Gary Gensler

Fiscal Policy in an Era of Surpluses

Good afternoon. I want to thank Peter Fisher for inviting me to speak here today. I am particularly pleased to talk about debt management in this new era of budget surpluses.

The fiscal year 1999 unified surplus was $123 billion, almost twice the size of the previous year's $69 billion. These surpluses capped seven consecutive years of improvements in the federal budget since the deficit peaked at $290 billion in fiscal year 1992. This represents the longest series of improvements in budget outcomes in the history of the United States.

This progress has had a significant effect on Treasury financing. In 1993, federal debt held by the public was projected to rise to $5.4 trillion by 1999. Fortunately, the stock of publicly held debt outstanding now stands at only $3.6 trillion, more than $1.7 trillion lower than it otherwise would have been.

As a result, Treasury debt is taking up an ever smaller share of the economy and the capital markets. Treasury debt held by the public has fallen from 50 percent of GDP in 1994 to less than 40 percent today. This string of six consecutive years of declining debt as a share of GDP is the longest since the period ending in 1967 more than thirty years ago. The decline in outstanding debt is expected to continue, dropping to 26 percent of GDP within five years.

The change is even more marked in relation to the capital markets. The Treasury's share of gross new issuance in the market has dropped from 38 percent in 1995 to 16 percent through the third quarter of 1999. Since the start of the Clinton administration, the Treasury's share of outstanding debt in U.S. markets has fallen from more than 33 percent six years ago to less than 25 percent today.

Reducing Treasury debt held by the public greatly benefits the economy and all Americans. It also brings with it new challenges for Treasury debt managers in achieving our three main goals: (1) to ensure that adequate cash balances are available at all times, (2) to achieve the lowest cost financing for taxpayers, and (3) to promote efficient capital markets. In pursuing these goals, we have sought to promote market liquidity and finance across the yield curve.

Debt Management Responses to Declining Debt

To date, the Treasury has managed the declining debt by refunding our regularly maturing debt with smaller amounts of new debt. To accomplish this, we have used the financing tools of modifying issue sizes, offering schedules, and the types of securities offered.

First, while maintaining the frequency of Treasury bill auctions, we reduced their average size. In 1996, the average size of our weekly bill auctions was close to $20 billion. By 1998, the average size of weekly bill offerings had dropped 28 percent, to just over $14 billion. This year, the size has increased modestly to an average of just over $15 billion.

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Next, we reduced the number of regular coupon issuances by one-third, from thirty-nine to twenty-six a year. We accomplished this by discontinuing the three-year, moving the five-year to quarterly offerings, and discontinuing the November thirty-year bond offering. This has allowed us to continue to issue large, liquid benchmark securities. While average auction size has declined modestly, by 6 percent since 1996, we have been able to maintain it at just under $14 billion for 1999.

We continue to consider whether further revisions to our auction schedule would be appropriate. Particularly, we continue to consider the frequency of issuance of one-year bills and two-year notes. Reducing the frequency of these auctions would give us some additional leeway in maintaining the size of our benchmark issues.

Debt Management Challenges

While we have been able to meet our debt management goals through these adjustments, we face additional challenges going forward.

First, debt held by the public is forecasted to shrink further, by $720 billion over the next five years and by over $2 trillion in ten years.

Second, the effect of seven years of fiscal discipline is already showing up in our maturing debt. There will be a great deal less maturing debt to be redeemed in the very near future. This fiscal year, $476 billion of coupon debt will mature, down from a peak of $510 billion in 1998. Over the next eighteen months, the last of the old seven-year and three-year notes will mature. Thus, by 2002, debt maturing will decline significantly. Depending upon the decisions we make this fiscal year about issuance of two-year notes, debt maturing in 2002 is likely to be less than $400 billion.

Third, we face the challenge of how to continue to issue sufficient longer term debt without an unacceptable lengthening of our maturity structure. For instance, if we maintain the current level of long-term financing (ten-year and thirty-year debt), the average maturity is forecasted to lengthen from about five and three-quarter years currently to eight years by the end of 2004. Over the long term, this would impose additional cost on the taxpayers to finance our debt.

To meet these challenges, new tools will be needed. By the end of the year, we will have in place two new debt management tools. This will provide us with important new means of managing the government's debt and responding to our improved fiscal condition.

First, we have issued a rule that will make it much easier for the Treasury to reopen its benchmark securities. The new rule allows the Treasury to reopen its benchmark securities within one year of issuance without creating concerns under the original issue discount (OID) rules. Under the previous rules, the Treasury generally could reopen an issue only if the price of the issue had not fallen by more than a *de minimus* amount. This significantly constrained our ability to reopen benchmark securities. The new rules will enable us to reopen issues more easily. This important new debt management tool will improve our ability to maintain the size and liquidity of our benchmark securities.

Second, we are putting in place a new rule that will permit us to conduct debt buybacks. This new rule will permit us to buy back Treasury debt in advance of its maturity date. Buying back outstanding debt in advance of maturity will enable us to maintain larger, more liquid auction sizes for our benchmark securities. Debt buybacks also will give us the ability to manage the maturity structure of our debt by selectively targeting the maturities to be repurchased. This will provide us with additional flexibility to continue issuing our long-end maturities without unduly lengthening the maturity structure of our debt. Finally, debt buybacks could be used as a cash management tool, absorbing excess cash in periods such as late April when tax revenues greatly exceed immediate spending needs.

Looking Ahead

Treasury securities currently play an important role in the global capital markets. They are actively used for hedging purposes. They provide a risk-free pricing benchmark across the yield curve. The Federal Reserve uses transactions in Treasury securities to affect the supply of reserves in the banking system.

As the Treasury market declines in size, other markets are likely to take on these roles. We believe that the financial markets should be able to make a smooth adjustment to these changes. Investors and hedgers will switch to trading other securities and derivatives.

This transition is already taking place. Market participants today use Eurodollar futures more actively than Treasury bills to hedge in the short end of the market. In addition, the role of Treasury securities as a pricing benchmark in the investment-grade bond market is changing. While high-grade corporates are still priced relative to Treasuries, growing weight is being given to the value of other high-grade corporates. We are already seeing underwriters pricing new issues relative to the value of similar recently issued securities in addition to Treasury yields.

Most important, the benefits of reducing our nation's debt far surpass the issues that arise for the capital markets from this reduction. As less savings flow into government bonds, more will flow into investment in businesses and housing. There will be less pressure on interest rates, reducing the borrowing costs for businesses and families alike. While debt reductions present challenges to the financial markets and to the Treasury's ability to manage the remaining debt, I think we can all agree that the enormous benefits for our economy make these challenges worth meeting.