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

February 1, 2011

Dear Mr. Secretary:

Since the Committee last met in early November, economic activity has picked up further, and the expansion appears to be more firmly entrenched. An improvement in the data and a turn toward more accommodative federal fiscal policy has supported expectations that the economy will grow above-trend in 2011. Job growth has remained tepid thus far, though some measures of labor market health have shown modest improvement lately.

Real GDP increased at a 3.2% annual rate last quarter, moderately quicker than the 2.6% rate experienced the prior quarter. Domestic final sales expanded at a similar 3.4% pace. Inventory accumulation slowed noticeably last quarter, as a decline in the volume of imports kept stockpiles relatively lean. The firming in business surveys at year-end suggests that industrial output is set to re-accelerate in the first half of this year, following a modest slowing late last year. The new orders index in the latest ISM manufacturing survey stood at 62.0, indicating the factory sector is benefiting from robust final demand growth.

Real consumer spending accelerated to a 4.4% annualized rate last quarter, the fastest pace so far in this expansion. A revival in demand for motor vehicles provided an important lift to consumer spending on durables. The rise in equity prices has bolstered household balance sheets, more than offsetting the decline in residential real estate values. The improved financial position of consumers has apparently fostered a modest firming in confidence, as saving rates drifted lower in the second half of last year. Households should receive a further boost early this year, as disposable incomes are lifted by the Social Security tax holiday.

Housing demand has picked up lately, but remains at low levels. Homebuilding activity has changed little and remains at depressed levels, as the inventory overhang limits the need for new housing units. Home price measures have continued to register modest declines, though the most recent data indicate some slowing in the pace of that decline.

Real business outlays grew at a 4.4% annual rate in the fourth quarter, well below the unsustainably strong rates experienced earlier in the year. Monthly spending data, as well as recent survey measures of capital spending intentions, point to continued good growth in capital outlays. Strong corporate profitability and the pent-up need to replace worn-out equipment continue to support capital expenditure growth. Financial conditions in capital markets remain favorable, and have been joined recently by increased bank lending to the business sector. Solid business capital spending has not yet translated into substantial gains in full-time hiring: The two labor market reports received since the last meeting point to continued slow growth in private employment and wages. However, the decline in jobless claims and the general rise in survey measures of business hiring intentions indicate that the long-awaited pick-up in private hiring may be getting nearer.

Low levels of resource utilization continue to put downward pressure on wage and price inflation. Measures of core consumer price inflation remain soft and the most recent reading of the core PCE is up a mere 0.7% from a year earlier. Some measures of rental inflation have firmed recently, though they have generally been offset by declining core consumer goods inflation. Rising prices for globally traded commodities, particularly for food and energy, could pass through to some degree into core consumer prices. However, most measures of inflation expectations remain well-contained.

Shortly after the Borrowing Committee last met, the FOMC instituted a $600 billion asset purchase program. Since then, Fed rhetoric has continued to emphasize that both employment and inflation are below levels consistent with their monetary policy mandate. This has reinforced market expectations that the Fed will follow through on the entire $600 billion plan, currently scheduled to be completed in June. At the same time, sharp public criticisms of asset purchases, as well as an improving economy, have both contributed to expectations that no further purchases will be instituted after the present program is completed.

The December change to tax policy has added to most estimates for federal fiscal deficits in coming years. CBO projects a federal budget deficit of $1.5 trillion in fiscal year 2011 year and $1.1 trillion for fiscal year 2012, with much of the improvement in the latter year owing to the lapsing of spending related to the 2009 stimulus package. State and local finances have come under increasing scrutiny, and actions taken to close budget shortfalls at this level of government have added to fiscal restraint on real economic activity. Longer-term fiscal challenges remain daunting. At the federal level, Social Security and Medicare face unfunded obligations of $66 trillion. Moreover, state and local governments also face substantial unfunded pension obligations.

Against this economic backdrop, the Committee's first charge was to examine what adjustments to debt issuance if any Treasury should make in consideration with its financing needs. Given the recent extension of the 2001 and 2003 tax cuts, the Committee felt that nominal coupon issuance should be maintained at current levels. Taking into account the current deficit outlook, the Committee does not anticipate further reduction of coupon issuance in the near-term.

Although the average maturity of marketable debt has increased meaningfully from its 2008 low of roughly 48 months to a current average of approximately 59 months, the Committee felt strongly that the longer term fiscal challenges warranted further progress on this front. It was noted that without changes to issuance patterns, the average maturity would stabilize just below 62 months in 2013. The Committee intends to focus on these issues at future meetings. Lastly, the Committee members anticipated an orderly resolution to the challenge posed by the current debt ceiling limit.

The second charge was to broadly examine, on an exploratory basis, a variety of alternatives to Treasury's current debt management program with the goal of minimizing borrowing costs, enhancing market liquidity, and expanding its investor base. The presentation, (attached), first examines the composition of outstanding Treasury debt holders and how substantial domestic demand may evolve over time. The presentation then focuses on potential new debt products, including, but not limited to, callable bonds, floating-rate bonds, and bonds longer than 30 years.

In the final charge, the Committee considered the composition of market debt for the remainder of the January 2011 to March 2011 quarter and the April 2011 to June 2011 quarter. The Committee's recommendations are attached.

Respectfully,

Matthew E. Zames
Chairman

Ashok Varadhan
Vice Chairman