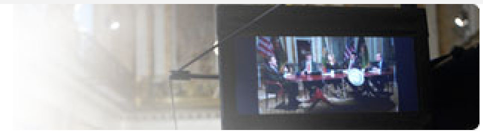
U.S. DEPARTMENT OF THE TREASURY

Press Center



Acting Assistant Secretary for Financial Markets Karthik Ramanathan Remarks to the CFA Institute's Fixed-Income Management 2009 Conference

10/1/2009

TG-305

Boston, MA
As Prepared for Delivery

Good morning.   It is a pleasure to be in Boston. I appreciate your invitation to address the Fixed-Income Management 2009 Conference to discuss the United States Treasury market. Today I would like to touch on the steps Treasury took to meet the challenges of the past year, the outlook for Treasury financing going forward, and the skills that financial market professionals may need to meet the challenges of the future.

Many of you are holders of the prestigious Chartered Financial Analyst (CFA) designation. Your skills as portfolio managers, investment officers, and analysts are among the finest in the profession. The mission underlying the designation – to set the highest standards of ethics, education, and professional excellence – is in great demand as markets and practices rapidly evolve. As a member of this group of professionals, your opinions and input are greatly appreciated during this critical period to ensure that public policy and financial market functioning strike the right balance.

The Fiscal Year Past and Our Strategic Outlook

The 2009 fiscal year just ended yesterday which makes our discussion particularly timely. In the course of 291 auctions in 251 business days, Treasury issued nearly $7 trillion in gross Treasury marketable securities to raise approximately $1.7 trillion to finance the government. Treasury accomplished this feat in the face of volatile financial markets in which equity markets both fell and rose sharply, credit spreads widened dramatically before reversing direction and investor sentiment and risk appetite widely fluctuated. Treasury managed its debt issuance to stabilize the banking sector and temper the economic downturn while at the same time financing the routine needs of the federal government.

The ability of the United States to attract capital from domestic and international investors encompassing both the official and private sectors despite these economic and financial market conditions is testimony to the unparalleled breadth and liquidity of the Treasury market. Even as many other credit, equity, and derivative markets faced extreme dislocations, with some effectively coming to a standstill on several occasions, the Treasury market remained open for business. Despite the skepticism of many critics, investors in the end determined that Treasuries offered a measure of liquidity and safety unmatched by any other asset class.

While the numbers associated with our borrowing are large on a nominal basis, and the frequency of our auctions has increased, they must be evaluated in context. Treasury's initial response to address the aggressive financial and fiscal stability measures was to ramp up bill issuance. Treasury addresses unexpected borrowing needs through the short end of the curve. Because of these needs, over the past year Treasury bills outstanding have averaged about $2 trillion, up from an average of $1.2 trillion over the past five years. Recognizing that a transition would be required from such financing, we complemented the swift and large increases in bill issuance with gradual increases in coupon securities and the addition of other nominal instruments.

Going forward, we expect to continue to incrementally and gradually increase nominal coupon issuance over the next nine months to extend the average maturity of the overall marketable debt portfolio. Indeed, given structural changes in the deficit, the average maturity of the debt is expected to stabilize at six to seven years, levels that exceed the historic average of five years. Such shifts in the overall Treasury portfolio would bring short term bill levels closer to historical averages while stabilizing coupon issuance by the middle of 2010.

Why are we making these changes and extending the average maturity of the marketable debt portfolio? Extending the average length at this time to bear the brunt of longer term structural shifts in the deficit while increasing capacity in the front end of the curve to address unexpected borrowing needs is prudent. While asset liability management is not readily applicable to Treasury's debt portfolio, understanding our future borrowing needs and preparing in advance makes sense.

We also expect to increase issuance of inflation- indexed securities to meet our additional financing needs. Investors with whom we have spoken anticipate increased demand for Treasury Inflation Protected Securities (TIPS) given the uncertainty surrounding economic growth and the inflation outlook. To better improve investor access to TIPS while potentially capturing a higher inflation premium, Treasury is considering extending the maturity of the longest dated TIPS by shifting issuance from 20-year TIPS to 30-year TIPS. We are also considering other measures which may improve liquidity in these securities.

Over the past year, the increase in coupon auctions across a limited number of business days has at times created uncertainty regarding Treasury's regular bill issuance. Often, we have had to reschedule bill auctions to 11:30 a.m. from 1:00 p.m. to accommodate securities added to the auction calendar, potentially creating uncertainty for investors. Given the frequency with which we have had to reschedule these auctions, an alternative idea that may be considered is moving all Treasury bill auctions to a consistent time such as 11:30 a.m. Such realignment may increase transparency while making our auction calendar more regular and predictable.

Of course, any changes in debt management policy, be it a shift to a 30-year TIPS or a shift in Treasury bill auction times, will be based on our analysis and the advice we receive from the private sector as well as our Treasury Borrowing Advisory Committee. As usual, any decisions will be announced through our quarterly refunding process.

Looking ahead, Treasury's potential borrowing needs – and the uncertainty surrounding such forecasts - will remain high in the medium term. In late August, the Office of Management and Budget (OMB) released its updated budget forecasts in its Mid-Session Review. In its assessment, OMB stated that while real GDP is expected to decline by 2.8 percent this year, it is expected to increase by 2.0 percent in 2010, and the recovery is projected to proceed more rapidly from 2011 to 2014. The shifts we are making in our portfolio will accommodate these forecasts and also take into consideration any potential deviations from this path.

Critical to future fiscal deficits and financing needs will be the funding requirements of entitlement programs such as Medicare, Medicaid, and Social Security. It is clear that secular financing needs for entitlement spending will become more of a concern over the longer-term unless action is taken, not only for the United States but for many other developed countries.

The United States has demonstrated a commitment to reforming these future liabilities and will take the lead in making the necessary transformations to entitlement programs. Indeed, Congress is currently engaged in a serious debate over health care reform. Given global demographic trends and their implications for sovereign debt markets, changes to our entitlement programs will lead investors to realize that medium term financing increases may lay the ground for longer-term fiscal stability – and a more attractive investment landscape.

Despite large increases in issuance, Treasury retains a high degree of flexibility in meeting unexpected changes to the government's financing needs. This flexibility is to a large degree a result of our practice of regular and predictable issuance. We communicate transparently and regularly with the market regarding any changes to the government's borrowing needs. We do not act opportunistically, nor do we time the market. Instead, Treasury issues debt in all interest rate environments to achieve our goal of lowest cost financing over time.

The Preeminent Role of Treasuries

We are confident that the unique characteristics of our sovereign debt market will continue to make Treasury securities a staple of investors' portfolios. Specifically, the unparalleled access to liquidity makes Treasuries preferable to many other instruments, particularly in the midst of uncertainty. In addition, the decline in issuance of high quality credit instruments and the desire to recapitalize balance sheets will continue to make Treasuries an attractive asset class. Indeed, the results we have seen in our Treasury auctions over the past fiscal year have been positive. While interest rate volatility surrounding any given auction can occur due to many market factors, the underlying trends have been encouraging from a participation and demand perceptive.

At Treasury, we constantly strive to broaden our investor base, and as we have seen in the past, we will continue to see shifts in demand over time. These shifts generally occur in a gradual, rational manner, with reductions in demand by any segment ultimately being replaced by other sources of demand. For example, various domestic investors, including households and community banks in the United States have materialized as yet another source of demand for Treasuries. Essentially, trends in demand are not linear in nature, and interpolating such trends or reversals in trends can be misleading.

At the same time, while we enjoy the deepest, most liquid sovereign debt market in the world, we do not take that standing for granted – we are always striving to enhance our products and broaden our investor community and we support private-sector efforts that further that goal. Measures that improve access to the Treasury market through increased participation in other tangential markets be it the repurchase markets or the futures markets, are welcomed.

The smooth functioning of the repo market, swaps market, and futures market is important because it bolsters the attractiveness of the cash market and also contributes to a lower cost of financing for Treasury. Conversely, dislocations in these markets could diminish the efficiency of the primary Treasury market and potentially increase the cost of financing the overall debt.

For example, widespread settlement failures to deliver in the Treasury repurchase, or "repo," market in the fall of 2008 impacted the attractiveness of Treasury securities as evidenced by a sharp decline in transactions in the Treasury cash market. This market dislocation subsequently impacted trading volumes in the Treasury futures and swaps markets, and gradually impacted other important markets in which Treasuries are used as a hedging instrument.

As settlement failures reached a peak of over $2.5 trillion in October 2008, Treasury debt managers made the decision to hold $40 billion in unscheduled or "snap" reopenings in some of the most severely affected failing securities issues. This decision was made to not only facilitate the settlement of failing repo trades but also to address our growing borrowing needs. As a result of these actions, fails levels dropped precipitously, and the functioning of critical segments of the fixed income markets resumed.

Soon after the reopening auctions, private Treasury market participants, led by the Treasury Market Practices Group (TMPG), began in earnest to identify trading practices to reduce the incidence of such disruptions. Subsequently, several practices were adopted, most notably, the institution of a fails charge of up to 300 basis points to penalize certain delivery failures. The price discovery roles of the cash, financing, and futures markets help to produce fair prices and liquid markets for Treasuries. This role will continue, and we are confident that the steps taken by the private sector will strengthen the mechanism for managing interest rate risk.

In the case of the dislocations in the Treasury repo market, the combination of sound debt management decisions and the development of this innovative private sector practice resulted in improved repo market clearing, better pricing information and liquidity. Since the beginning of the year, transaction volumes have stabilized and are gradually trending upward. A resilient and robust repo market is critical to Treasury's ability to continue to attract domestic and international capital and to lower our financing costs.

Other developments have also boosted the attractiveness of the Treasury market. The launch of the 3-year Treasury note futures contract by Chicago Mercantile Exchange in March 2009 filled another part of the interest rate curve and improved liquidity for all sectors of the Treasury market. The announcement of a Long-Term "Ultra-Long" U.S. Treasury Bond futures contract, set to launch in January 2010, will potentially relieve stresses in longer dated swaps resulting from liability driven investments. The potential for additional products, such as a 7-year Treasury note futures contract or an inflation-linked futures contract, also bodes well for the interest rate futures markets and provides investors with even more alternatives to hedge risk.

While the Treasury market's functioning is important, so is that of other major financial markets. Over the past six months, Treasury and the Administration have proposed a comprehensive set of measures that will make our overall financial markets even more attractive. For example, the reforms to the supervisory and regulatory structure that have been proposed by the Administration will result in more transparent financial markets and restore investor confidence.

Treasury is committed to building a new foundation for financial regulation and supervision, comprehensive monitoring of financial markets, and the protection of consumers and investors. Additional financial crisis management tools, improved international regulatory standards, and better international coordination will also reaffirm confidence in our financial markets.

The regulatory measures under consideration will impact nearly every aspect of the financial system, from the over-the-counter derivatives markets to counterparty risk management to central clearinghouses to capital standards. While many of these ideas have been raised in Washington in the past, never has such an important, serious effort from so many components of the public and private sectors come together to strike the right balance.

The New Generation of Financial Professionals

We meet here in October 2009 with a renewed sense of optimism and confidence. At the same time, there is still much work to do, and complacency is not an option. The theme of this year's conference, "Rebuild Everything," certainly captures the fervor in capitals around the world to address these complex issues. In the United States, members of Congress will debate the framework for a financial system based on new rules and regulations to prevent or mitigate future crises. One of the most important components of this process is you.

As various policies are contemplated and debated, your roles as stewards of industry will be critical. It is my belief that one result of the crises will be the skill set for financial professionals will change and expand. Portfolio managers will need to establish additional metrics which emphasize fundamental credit analysis rather than relying purely on services provided by credit rating agencies. Chief Investment Officers will need to evaluate public policy initiatives and regulatory decisions to a much greater degree to determine the optimal corporate cash management strategy, executive compensation practices, and capital structures which incentivizes prudent risk taking.

Investment Committees will need to consider their fiduciary responsibilities to an even greater extent when making allocation decisions such as inflation protection and external asset management. "Financial Engineers" will give way to "Financial Partners" able to offer advice and possibly structure future public private partnerships to perhaps address major issues such as entitlements, pension fund restructurings, and longer term fiscal policy.

Over the past two years, I have had the opportunity to work with some of the brightest, hardest working financial professionals and public policy officials across the world. The issues which faced Treasury and our nation, be it the structured investment vehicle sector, the asset backed commercial paper market, the money market mutual fund industry, or the investments made into the banking system through the Troubled Asset Relief Program, all demanded and will continue to demand the exceptional talent of individuals From the private sector.

Moreover, be it central bank reserve managers, fixed income traders, mutual fund managers or civil servants, the best in breed have always been able to not only identify potential issues well in advance of others, but more importantly also offer potential solutions. At times, these discussions have taken place under intense time constraints and enormous market disruption, and at other times, they have simply been part of an ongoing dialogue. Regardless, these individuals parlay their market expertise beyond their traditional objectives of profit to focus on the much larger issues affecting all market participants, and at times, the overall financial system.

The work and dedication of such professionals have contributed to the progress we have made to date. This will not be the last time such dialogue will be needed, and I encourage you to offer your expertise and propose solutions whenever practical. Rather than offering criticism for a particular approach, offer alternatives bearing in mind the constraints which policy makers in Washington face. As we confront challenges in the years to come, be it addressing our large borrowing needs or reforming the health care system or implementing a comprehensive set of regulatory reforms, your expertise will be actively sought.

The Role of the Private and Public Sector Going Forward

Thank you for inviting me to speak here today. Your opinions are valued by Treasury as we work to establish the next path in financial market regulation. We appreciate the opportunities to communicate with you in forums like this, and value market participants' efforts to educate and inform Congress, regulators, press, and the general public about the fixed-income markets. It is encouraging to see the responsibility is borne by both the public and private sectors. Let me assure you that as economic and financial market conditions vary, Treasury will strive to remain a fixture for stability and a driver of change.

###