing additional cycles of existing maturity debt such as bi-monthly 52-week bills, 2-year notes or 5-year notes. Debt repurchases for cash management purposes and a regular schedule of off-cycle reopenings of longer-dated securities have also been suggested and continue to be reviewed.

Treasury debt management requires constant reevaluation of our issuance calendar and available tools as we seek to finance the government's expenditures at the lowest cost of financing over time. However, we do not time the markets. We issue debt in both a low and high interest rate environment which helps keep the market for Treasury securities deep and liquid and enables us to attract capital in even the most challenging financial market conditions. This certainty of supply results in a premium for Treasury securities which in turn reduces our borrowing costs over time.

Increasing demand for Treasuries has been aided by the decline in risk appetite by both traditional and non-traditional Treasury market participants and thus far the increase in Treasury issuance has been easily absorbed. The growth of Treasury and government-guaranteed debt will act as a catalyst for the return of smooth functioning credit markets and economic recovery, both of which will gain momentum as risk appetite returns.

As we move forward in thinking about how to potentially raise a significant amount of debt over a relatively short period of time, we recognize that we may need to progress beyond the conventional means of the past, particularly if our borrowing needs do indeed reach the upper end of market estimates. Nonetheless, as we continue to issue debt to finance the government's initiatives to facilitate credit market and economic recovery, we must remain aware of the possibility of a rapid increase in risk appetite if the economic outlook becomes less negative, as well as any structural shifts in the economy.

At the same, we will need to be mindful of the effects any decisions may have on the volatility of our cash balances and the maturity structure of the debt, and uncertainty surrounding the fiscal outlook. We encourage market participants and others to share their ideas and suggestions with us regarding how Treasury might most appropriately raise the funds necessary, given the constraints and uncertainty we face.

Thank you.

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