Remarks by Acting Assistant Secretary for Financial Markets Karthik Ramanathan at the Global Borrowers Investor Forum

(London) Good morning. I'd like to thank you for giving me the opportunity to speak with you regarding the United States Treasury market, our debt issuance strategy, and the outlook for supply. Considering the attention being placed on Treasury debt issuance by investors, other sovereign debt issuers, and the media, I believe this discussion is particularly timely.

Moreover, while the Treasury has already addressed the majority of its financing needs for this fiscal year, and is well situated to manage its borrowing needs for fiscal year 2010, I think several important points need to be made. As a result, I hope you will come away with a better understanding of the challenges faced by sovereign debt managers and the process we take to address our borrowing needs in a transparent manner.

Let me begin as you may expect – in Istanbul. Ten days ago, thirty of the world's largest issuers of sovereign debt, representing nearly $3 trillion in net marketable debt issuance in 2009, gathered in Turkey at the International Monetary Fund's Annual Public Debt Managers' Forum. Istanbul has been a crossroads for civilization and a breeding ground for cultural exchange for thousands of years. Capturing the essence of the city in one or two phrases is virtually impossible because of the confluence of ideas, customs, and religions. Perhaps as a parallel, our meeting presented the perfect opportunity to exchange financial market perspectives, discuss short- and long-term debt management strategies, and review ideas from the perspective of debt managers.

I took away a number of important perspectives from this forum. By and large, we came to the conclusion that, yes – our debt issuance in the coming years will be large – but by providing market participants with as much transparency as possible, we can minimize dislocations resulting from increases in supply. Moreover, each debt manager faced a number of country specific initiatives and limitations which made broad generalizations regarding debt issuance difficult. Finally, we all agreed that while investors have become more sophisticated, the experience of the past two years may have lowered the threshold for risk tolerance. Taken together, all of these viewpoints underscore the need to stick to a coherent, consistent debt management strategy.

I relay the thoughts of this meeting and the nature of the conversations to highlight the mutual dependence that we as debt managers have not just with one another, but with credit markets generally. There has been a proliferation of instruments with characteristics similar to sovereign debt including guaranteed bank debt as well as debt issued by government entities and central banks. Investors have many options to choose from as risk appetite reemerges.

And certainly, many of the measures being taken by governments around the world are geared to provide this very outcome – the return of normalcy to credit markets, the return of private sector lending, and the flow of credit generally. As this risk appetite reappears, we should be encouraged, not discouraged, that investors are seeking investments outside of sovereign debt markets. Naturally, as investors branch out from sovereign debt to other securities, interest rates will reflect a return to some degree of normalcy.

Treasury firmly believes that its aggressive initiatives, along with those of fellow financial authorities both domestically and globally reduced the risk of a much more significant downturn in economic growth.   To be sure, we still face challenges, but we are beginning to see incremental improvements across credit markets. At the very least, investors are finally turning to fundamentals such as inventories, industrial production and employment, rather than scrutinizing LIBOR/OIS spreads or commercial paper liquidity on a minute by minute basis.

These fiscal measures and initiatives, however, do have a cost. Recently there has been significant discussion in the media about the roughly $2 trillion in estimated net marketable supply that Treasury will issue this year. However, for the majority of the investment community, this is not new news. Treasury in a speech in December 2008 and through our Quarterly Refunding statements since November 2008 clearly telegraphed to the market that net marketable borrowing needs would be in the $1.5 to $2.0 trillion range. As a result, while the numbers associated with our borrowing needs are large on a nominal basis, they must be evaluated in context.

Through the first eight months of Fiscal Year 2009, net marketable borrowing by the U.S. Treasury has totaled $1.3 trillion. Effectively, the Treasury has already financed nearly 80% of its expected borrowing needs for fiscal year 2009, which ends on September 30, 2008. We are well poised to address our remaining borrowing needs for this year and next through gradual increases in issuance sizes of our existing suite of coupon securities.

As we move forward, we emphasize that the U.S. Treasury retains a high degree of flexibility in meeting uncertainties in our financing needs even as we maintain our regular and predictable issuance of large, liquid benchmarks. Since the beginning of the fiscal year, Treasury bills outstanding have averaged about $2 trillion, up from an average of $1.1 trillion over the past 5 years. Bill financing was increased in order to address the rapid growth in short-term borrowing needs related to financial and fiscal stability measures. The rapid increase in short-term debt issuance, however, resulted in a drop in the average maturity of the debt outstanding, from 52 months in December 2008 to 49 months in April 2009.

Treasury debt managers, however anticipated well in advance this reduction in average maturity, and formulated a coherent plan to gradually shift from bill issuance to coupon issuance over the medium term.

To reduce rollover risk and counter the drop in average maturity, we began layering in predictable increases in nominal coupon auctions. In addition, we reintroduced a 3-year note and a 7-year note to the monthly auction calendar. We also added a second reopening of the 30-year bond. Since the start of the year, we have raised approximately $600 billion through note and bond issuance. This has begun the process of moving the average maturity of debt outstanding closer to its historical average of 60 months.

As the economy recovers, Treasury net issuance will begin to decline, as government receipts start to increase in response to improving economic conditions. Decreases in Treasury issuance will be undertaken just as supply in other fixed income markets increases. Market participants can expect coupon issuance to remain fairly stable and the reliance on bill issuance to abate.

To be clear, downward adjustments to our coupon sizes should be expected to lag improved economic conditions, in part due to the refinancing of maturing securities. Also it takes time for growth in the overall economy to be reflected in the government's receipts. Recent Administration forecasts estimate the budget deficit will more closely align with the inflow of tax receipts by 2012. As of today, however, uncertainty remains around the pace of economic contraction, and the timing of economic recovery. We expect non-withheld tax receipts to remain depressed, but we will closely watch corporate taxes and withheld taxes, as well as trends in employment, to better calibrate our debt issuance strategy.

Clearly, critical to future fiscal deficits and financing needs will be the funding requirements of entitlement programs such as Medicare, Medicaid, and Social Security. The U.S. has demonstrated a commitment to reforming these future liabilities. We also acknowledge that secular financing needs for entitlement spending will become more of a concern over the longer-term unless action is taken. The mere fact that the Administration and Congress are willing to raise these issues is heartening. The United States will lead this necessary transformation, and given demographic trends globally, investors will realize that our short term financing increases will lead to longer-term fiscal stability – and frankly, a more attractive investment landscape.

During this period of growing debt issuance, we as sovereign issuers have greatly benefitted from a long period of lower rates, primarily due to significant flight-to-quality flows as well as a renewed approach to risk management. Following this period of below normal rates, we are now seeing a reversion to more normal levels. But, for the United States Treasury, a discussion on rates is moot.

Our mission is to finance the U.S. government's expenditures at the lowest cost over time. To achieve this goal, we issue debt in a regular and predictable manner, with any changes to debt issuance communicated to the market as transparently as possible. We do not time the market when we issue debt; instead we issue debt in all interest rate environments – whether one of rising interest rates or falling interest rates. We are too big to act opportunistically. To provide even greater certainty, Treasury follows a basic set of principles when addressing its borrowing needs by first increasing issuance sizes and then considering changes to the auction calendar.

The premium associated with this certainty of supply is underestimated. Removing a major source of uncertainty from the supply-demand equation allows investors to focus on other factors facing credit markets. Moreover, our approach to debt issuance provides continuity for our investors who desire a liquid, risk-free asset that meets their investment and cash management strategy.

This approach, combined with the fundamental resilience and long term growth potential of the United States economy has made the Treasury market the deepest, most liquid sovereign debt market in the world. This characteristic enables the United States government to capture a liquidity premium, thereby reducing our cost of financing.

As a result of this consistent approach, we have managed to address our large borrowing needs with minimal disruption to the market. This was due in part to the global decline in risk appetite as Treasuries became a safe haven for both traditional and non-traditional Treasury market participants. The low yield levels we have benefitted from indicate the continued attractiveness of the Treasury market to investors seeking sanctuary in an uncertain financial environment.

During this time, Treasury supplied needed liquidity to the credit markets as private sector borrowing sharply contracted. As outstanding debt matured, Treasury securities filled the void left by traditional issuers who were unable to access the capital markets. As a result, despite increased Treasury borrowing, any dislocation between supply and demand across the global fixed-income markets was minimized.

Recently there has been some concern expressed that our increased issuance may be leading to less positive auction dynamics. As evidence, some observers point to metrics from recent Treasury auctions such as coverage ratios, indirect bidding, and market "tails" – the last metric being the difference between the auction stop-out yield, or award yield, and the contemporaneous when-issued rate. One must use caution, once again, in interpreting the meaning of any of these metrics in isolation.

For example, a market tail in and of itself is not particularly useful information absent any context. Movements in Treasury rates in the days and hours both before and after an auction are just as critical as rates at the time of an auction. One must take into account the timing of the when-issued rate used to determine the market tail, the source of the rate quote, and the level of activity in the market. Increased volatility further clouds such measures. Seizing on one measure leads to uninformed, and at times, erroneous, conclusions.

Moreover, the Treasury auction is in itself an institution – it provides investors an unparalleled opportunity to access enormous liquidity at a fixed price, yet in an open, competitive, and transparent environment. We provide access to liquidity in a predictable manner, and serve as a pricing point for private issuers. We believe large, liquid benchmark securities further reduce our cost of borrowing, and draw investors to our auctions. And we will continue to ensure the integrity of the Treasury auction process.

Similarly, focusing on just one segment of the investor base may not prove to be fruitful. Trends in Treasury purchases are a function not only of investor desire for safety and liquidity, but also alternative investments. We expect some of the flight-to-quality purchases to return to other markets, such as corporate debt and equity markets. At the same time, the decision to diversify an investment portfolio is not binary. We are confident that the unique characteristics of the Treasury market will make our securities a staple of any investor's portfolio.

From Treasury's perspective, we constantly strive to broaden our investor basis, and as we have seen in the past, we will continue see shifts in demand over time. These shifts generally occur in a gradual, rational manner, and ultimately other sources of demand emerge. For example, various domestic investors in the United States have materialized as yet another source of demand for Treasuries. Essentially, trends in demand are not linear in nature, and interpolating such trends or reversals in trend can be misleading.

As we are focused on the demand front, addressing the recent initiatives of the Federal Reserve to purchase Treasury debt in the secondary market seems appropriate. Let me explicitly state that Treasury's debt management strategy is fully independent of decisions made by the Federal Reserve to purchase Treasuries. We issue debt based on the government's financing needs, not to take advantage of specific pockets of demand. To be clear, the stated goal of the Federal Reserve's purchase program is to reduce private credit market borrowing costs, and it does not impact our debt management strategy.

Another way in which debt managers can further increase demand for their securities is by taking steps to enhance the liquidity of secondary markets. In the United States, we have a successful example of such an initiative. Specifically, Treasury market liquidity was enhanced by addressing settlement failures in the Treasury repurchase, or "repo," market. After widespread settlement failures peaked last October, the private sector, led by the Treasury Market Practices Group (TMPG), identified market practices to reduce the incidences of such disruptions.

One of the recommendations of the TMPG was the adoption of a 300 basis point financial penalty for failing to deliver Treasury securities. Despite concerns by many market participants regarding the potential impact to Treasury market liquidity, market participants instituted this fee on May 1, 2009. Subsequently, specials volumes in the repo market have increased. At the same time, failures to deliver have dramatically declined, and investors generally believe such episodes will occur less frequently.

We believe that investors globally, be it central banks or institutional investors, will gradually realize that securities lending is a good opportunity to earn incremental income on their holdings of Treasuries. In particular, the opportunity to lend at higher rates, despite the fact that the overall level of rates remains low, should prove to be a powerful incentive. At the same time, given that we are only seven weeks into the implementation of this dynamic fails charge, we expect there to be a gradual understanding of how negative rate trading works. The Securities Industry and Financial Markets Association as well as other private sector groups are spearheading these efforts. As systems are upgraded and contracts redesigned, we believe many traditional lenders of securities will reappear.

Despite the continuing challenges we face, our country's favorable demographics, economic diversity, and high capacity for innovation will set the stage for the successful recovery of our financial markets and the overall economy. As we address the borrowing needs associated with the initiatives Treasury has taken, we clearly understand the importance of communication with investors. Let me state unambiguously that Treasury's borrowing needs, while large, are manageable.

We will remain a pillar of stability in turbulent times through our regular and predictable issuance. At the same time, while the United States enjoys the deepest, most liquid sovereign debt market in the world, we do not take that standing for granted – we are always striving to enhance our standing. As economic and financial market conditions change, you can depend on Treasury debt managers to make any adjustments in as transparent a manner as possible to finance the federal government.