Report to the Secretary of the Treasury from the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association

August 4, 2021

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Letter to the Secretary

Dear Madam Secretary:

Economic activity rose in the second quarter of 2021, with a 6.5% annualized increase in real GDP. Strong consumer spending and recovery in the sectors of the economy most affected by the virus have contributed to an acceleration in economic activity and employment. Around 70% of American adults have now received at least one dose of a vaccine, which has allowed a considerable amount of renormalization of economic activity. However, the sharp increase in new COVID cases in recent weeks driven by the spread of the Delta variant presents a downside risk to the outlook.

The robust recovery of economic activity has led to considerable improvement in labor market conditions. Nonfarm payrolls increased by 850k in June, including a 343k increase in the leisure and hospitality sector. The unemployment rate increased slightly in June to 5.9%, but the broader U6 underemployment rate fell by 0.4 pp to 9.8%. The labor force participation rate stayed at 61.6% in June, and the employment-to-population ratio remained at 58%.

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 6.4% annualized rate in the second quarter, while the core measure excluding food and energy increased at a 6.1% rate. The core measure rose 3.4% over the last four quarters, above the Federal Reserve’s 2% target, reflecting both the comparison with large price declines at the outset of the pandemic and the impact of supply chain disruptions in the auto industry and elsewhere.

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 6%, and the trade-weighted dollar rose by 0.3%. The 2-year Treasury yield rose by 3 basis points to 0.19% and the 10-year Treasury yield declined by 41 basis points to 1.28%.

Given accommodative financial conditions, supportive fiscal policy, ongoing normalization of activity, and high accumulated savings by households, the economy appears poised for continued above-trend growth and ongoing improvements in labor market conditions. The FOMC maintained its accommodative policy stance, including the pace of its purchases of Treasury and mortgage-backed securities. Its policy guidance indicates that the current pace of those purchases ($120 billion per month) will be maintained until “substantial further progress” is made towards its economic objectives. The FOMC has begun a discussion on assessing that progress, but it has not yet indicated any intention to begin tapering its asset purchases.

In light of this financial and economic backdrop, the Committee reviewed Treasury’s August 2021 Quarterly Refunding Presentation to the TBAC. Through Q3 of FY 2021, receipts were $3.1 trillion, which is 35% higher than the same period in 2020. Total outlays over the same period were $5.3 trillion, an increase of 6% relative to the comparable period in 2020, mainly due to Economic Impact Payments and other tax credits. Q3 FY21 outlays were 31.4% of GDP, compared to 31.8% of GDP for Q3 FY20. Based on the Quarterly Borrowing Estimate, Treasury’s Office of Fiscal Projections currently projects a net privately-held marketable borrowing1 need of $673 billion for Q4 FY 2021, with an end-of-September cash balance of $750 billion, which assumes that any debt ceiling issues are resolved. For Q1 FY 2022, the net privately-held marketable borrowing need is estimated to be $703 billion, with a cash balance of $800 billion at the end of December. Both of these estimates do not include any assumption for additional legislation that may be passed.

The Committee noted Treasury’s cash balance had declined significantly to $459 billion as the debt limit suspension period ended on July 31st. The Committee acknowledged that Treasury has a short and uncertain window during which extraordinary measures can be used to continue funding the government. The efforts to address the expiration of the debt limit suspension could, in some scenarios, cause the outstanding stock of bills and Treasury’s cash balance to decline to undesirable levels. Abrupt declines in bills outstanding, reductions in cash balances below Treasury’s prudent policy level, and any

broader uncertainty about Treasury's funding capacity are detrimental to the Treasury market and should be avoided. The Committee believes that discussions of fiscal responsibility are more appropriately considered when making appropriations rather than when funding previously approved appropriations. This episode marks the expiration of the seventh debt limit suspension since February 2013, and the Committee believes that allowing these episodes to occur, given the challenges that they pose for Treasury market functioning, is a reckless and inappropriate approach to managing fiscal policy issues.

The first charge that the Committee reviewed explored the appropriate adjustments to Treasury issuance in upcoming quarters in light of current fiscal forecasts. The presenting member relied on a participant model to review several scenarios with the goals of maintaining a regular and predictable issuance pattern and keeping the T-bill share of total outstanding debt between TBAC's recommended range of 15% and 20%. The member noted that, under a variety of assumptions, maintaining the current coupon auction sizes would result in a T-bill share that would fall to near zero by 2026, highlighting the degree of overfunding under current auction sizes. The member ran two more plausible scenarios as a baseline for the discussion. In the first scenario, the member reduced coupon auctions pro-rata to maintain T-bill share in the target range throughout, which required cuts to auction sizes of 35% over calendar year 2022, bringing them largely in line with pre-COVID levels. The second baseline scenario limited that adjustment to 25% for the purpose of imposing more stability in the auction sizes of coupon securities over a longer horizon, knowing that auction sizes will eventually have to move higher again five to ten years ahead. However, that alternative requires the T-bill share to drop modestly below the recommended range for a number of years.

The Committee discussed the meaning of regular and predictable and whether it involves smoothing expected auction sizes over such a long horizon. Most members agreed that, the regular and predictable approach is meant to encourage gradual, deliberate, and transparent changes in issuance over time, rather than trying to maintain auction sizes over a multi-year horizon. This interpretation allows debt issuance to adjust over time, which is seen as desirable given the variation in funding needs and the inherent uncertainty in fiscal and economic outcomes.

The member next considered an alternative scenario that reduced sectors that have seen more limited market demand. The member then considered two additional scenarios relative to that one that involved changes to the maturity structure of the debt: one that also

increased the belly share, and one that increased long end issuance. Members saw these scenarios as illustrative for highlighting the trade-offs that the Treasury would face going forward.

In considering the path of auctions going forward, committee members unanimously favored proportionately larger declines in 7-year and 20-year securities. In particular, the group noted that coupon auction sizes have increased roughly 50% since January of 2020, with the exception of the 7-year note, which has nearly doubled, and the 20-year bond, which saw its inaugural issuance in May of 2020 and was subsequently increased a further 30% within six months, leaving it well above the size recommended by TBAC.

Given the current fiscal and economic outlook, the Committee strongly supports coupon reductions beginning at the November refunding. The Committee estimates that beginning the adjustment in November rather than waiting until the February 2022 refunding results in about a $350 billion reduction in the amount of coupon debt outstanding, allowing the Treasury to maintain more T-bill supply for a given amount of coupon cuts. For November, the Committee recommends reductions of 2-, 3-, and 5-year securities by $2 billion per month. The Committee also recommends reductions of the 10-year security by $3 billion, and the 30-year security by $2 billion for both new issues and reopenings in the quarter. For 7-year and 20-year securities, the Committee recommends declines of $3 billion and $4 billion, respectively2, which are somewhat larger than the declines in surrounding securities. It was expected that, based on current fiscal and economic projections, these cuts would need to be sustained over a few quarters in order to maintain T-bills in the recommended range of 15 to 20% of total debt outstanding over time. However, the Committee recognizes that a wide range of funding needs are possible and that Treasury would need to adapt issuance plans based on incoming information over time. The group acknowledged that while these reductions are sizeable, the gradual pace of the adjustment and the advance signaling of these changes would be generally in line with Treasury's approach of regular and predictable issuance.

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 around 7.5% from around 9% in the pre-COVID period. The Committee is supportive of continued increases in TIPS auction sizes for some time but acknowledged more work was needed to validate a specific recommendation on the TIPS share that should ultimately be reached.

The Committee continues to recommend that Treasury issue a 1-year SOFR-based FRN. 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, this issuance path would lengthen the average maturity of Treasury debt and the average duration of debt to above their historical ranges; 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 reviewing money market fund (MMF) reform options outlined by the President's Working Group on Financial Markets (PWG). The presenter reviewed how 2014 MMF reform had increased the weekly liquid assets (WLA) at MMFs, but also instituted rules for imposing fees and gates in the case WLA dropped below predetermined thresholds. The presenter expected many of the PWG reform options would be effective in improving the resilience of MMFs, including weakening links between WLA and fees/gates, reforming conditions for imposing gates, and greater standardization of funds. The presenter also noted that several proposals, such as capital buffers, minimum balance at risk, and sponsor support requirements, would likely reduce the benefits of MMFs and hasten their end. In fact, several MMF complexes eliminated their prime funds as early as July of 2020, with little to no disruption in the markets. The presenter questioned the benefit, particularly in the current low rate environment, of prime funds as compared against the broader financial stability risks they pose.

Respectfully,

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Beth Hammack

Chair, Treasury Borrowing Advisory Committee

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Brian Sack

Vice Chair, Treasury Borrowing Advisory Committee

[1]It 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.

[2]Recommended 7- year reductions are $3 billion monthly and $4 billion to each 20-year new-issue and reopening in the quarter. Please see recommended refinancing tables for further details.