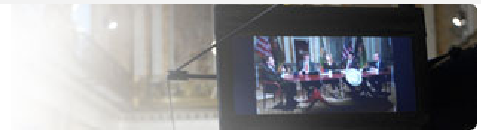
U.S. DEPARTMENT OF THE TREASURY

## Press Center



# November 2014 Quarterly Refunding Report to the Secretary of Treasury

11/5/2014

November 4, 2014

Letter to the Secretary

Dear Mr. Secretary:

Since the Committee last met in early August, the economic expansion has remained vigorous, with overall real GDP expanding at a 3.5% annual rate in the third quarter. The first half gyrations in growth have given way to a steadier pace more recently, and most available indicators from October suggest that the momentum of economic activity remained favorable early in the fourth quarter. The specter of a global growth slowdown has loomed over the US economic outlook, although recently, somewhat more favorable data from key trading partners has helped to partly alleviate financial market concerns about the spillover to domestic economic performance. While the strengthening dollar does provide a headwind for US exporters, the decline in petroleum prices entails significant near-term support for consumer purchasing power. On balance, most forecasters continue to expect domestic resilience and look for above-trend growth in the medium-term.

Real consumer spending has expanded at a modest pace lately, increasing at a 1.8% annual rate in the third quarter. Consumer spending on goods rose at a respectable 3.1% rate, while service spending growth continues to be lackluster, expanding at only a 1.1% rate last quarter. Consumer spending on services accounts for 45% of GDP, and the persistent weakness in this category is a major reason why the overall contour of the expansion has been disappointing.

Overall real business investment spending rose at a solid 5.5% annual rate last quarter. Business spending on equipment rose at a 7.2% rate. Spending on industrial equipment continues to grow nicely, while business tech spending remains a weak link and is basically flat on a year-ago basis. Business construction spending was up at a 3.7% rate, while outlays for intellectual property products rose 4.2%. Inventory investment slowed to a $63 billion annual pace, subtracting 0.6 percentage point from GDP growth last quarter.

The recovery in the housing market has been uneven in recent months. Home sales generally have tended to drift higher, although surveys of builders and realtors have indicated only halting growth in prospective demand. Housing starts and permits have drifted sideways in recent months, consistent with the modest 1.9% annual rate of increase in real residential investment in the third quarter.

Real government spending increased at a 4.6% rate last quarter, the fastest pace since the Recovery Act boosted spending growth in the second quarter of 2009. The gain was led by a 16.0% gain in the volatile defense spending series, which may have been related to operations in the Middle East. State and local government spending increased at a 1.3% rate and has increased in most quarters over the past two years, a marked shift from the 2009-2012 period when this sector presented a persistent drag to overall economic performance.

Foreign trade added 1.3 percentage points to GDP growth last quarter, as gross exports increased at a solid 7.8% rate, while imports posted a rare decline, contracting at a 1.7% rate. The recent increase in the broad, trade-weighted dollar has yet to have a visible impact on survey-based measures of export orders, yet some slowing in export growth seems likely in coming quarters.

Labor market activity has remained robust; over the last three months, nonfarm employment has increased by an average of 224,000 per month. Over that same period, the unemployment rate has declined another 0.3 percentage point to 5.9% in September, and the U-6 measure of labor market underutilization has fallen by the same amount. Most measures of wage growth remain muted, though there has been a modest acceleration recently in the broad Employment Cost Index, which increased 0.7% in the third quarter and is up 2.2% over the past year.

Consumer price inflation has been quite soft recently, reflecting in part a decline in energy prices. Total personal consumption expenditure (PCE) prices increased at only a 1.2% pace in the third quarter, as consumer energy prices contracted at a 4.0% rate. However, even the core PCE measure – which excludes food and energy prices – has been tame recently. The core measure increased at a 1.4% rate in the third quarter, and in September stood only 1.5% above its year-ago level. The stronger dollar should restrain import prices in the near-term, which will add downward pressure to core goods prices. Even so, steadier service prices and modestly firming wages should limit deflationary concerns.

At its most recent meeting, the FOMC decided to complete the latest asset purchase program, sometimes known as QE3. Forward guidance on the expected path of interest rates has remained steady. The interest rate projections released at the September FOMC meeting continue to point to a likely beginning of interest rate normalization sometime next year. The October FOMC meeting did not produce new forecasts, but the statement indicated continued approval with the recovery in the jobs market and only limited concern about downside inflation risk.

Against this improved economic backdrop, the Committee's first charge was to examine whether adjustments to the Treasury's debt issuance schedule were warranted in light of current and projected funding needs. To inform this discussion, Treasury provided the Committee with the attached presentation on the fiscal outlook, receipts and outlays, financing projections and auction demand. Given the improved fiscal outlook and projected surplus funding in FY 2015, the Committee recommended that the current funding schedule be reduced moderately, through a modest reduction in 2 and 3-year note issuance, consistent with the reductions that occurred in FY 2014. One consideration behind this recommendation was to avoid a further reduction in Bill issuance, which currently represents a historically low share of outstanding debt at 11% of total. Members noted that this recommendation would support the orderly function of the short-term funding markets given the increasing demand for high-quality liquid assets. The Committee recommended that the Treasury reconsider its funding schedule in the coming quarters, especially in light of increasing borrowing needs in 2016 and beyond. The Committee reiterated its recommendation that the Treasury increase its structural cash balance, on the order of $500 billion, to mitigate operational risk. Given the progress made to date in extending the weighted-average maturity of outstanding Treasury debt, members recommended that the Committee study the projected average maturity and the pace of increase in the WAM were the Treasury to maintain current issuance patterns.

Next, the discussion turned to the intra-day market volatility that ensued in the Treasury cash and futures markets and other financial markets on October 15, 2014. Committee members cited a variety of views about the factors that contributed to the market volatility but ultimately agreed that it was a confluence of events. First, there was an apparent simultaneous pull back in risk tolerance possibly due to one or a combination of the following reasons: geopolitical tensions, uncertainty regarding Federal Reserve monetary policy, fears regarding the Ebola virus, the potential effects of the significant drop in energy prices, and slowing economic growth outside the United States. Second, given changes to market regulation and to market structure, the ability and willingness of intermediaries to make markets was significantly diminished. Third, the increased volatility and uncertainty led to an unwind of crowded leveraged trades. Fourth, members discussed the possibility of algorithmic trading exacerbating the price changes. It was agreed that further research is warranted, as the risk of future flash price adjustments exists and needs to be better understood.

The Committee's second charge was to provide an update on the trends in student loan markets over the past several years, and the potential implications for Treasury financing needs. Two members provided a brief history of student lending environment, including an update to the trends discussed in the July 2012 TBAC presentation. The attached presentation discussed default trends and their implications, factors contributing to growth in the direct student lending program, potential reform proposals, and the implications for Treasury funding under various scenarios. Since the passing of the Student Aid and Fiscal Responsibility Act of 2010, all federal student loans are made directly by the Department of Education and funded by the US Treasury. The total balance of student loans is $1.3 trillion as of Q2 2014 and the federal government represents 85% of origination volume. For a variety of reasons, loan growth is increasing and default rates are high and rising. In addition to the current

CBO scoring methodology, members stated that future projected cost trends should include other factors such as market risks, demographics trends, increasing demand for higher education, and policy proposals to address the rising debt burden, including lowering the loan rate, extending repayment timeline and forgiving loans under various circumstances. Offsetting factors could include policies to reduce the pace of origination such as qualification requirements for higher education institutions, especially for profit institutions with low graduation rates, or the potential for improved servicing results. For illustrative purposes only, as detailed micro data is needed to do so accurately, the members simulated a range of direct student loan balances that could result in a large increase in financing by the Treasury. Members recommended that future Committee analysis focus on developing an asset liability framework for funding the growing direct student lending program.

Respectfully,

_______________________ _______________________

Dana M. Emery Curtis Arledge
Chairman Vice Chairman

TBAC Recommended Financing Table Q1 2015 & TBAC Recommended Financing Table Q4 2014