U.S. DEPARTMENT OF THE TREASURY

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

November 3, 2021

November 2, 2021

Letter to the Secretary

Dear Madam Secretary:

Economic activity rose at a slower pace in the third quarter of 2021. Real GDP grew at a 2.0% annualized rate, a large disappointment from consensus forecasts of about 7% at the start of the quarter. Consumer spending grew at a 1.6% rate, down from a double-digit pace in the first half of the year, and consumer demand was again met in part by further drawdown of inventory and a widening of the trade deficit led by strong growth of imports. Business investment was weak, with declines in structures and equipment spending, and residential investment fell.

The main causes of the disappointment were the spread of the Delta wave and ongoing global supply chain disruptions that were worsened by restrictions imposed in other countries to limit virus spread. Auto production in particular fell well short of initial expectations due to a shortage of semiconductors, and business surveys continue to report the longest supplier delivery times since the 1970s. US ports have also become severely congested owing to the elevated volume of goods imports as well as shortages of transportation workers and warehouse space.

Forecasters expect the economy to reaccelerate in Q4 due to the decline in virus cases and expected progress in resolving supply chain problems now that many countries have relaxed Covid-related restrictions following progress on vaccination. This should allow for further recovery in the service sector, increased production and availability of goods, and inventory restocking, with positive growth effects that are expected to last into 2022.

Payroll employment grew 1.1mn in July but slowed sharply during the Delta wave to 366k in August and 194k in September, with much weaker gains in the virus-sensitive leisure and hospitality sector in particular. The unemployment rate fell to 4.8% in September, a 1.1pp

decline since June. The labor force participation rate remains at 61.6%, about 1.4pp below the pre-pandemic trend. The low participation rate has contributed to an imbalance in labor markets, with job openings and survey-based measures of job availability remaining at unusually high levels.

Continued strong demand for goods coupled with longer-lasting supply problems has led to a surge in goods prices, helping to push inflation to the highest rate since the early 1990s. Some more persistent signs of inflation have also emerged in faster rent growth and faster wage growth, especially among lower-paid workers. Short-term inflation expectations are quite high, and long-term inflation expectations have also been edging higher.

The Federal Reserve appears likely to announce at its November meeting that “substantial further progress” toward its goals has been achieved and tapering will therefore begin. The minutes to the latest Federal Open Market Committee (FOMC) meeting indicated that tapering will likely occur at a $15bn per month pace, which puts it on track to end around the middle of 2022. Concerns that the run-up in inflation is turning out larger and more persistent than expected pushed up expectations in the bond market for policy rate hikes in 2022 and 2023.

Since the last refunding, financial conditions have tightened somewhat amid elevated inflation and global central bank hawkishness, notably from the UK and Canada. Over that same period, equity prices have risen by roughly 5%, and the trade-weighted dollar rose by 2.2%. Interest rates have broadly risen, with the 2-year Treasury up 30bps to 0.46% and the 5- year increasing nearly 50bps to 1.15%. However, the long end has remained quite contained, rising only 12bps to 1.96%, and as such the yield curve has flattened roughly 20-40bps. Further, increased interest rate volatility has weighed on the Treasury market, with the 7- and 20-year points experiencing meaningful underperformance, such that the 20- and 30-year points are now inverted.

In light of this financial and economic backdrop, the Committee reviewed Treasury’s November 2021 Quarterly Refunding Presentation. Based on the marketable borrowing estimates published on November 1, the Treasury currently projects a net privately-held marketable borrowing[1] need of $1.015 trillion for Q1 FY 2022 (Q4 CY 2022), with an end-of-December cash balance of $650 billion, which assumes that any debt ceiling issues are resolved. For Q2 FY 2022 (Q1 CY 2022), the net privately-held marketable borrowing need is estimated to be $476 billion, with a cash balance of $650 billion at the end of March. These estimates do not include any additional legislation that could potentially be passed.

The Committee remains deeply concerned about the debt limit. While legislation to raise the debt limit by $480 billion was signed into law on October 14, it does not represent a sustained or permanent solution to this problem. Once that capacity is used, the same circumstances will again arise. Efforts to address the exhaustion of available borrowing authority 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 continues to believe 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 size of TIPS issuance for CY2022. The presenting member noted that the TIPS share of outstanding debt has declined as overall debt issuance increased in recent years. This phenomenon is typical of a recessionary environment, where T-bills issuance spikes, driving TIPS share lower. Demand for TIPS has been relatively strong over the past few years, particularly in the 5- and 10-year sectors, with strong appetite from domestic investment funds amid the current environment of elevated inflation. The Committee discussed whether the current robust demand for TIPS was likely to persist even if inflationary pressures prove to be transitory. At the current issuance sizes, TIPS share is expected to decline given overall borrowing needs. The Committee generally agreed that TIPS are an important asset class and source of diversified funding for Treasury, and that increasing share of outstanding debt is desirable, despite declining funding needs. The group agreed that increases should be gradual, perhaps somewhat slower than the baseline presented in the charge and Treasury should continue to monitor conditions to ensure demand remains robust.

The second charge that the Committee reviewed explored the appropriate levels of T-bills as a share of outstanding debt. Without coupon cuts, it is expected that T-bills share would drop below the Committee's recommended range of 15-20% of outstanding debt. There is considerable demand for short-term debt instruments in the current environment, as evidenced by the significant participation at the Fed's reverse repo facility (RRP). In fact, this participation may be masking the richness that the T-bill sector would otherwise have reached, as the ability of Money Market Funds (MMFs) to invest cash at 5bps at the RRP facility might be providing a floor on the level of T-bill yields. The Committee acknowledges

that the T-bill share is likely to decline to the lower end of the recommended range, but cautions against a sustained decline notably below this threshold.

Given the current fiscal and economic outlook, the Committee continues to support reductions in the auction sizes for nominal coupon securities beginning at the November refunding. As previewed in our August letter, 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 2-year FRN and 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 (per month) and $4 billion (for both new issues and reopenings in the quarter), respectively, which are somewhat larger than the declines in surrounding securities.

It was expected that, based on current fiscal and economic projections, cuts to these issue sizes would need to continue for 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, especially with fiscal legislation still pending, 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. Despite reductions in nominal coupon gross issuance and in line with the earlier charge, the Committee is supportive of moderate increases in TIPS auction sizes, particularly in 5- and 10-years, but recommends continued monitoring of the sector and its performance.

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 levels modestly above their historical ranges; leave the T-bill share of outstanding debt 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.

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.