Report to the Secretary of the Treasury from the Treasury Borrowing Advisory Committee

May 5, 2021

May 4, 2021

Letter to the Secretary

Dear Madam Secretary:

Economic activity rose strongly in the first quarter of 2021, with a 6.4% annualized increase in real GDP. Since the Committee last met, further fiscal support, rapid vaccination that has now reached more than half of American adults, and a recovery in the sectors of the economy most affected by the virus have contributed to an acceleration in economic activity and employment.

The course of the virus and further progress on vaccination will continue to influence the trajectory of the economy. But the economic situation of last April, when GDP had fallen an estimated 15% below the pre-pandemic level and the unemployment rate stood at the highest level since the Great Depression, increasingly feels like a long time ago in a galaxy far, far away.

Since the last refunding, the Federal Open Market Committee (FOMC) maintained the target range for the federal funds rate at the effective lower bound of 0%-0.25%. Financial conditions have remained easy overall since the Committee last met. Equity prices rose by roughly 10%, and the trade-weighted dollar declined by roughly 1%. The 2-year Treasury yield rose by 5 basis points and the 10-year Treasury yield rose by 50 basis points.

Consumer spending rose at a 10.7% annualized rate in the first quarter, a sharp acceleration from the 2.3% annualized increase in the fourth quarter of 2020. Durable goods spending increased at a 41.4% annualized rate and nondurable goods spending rose at a 14.4% rate, while services spending increased at a 4.6% rate. The recovery in consumer spending has varied widely by industry. Overall goods spending was 12.5% above year-ago levels in the first quarter, but services spending remained 3.3% below year-ago levels. The slower recovery in services reflects continued weakness in sectors requiring face-to-face contact such as transportation, recreation, and food services.

Business fixed investment increased at a 9.9% annualized rate in the first quarter and is now 2.7% above year-ago levels. Structures investment declined for the sixth consecutive quarter at a 4.8% rate, equipment investment rose at a 16.7% rate, and investment in intellectual products increased at a 10.1% rate. The change in inventory investment subtracted 2.6 percentage points from GDP growth in the first quarter. Regional and national manufacturing surveys have reported sharp increases in the level of activity through April. The Federal Reserve's Beige Book also indicated that manufacturing activity continued to recover in almost all Districts.

Residential investment rose at a 10.8% annualized rate after surging at a 36.6% rate in the prior quarter and is now 12.3% above the year-ago level. New and existing home sales, housing starts, and building permits have all surpassed their pre-virus levels in recent months. Surveys continue to show very high levels of optimism among home builders, and mortgage rates remain at low levels and should continue to support the housing sector.

Net exports subtracted 0.9pp from real GDP growth in the first quarter. Real exports declined at a 1.1% annualized rate while real imports increased at a 5.7% annualized rate, following sharp increases in both in the second half of 2020. Federal spending rose at an 13.8% annualized rate in the first quarter, while state and local spending rose at a 1.7% rate.

The labor market improved rapidly in the first quarter. Nonfarm payrolls increased by 916k in March, including a 280k increase in the leisure and hospitality sector. The unemployment rate declined to 6.0%, while the broader U6 underemployment rate fell by 0.4pp to 10.7%. The labor force participation rose 0.1pp to 61.5% in March, and the employment-to-population ratio rose by 0.2pp to 57.8%.

Consumer price inflation has risen in recent months, driven in part by higher energy prices and large price increases in some virus-sensitive sectors. The total personal consumption expenditures price index increased at a 3.5% annualized rate in the first quarter, while the core measure excluding food and energy increased at a 2.3% rate. The core measure rose 1.5% over the last four quarters, well below the Federal Reserve's 2% target. The rate of change over the last year is likely to jump sharply in the second quarter, reflecting the comparison with large price declines at the outset of the pandemic. Strong demand and supply chain disruptions, including a shortage of semiconductors, are likely to put upward pressure on inflation this year.

The federal budget deficit was $1.1 trillion in the first quarter of 2021, up from the previous quarter. The deficit is set to remain elevated following passage of the roughly $1.9 trillion American Rescue Plan Act in March. The White House has since introduced two additional plans, the American Jobs Plan and the American Families Plan, that aim to increase spending on infrastructure, manufacturing and R&D incentives, and social benefits as well as increase corporate and individual taxes.

The FOMC kept the funds rate at the effective lower bound at its March and April meetings and has not yet indicated any intention to begin tapering its asset purchases, which continue at a pace of $120 billion per month. At the March meeting, FOMC participants made changes to their interest rate projections. The median participant projected no change in the funds rate through the end of 2023, but seven participants showed at least one rate hike by 2023.

In light of this financial and economic backdrop, the Committee reviewed Treasury's May 2021 Quarterly Refunding Presentation to the TBAC. Through Q2 of FY 2021, receipts were $1.74 trillion (6%) higher than the same period in 2020. Total outlays over the same period were $3.41 trillion, an increase of 45% relative to the comparable period in 2020, mainly due to recent legislation. Q2 FY21 outlays were 30.6% of GDP, compared to 22.4% of GDP for Q2 FY20. Based on the Quarterly Borrowing Estimate, Treasury's Office of Fiscal Projections currently projects a net privately-held marketable borrowing1 need of $463 billion for Q3 FY 2021, with an end-of-June cash balance of $800 billion. For Q4 FY 2021, the net privately-held marketable borrowing need is estimated to be $821 billion, with a cash balance of $750 billion at the end of September. Both of these estimates do not include any assumption for additional legislation that may be passed.

The Committee noted Treasury's cash balance had reduced significantly, dropping below $1 trillion, as Treasury used those balances to meet some of its need for funds over the period. Treasury noted that it is projecting a cash balance of $450 billion at the end of the debt limit suspension on July 31st, based on expected outflows under its cash management policies and consistent with its authorities and obligations, including the Bipartisan Budget Act of 2019. The Committee was encouraged that the cash balance in this scenario would remain larger than many market participants had expected, and that it would be in line with Treasury's normal cash management approach (including holding a balance generally sufficient to cover one week of outflows). Nonetheless, elevated risks of volatility in money markets remain as this date approaches and Treasury bills outstanding decline. TBAC strongly urges Congress to suspend or raise the debt limit in a timely manner.

The Committee discussed financing strategies to accommodate the higher financing needs from the American Rescue Plan Act and the uncertain fiscal needs from additional fiscal proposals. The Committee noted that prior increases in coupon issuance will continue to result in sizable net funding to Treasury going forward. Maintaining current auction sizes for nominal coupon securities would result in a higher level of net funding than needed in coming years, requiring Treasury to reduce the outstanding stock of Treasury bills to levels below the TBAC's prior recommended range of 15-20% of outstanding debt. Thus, the Committee anticipates that Treasury may want to reduce nominal coupon sizes beginning late this year or early next year. Additionally, Committee members recognize that a wide range of funding needs are possible and that information about both fiscal and economic outcomes in coming quarters would affect these decisions.

Committee members noted that pressure on the 20-year bond observed since the last refunding had made it a somewhat more expensive funding point for Treasury. Members believe this outcome was partly driven by the earlier increases in auction sizes of the 20-year bond to levels above what TBAC had recommended. Accordingly, members agree that the supply of 20-year bonds relative to other coupon issues should be reduced modestly. However, given Treasury's regular and predictable issuance strategy, expected fiscal needs, and the likelihood of broader coupon reductions late this or early next year, the majority of Committee members feel that any such adjustment should take place at a later time and in the context of broader reductions. Thus, the Committee recommends maintaining the sizes of nominal coupon securities for the current quarter.

The Committee further recommends ongoing moderate increases in TIPS issue sizes. Given the meaningful increases in nominal debt issuance in 2020, TIPS share of outstanding debt has fallen to 7.5% from around 9% in the pre-COVID period. The Committee is supportive of $1 to $2 billion increases in TIPS auction sizes over time, with larger increased in the 5-year sector, to gradually move TIPS share of debt outstanding in the direction of pre-COVID levels, while monitoring market functioning and the relative valuation of TIPS to nominal securities as this adjustment takes place.

Further, the Committee recommends that Treasury issue a 1-year SOFR-based FRN and commit to an inaugural issue in 2021. Members believe that this FRN will be an effective funding instrument for the Treasury. In addition, it would benefit the transition of market instruments away from LIBOR and towards SOFR as the benchmark short-term rate.

Overall, the recommended path of auction sizes for the current and next quarter should allow Treasury to meet its financing needs in an efficient manner while maintaining flexibility to accommodate further meaningful funding needs should they arise. Over a longer horizon, we recommend an issuance path that would lengthen the average maturity of Treasury debt to above its historical range; gradually reduce the share of debt maturing within one, three, and five years; leave the T-bill share of outstanding debt on a general downward trajectory, leveling out within the recommended 15% to 20% range; and gradually increase the share of TIPS in outstanding debt. Of course, given the considerable uncertainty surrounding current fiscal projections, the economy, and the Fed's balance sheet policy, Treasury will need to retain flexibility in its approach.

Finally, the Committee reviewed a charge on recent Treasury market liquidity in times of stress. The presenter highlighted four recent episodes – the flash rally in 2014, repo spike in 2019, COVID crisis in 2020, and a few days in February 2021 – during which market functioning came under pressure. Each of these episodes highlights that the Treasury market, which in normal times is the deepest and most liquid securities market in the world, can be vulnerable to stress. The presenter reviewed several proposals to enhance market functioning, including a standing repo facility, adjustments to regulatory capital rules (namely SLR and Tier 1 leverage), mandatory clearing, and enhanced reporting, among others. The discussion focused on two of the proposals that were seen as particularly appealing -- the standing repo facility and adjustments to the leverage requirements that could enhance intermediaries' ability to expand balance sheets in times of stress. The Committee highlighted the tremendous importance of maintaining effective market functioning and sound liquidity conditions in the Treasury market, and it emphasized the importance of considering the impact of any proposals during both normal and stressed market conditions.

Respectfully,

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Beth Hammack

Chair, Treasury Borrowing Advisory Committee

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Brian Sack

Vice Chair, Treasury Borrowing Advisory Committee

1It was noted that privately-held net marketable borrowing excludes rollovers of Treasury securities and Treasury Bills held in the Federal Reserve's System Open Market Account (SOMA). Secondary market purchases of Treasury securities by SOMA do not directly change net privately-held marketable borrowing, but when they mature would increase the amount of cash raised for a given privately-held auction size by increasing the SOMA "add-on" amount.