Remarks by Acting Assistant Secretary for Financial Markets Karthik Ramanathan to the Futures Industry Association Treasury Markets Forum

(New York) Good morning. It is a pleasure to be back in New York City. I appreciate your invitation to address the Futures Industry Association regarding the United States Treasury market.

With the rapidly changing financial markets, the series of government interventions, and the demands on Treasury financing given the fiscal outlook, I am often reminded of how daunting a task our first Secretary of the Treasury, Alexander Hamilton, must have faced when first establishing a system of public credit.

Hamilton accomplished this awesome feat following a financially debilitating war that drained public resources and in an environment of widespread distrust over a strong central government. In the midst of this highly tumultuous period, and under enormous political scrutiny and even physical threats, he stood firmly, ultimately creating the financial foundation on which our current system is built on.

In establishing a federal debt system subject to the needs of a growing nation, Hamilton understood that raising capital for sovereign use was not only beneficial to developing the nascent financial markets at the time but also a major buttress to the growing economy. He implored his fellow countrymen to "*Learn to think continentally*" well before the term "global" became fashionable in the language of business. Moreover, Hamilton surmised that the size of the public debt could not be static, but that it would ebb and flow with the pace of the economy.

The insightfulness of this notion of broadening the financial reach and might of the United States through its ability to function in the capital markets efficiently has been borne out by events over the course of the past year. In fiscal year 2009, Treasury will have issued in gross over $7 trillion in Treasuries.

This issuance was necessary to meet nearly $1.7 trillion in net marketable borrowing needs, nearly $1 trillion more than the prior fiscal year. These extraordinary financing measures were taken to stabilize the financial system and promote economic growth while at the same time financing the ongoing needs of the United States government.

Treasury firmly believes that its aggressive initiatives, along with those taken by the Federal Reserve, other domestic regulators and central bankers' abroad, reduced the risk of a more significant economic downturn. To be sure, we still face challenges, but the incremental improvements across credit markets and the economy are encouraging. At the very least, investors are turning back to the fundamental factors such as inventories and employment rather than scrutinizing credit spreads on a daily basis. And certainly, many of the coordinated measures taken by governments around the world were geared to provide this very outcome – the return of normal functioning to credit markets and private sector lending, and the flow of credit generally.

Interestingly, Treasury has continued to fund the U.S. government at historically low interest rates despite the views of many individuals and market participants. This occurred despite the almost 40% increase in equity markets since March, a significant tightening of credit spreads, and a reemergence of risk appetite. The Treasury market continues to attract capital from domestic and international investors from both the private and public sectors. As the recovery in global financial markets progresses, we expect some of the flight-to-quality purchases to return to other markets. As risk appetite reappears, we should be encouraged - not discouraged - that investors are seeking investments outside of sovereign debt markets.

At the same time, we are confident that the unique characteristics of our sovereign debt market will continue to make Treasury securities a staple of investors' portfolios. Specifically, the unparalleled access to liquidity makes Treasuries preferable to many other instruments, particularly in the midst of crisis. In addition, the decline in issuance of high quality credit instruments and the increase in household savings will continue to make Treasuries an attractive asset class. Indeed, the results we have seen in over 250 Treasury auctions over the past fiscal year have been positive. While interest volatility surrounding any given auction can occur due to many market factors, the underlying trends have been encouraging from a participation and demand perceptive.

While the numbers associated with our borrowing are large on a nominal basis, and the frequency of our auctions has increased, they must be evaluated in context. Treasury responded to address the rapid growth in short-term borrowing needs related to financial and fiscal stability measures by ramping up bill financing. Because of these factors, over the past year Treasury bills outstanding have averaged about $2 trillion, up from an average of $1.2 trillion over the past five years.

Going forward, we expect to increase both nominal and inflation-indexed coupon issuance incrementally and gradually over the next nine months to extend the average maturity of the overall debt. Indeed, given structural changes in the deficit, I expect the average maturity of the debt to stabilize at six to seven years, levels that will most likely exceed the historic average of five years.

This shift in the overall Treasury portfolio will permit us to bring short term bill levels closer to historical averages while stabilizing coupon issuance by the middle of 2010. While Treasury will address unexpected borrowing needs through the short end of the curve given normal yield curve dynamics, lengthening the portfolio at this time still remains prudent.

Looking ahead, Treasury's potential borrowing needs – and the uncertainty surrounding such forecasts - will remain high in the medium term. Four weeks ago the Office of Management and Budget (OMB) released its updated budget forecasts in its Mid-Session Review. In its assessment, OMB stated that while real GDP is expected to decline by 2.8 percent this year, it is expected to increase by 2.0 percent in 2010, and the recovery is projected to proceed more rapidly from 2011 to 2014.

Even so, the Administration has stated that forecasts of deficits of 4 percent of GDP are higher than desirable. In this vein, the Administration plans to propose further steps in the 2011 Budget to reduce the deficit and stabilize the debt-to-GDP ratio. The path Treasury has taken to gradually shift issuance to longer-dated securities while providing capacity in shorter-term issuance will ensure that financing needs are indeed met.

Critical to future fiscal deficits and financing needs will be the funding requirements of entitlement programs such as Medicare, Medicaid, and Social Security. The United States has demonstrated a commitment to reforming these future liabilities. It is clear that secular financing needs for entitlement spending will become more of a concern over the longer-term unless action is taken. The United States will lead this necessary transformation, and given global demographic trends, investors will realize that our short term financing increases will lead to longer-term fiscal stability – and frankly, a more attractive investment landscape.

Despite large increases in issuance, Treasury retains a high degree of flexibility in meeting unexpected changes to the government's financing needs. This flexibility is to a large degree a result of our practice of regular and predictable issuance. We communicate transparently and regularly with the market regarding any changes to the government's borrowing needs. We do not act opportunistically, nor do we time the market. Instead, Treasury issues debt in all interest rate environments to achieve our goal of lowest cost financing over time.

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 costs of financing.

Importantly, other factors also contribute to a lower cost of financing for Treasury including the smooth functioning of the repo market, swaps market, and futures market – all of which serve to bolster the attractiveness of the cash market. Conversely, dislocations in these markets could diminish the efficiency of the primary Treasury market and potentially increasing the cost of financing the debt of the United States.

For example, widespread settlement failures in the Treasury repurchase, or "repo," market in the fall of 2008 impacted the attractiveness of Treasury securities as evidenced by a sharp decline in transactions in the Treasury cash market. This market dislocation subsequently impacted trading volumes in the Treasury futures and swaps markets, and gradually impacted other important markets in which Treasuries are used as a hedging instrument.

In general, unscheduled reopenings are contrary to Treasury's policy of transparency, regularity, and predictability. But as settlement failures reached a peak in early October 2008 at over $2 trillion, Treasury debt managers made the extraordinary decision to hold unscheduled or "snap" reopenings in some of the most severely affected failing securities to improve liquidity in the Treasury financing market and facilitate the settlement of failing repo trades. As a result of these actions, fails levels dropped precipitously, and the functioning of critical segments of the fixed income markets resumed.

Soon after the reopening auctions, private Treasury market participants, led by the Treasury Market Practices Group, began in earnest to identify trading practices to reduce the incidence of such disruptions. Subsequently, several practices were adopted, most notably, the institution of a fails charge to penalize certain delivery failures.

As the operational changes to the Treasury repo market were implemented this year, we often looked to the exchange-traded futures markets as a model. With well defined rules, explicit roles for policy makers and regulators, a private sector with both the motivation and ability to act as a self regulator of sorts, and the ability to adapt practices to changing market dynamics, the futures exchange can serve as a role model for market efficiency and transparency. Such arrangements could certainly benefit other less transparent financial markets.

In the case of the dislocations in the Treasury market, the combination of sound debt management decisions and the development of innovative private sector practices resulted in improved repo market clearing, better pricing information and liquidity. The functioning of the Treasury cash market improved as well. Since the beginning of the year, transaction volumes have stabilized and are gradually trending upward. A resilient and robust repo market is critical to Treasury's ability to continue to attract domestic and international capital, and lower financing costs.

Other measures will also serve to attract capital to our financial markets. For example, the reforms to the supervisory and regulatory structure that have been proposed by the Administration will result in stronger and more transparent financial markets and restore investor confidence. Treasury is committed to building a new foundation for financial regulation and supervision that includes robust supervision and regulation of financial firms, comprehensive regulation of financial markets, and the protection of consumers and investors. Additional financial crisis management tools, improved international regulatory standards, and better international coordination will also instill confidence in our financial markets.

The reforms will impact nearly every aspect of the financial system, from over-the-counter derivatives (OTC) markets to counterparty risk management to central clearinghouses to capital standards. And while many of these ideas have been raised in Washington in the past, never has such an important, serious effort from so many components of the public and private sectors come together to strike the right balance.

Notably, discussions pertaining to the futures market have centered on the regulation of OTC derivatives. Historically, the OTC derivatives markets had managed counterparty credit risk related to OTC derivatives with little oversight. However, the events of last year clearly demonstrate that certain instruments and off-balance sheet arrangements should be subject to a comprehensive regulatory framework to prevent activities to minimize risk to the overall financial system, promote efficiency and transparency, and ensure the appropriate conditions in marketing OTC derivatives.

Perhaps one of the simplest examples to consider is related to the swaps market which is traded OTC. While LIBOR rates remained stubbornly high and volatile for many weeks last fall due to a number of exogenous factors including counterparty risk, exchange traded Eurodollar futures remained a resilient hedge to fluctuations in short-term rates, benefitting from the convenience of cash settlement and central clearing. Essentially, this hallmark of futures contracts provided the market with price discovery in the midst of illiquidity and opacity in the front-end of the interest rate curve.

Historically, swaps have been customized, privately-negotiated agreements that, when prudently managed and regulated, can add greatly to the competitiveness, risk management capacity, and liquidity found in our markets. In recent years, many swap terms, conditions, and conventions have become standardized. The Administration and Treasury have recommended that standardized OTC derivatives, including standardized credit default swaps, should be moved onto regulated exchanges and regulated transparent electronic trade execution systems. There should be timely reporting of trades and prompt dissemination of prices and other trade information.

Clearing of standardized contracts through regulated central counterparties should be required as well. Non-standardized trades that are not cleared by a central counterparty should be reported to a regulated trade repository. The futures industry can contribute here to the dialogue for laying a new foundation for the derivatives markets.

We also recommended that there should be other risk controls for OTC derivatives, including robust margin requirements. Daily marking-to-market of positions ensures that unrealized losses from market moves are accounted for. The guarantee of trades by a prudently-managed regulated clearing house provides investor confidence and financial stability in the futures markets.

We have learned a lot from the events of last year. As liquidity all but dried up in other fixed income markets, the number of contracts traded on domestic exchanges rose almost 40 percent. Although volumes dropped off significantly by year-end as some traders exited the market, this decline is viewed as a temporary, not a structural, change. The price discovery roles of the cash and futures markets help to produce fair prices and liquid markets for Treasuries. This role will continue, and we are confident that the steps being taken by the private sector and by Treasury will strengthen the mechanism for managing interest rate risk.

Recent initiatives by the futures participants including the CME will also serve to broaden participation from active traders which would improve liquidity to this important sector of the Treasury market. The launch of the 3-year futures contract in March 2009 by the CME certainly filled another part of the interest rate curve. Recent discussions focused on introducing an ultra-long futures contract, a new 7-year contract, and futures on inflation protection all bode well for the interest rate futures markets and provide alternative ways to hedge or establish risk.

Going forward, Treasury appreciates the continued commitment of the Futures Industry Association to educate and inform the press, Congress, market participants, and regulators about futures markets and the lessons that can be applied across other less robust markets. Your opinion is valued, and your trading platforms and clearinghouses are models for transparent execution and counterparty risk novation. Treasury will in parallel work to address inefficiencies in the regulatory structure to promote greater transparency and robustness. And from a debt issuance perspective, Treasury will remain a fixture for stability in volatile times through our regular and predictable approach to financing the United States government.

At the same time, while we enjoy 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 and broaden our investor community. As economic and financial market conditions change, let me assure you that you can depend on Treasury debt managers to make any adjustments to finance the federal government in as transparent a manner as possible.