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FEDERAL DEBT

Debt Management in a Period of Budget Surplus

Statement of Paul L. Posner
Director, Budget Issues
Accounting and Information Management Division

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to appear before you to discuss managing debt in a time of surplus. As you requested, my testimony today will be drawn from a report we are issuing today to Senate Budget Committee Chairman Pete V. Domenici and you regarding actions taken by the Treasury to manage the marketable debt held by the public in this new fiscal environment.[1]

The federal budget is about to record the first back-to-back budget surpluses in more than 40 years. As a result, federal debt held by the public has declined and, if projected surpluses materialize, it will continue to fall throughout the next 10 years. The Treasury faces the challenge of managing the surplus rather than financing a deficit. To support its management goals, the Treasury has concentrated its borrowing into fewer but larger debt offerings, and targeted its reductions to offset the trend toward generally more costly long-term debt.

In August, the Treasury published proposed rules for advanced repurchase of outstanding debt held by the public–a debt “buy-back.” These repurchases could require the Treasury to pay a premium since most of the older securities have interest rates higher than those issued today. Since the Treasury has the authority for these repurchases, any premiums would not require an offset under the Budget Enforcement Act, but the payment of a premium would affect the size of the surplus.

As debt declines, the Treasury will face more difficult trade-offs in achieving broad and deep markets for its securities and lowest cost financing for the government. There will be greater pressure on the Treasury to further concentrate debt in fewer issues to maintain deep and liquid markets in benchmark securities. Although markets tend to adjust over time, these changes may not be seamless or without cost.

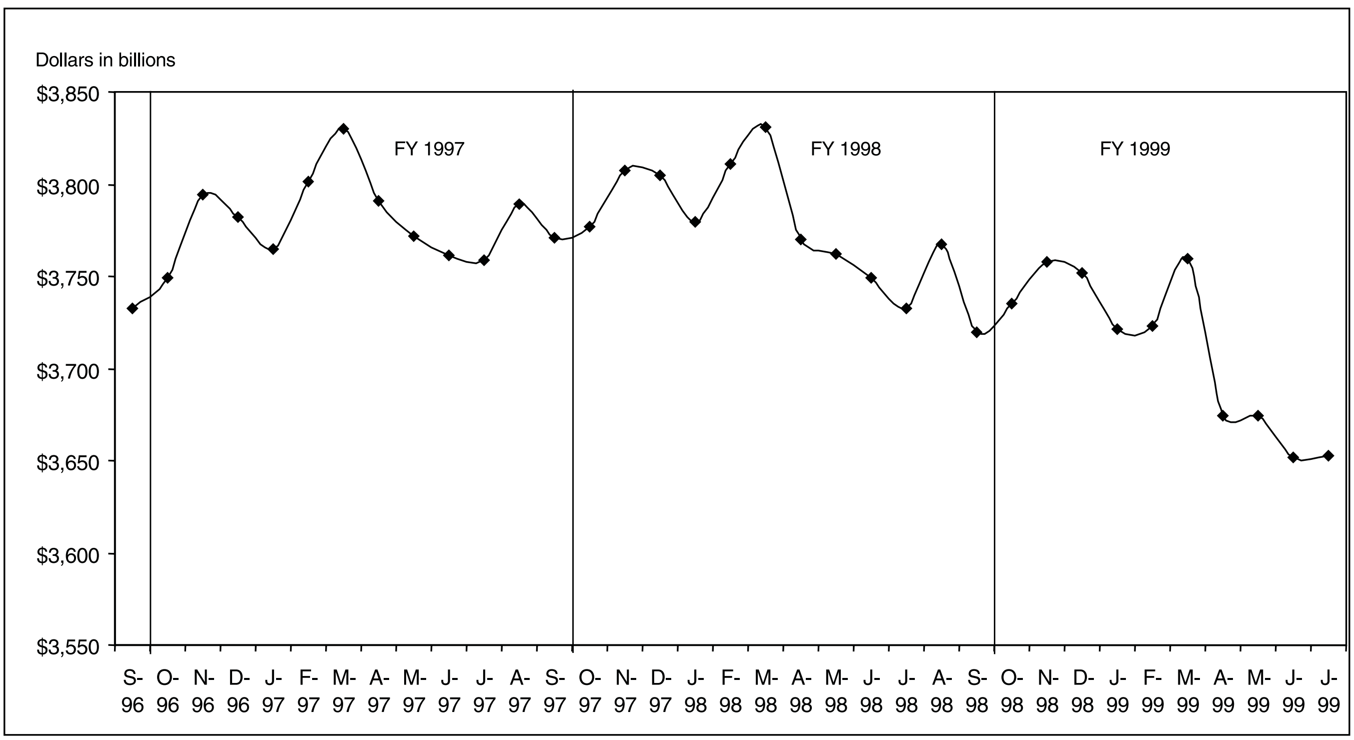
[1] *Federal Debt: Debt Management in a Period of Budget Surplus* (GAO/AIMD-99-270, September 29, 1999). This report is a follow on to a “primer” on federal debt issued in May entitled *Federal Debt: Answers to Frequently Asked Questions–An Update* (GAO/OCG-99-27, May 28, 1999).

Federal Debt Held by the Public Is Declining

As all of you know, fiscal year 1998 brought the first unified budget surplus since 1969. The fiscal year that ends tomorrow also will show a surplus–although we don't know its exact size yet. The Congressional Budget Office's (CBO) July update showed surpluses continuing throughout the next 10 years.

In fiscal year 1998, debt held by the public fell by about $51 billion, and the Treasury has already reduced the amount of debt held by the public by $68.2 billion in the first 9 months of fiscal year 1999. As figure 1 shows, the debt held by the public reached a peak of $3.83 trillion in March 1998 and dropped by $180 billion, to $3.65 trillion, by July 31, 1999.[2]

Figure 1: Federal Debt Held by the Public, September 1996 Through July 1999



Source: *Monthly Treasury Statement*, Department of the Treasury.

[2]This total is net of unamortized premiums and discounts on public debt securities.

CBO's July projections show debt held by the public falling further from $3.65 trillion in fiscal year 1999 to $0.9 trillion in 2009, assuming current policies.[3]

The Treasury's Debt Management Goals and Challenges

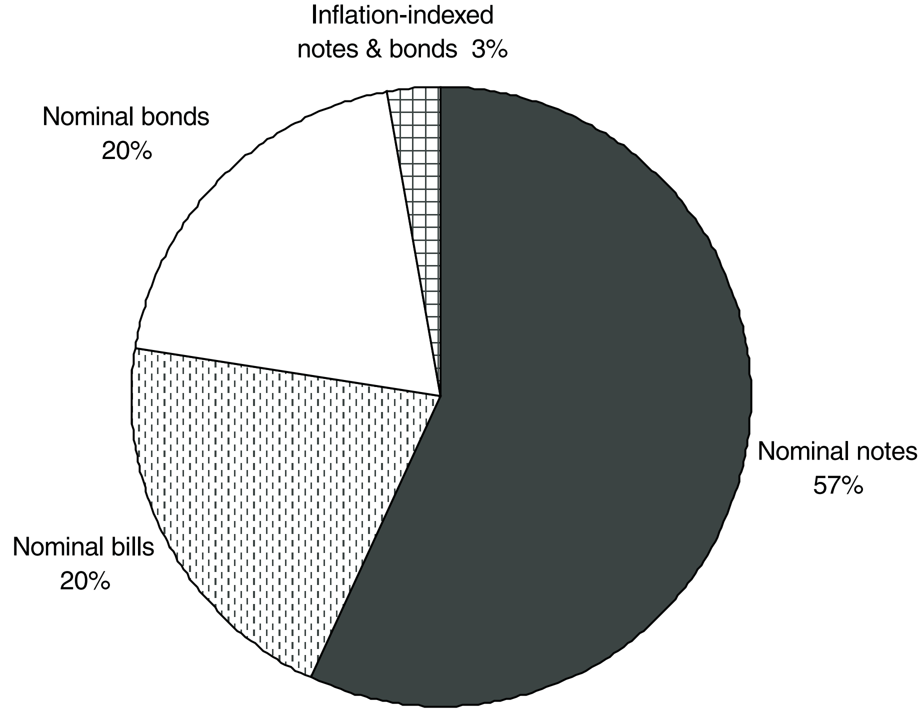
The Treasury's stated goals for debt management have remained the same to date regardless of whether the unified budget is in surplus or deficit: to have sufficient operating cash to meet the government's obligations, to achieve lowest financing cost, and to promote broad and deep capital markets. Although the goals may be the same, the management challenges are not.

Just as deficits lead to increased borrowing, surpluses generally result in the Treasury retiring debt. These two actions are not symmetrical, however. When the debt is increasing, the Treasury is issuing more securities than are maturing and is adding to the amount of debt outstanding. By selecting the instruments with which to borrow, the Treasury can have a greater effect on the maturity profile of the outstanding debt. In contrast, during periods of surplus, the Treasury is retiring more debt than it is issuing. Because the Treasury is not adding to the amount of debt outstanding, the maturity profile is more determined by the maturities of the remaining outstanding debt. As a result, the profile of outstanding marketable debt–both the type of security and when the debt matures–is a significant determinant of how and when the Treasury can reduce debt.

The profile of the Treasury's marketable securities consists of bills that mature in a year or less, notes with original maturities of at least 1 year to not over 10 years, and bonds with original maturities of more than 10 years out to 30 years. As figure 2 illustrates, as of July 1999, 57 percent of the outstanding marketable public debt is nominal (not adjusted for inflation) notes, 20 percent is bills, 20 percent is nominal bonds, and the remaining 3 percent is inflation-indexed notes and bonds.

[3]These budget projections assume compliance with discretionary spending caps on such spending through 2002, that discretionary spending will grow at the rate of inflation thereafter, and that all surpluses are used to reduce debt.

Figure 2: Treasury Bills, Notes, and Bonds as Percentages of Marketable Public Debt Outstanding, July 31, 1999



Source: *Monthly Statement of the Public Debt of the United States*, Department of the Treasury.

The Debt Management Story to Date

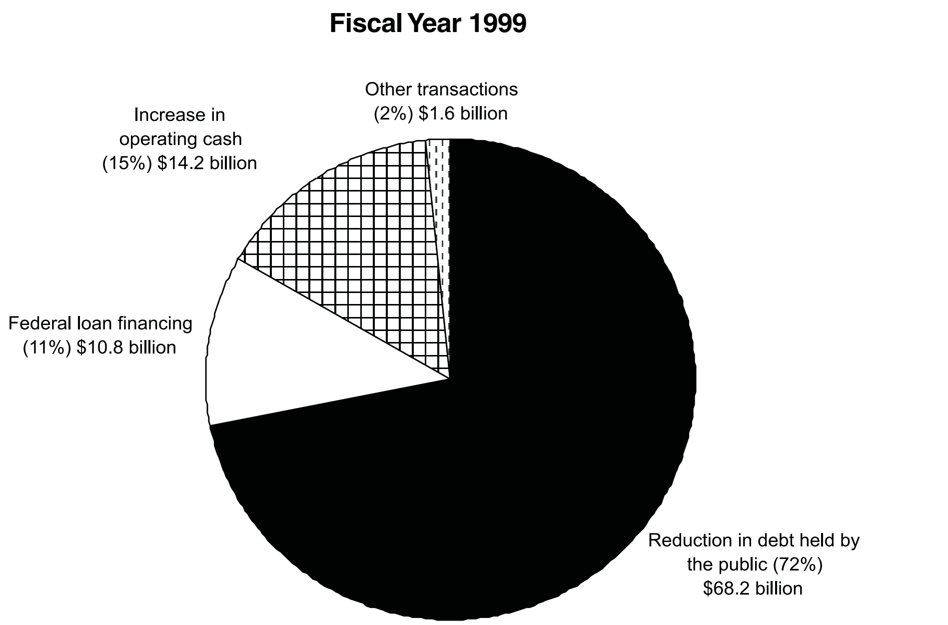
The “April surprise” that occurred in fiscal years 1997 and 1998 created a situation in which the Treasury suddenly and quickly absorbed unexpectedly high tax revenue, which initially resulted in reductions in short-term debt. Since some bills mature each week, the unexpected cash inflows were used to redeem bills. However, according to a Treasury official, bills were redeemed at such high levels that the liquidity of the bill market was adversely affected and the average life of marketable debt increased modestly–as shown later in figure 4. Although in fiscal year 1998 total marketable debt declined 3.2 percent, the amount of outstanding bills fell 9.2 percent. If left unaddressed, the shortage of bills and the lengthening of the average maturity of outstanding debt could have increased the Treasury's cost of borrowing. According to Treasury and Federal Reserve officials, the amount of bills reduced was sufficiently large to cause the market for bills to become less liquid.

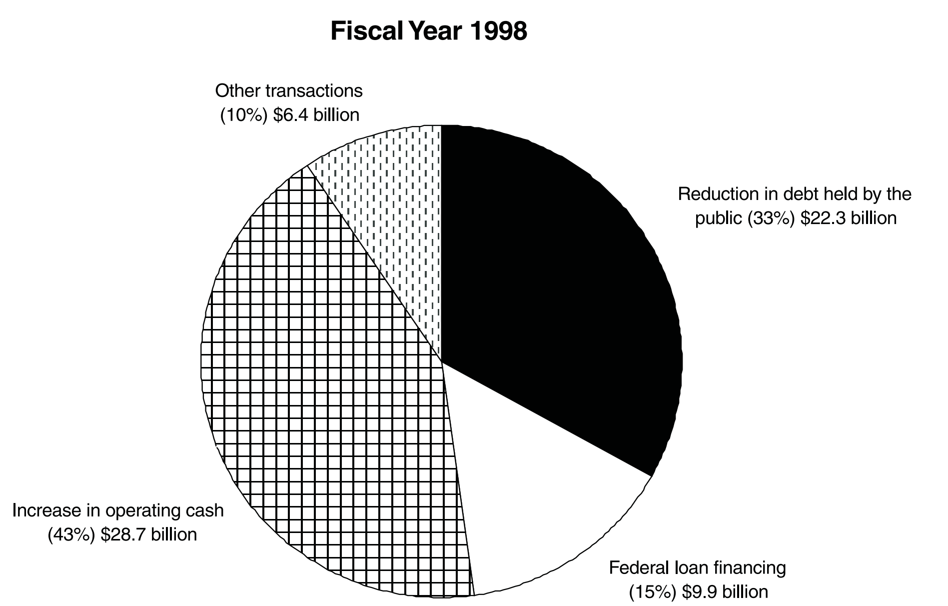
After this experience, the Treasury took steps to offset these trends and to better position itself to reduce debt without endangering its management goals. Instead of reducing the size of all issues equally, the Treasury concentrated its borrowing in fewer but larger debt offerings, eliminating the 3-year note and reducing the frequency of the 5-year note from monthly to quarterly in May 1998. In anticipation of a large influx of April tax receipts in 1999, the Treasury operated with a lower cash balance, using cash management bills to ensure adequate cash balances.

Figure 3 compares the allocation of the surpluses for the first 9 months of fiscal years 1999 and 1998.[4] The higher level of operating cash shown for this period of fiscal year 1998 reflects the fact that this was the first year of budget surplus. As the year continued, the Treasury both reduced outstanding debt and moved to change the profile by significantly reducing bills, reducing some notes, and continuing to issue bonds and inflation-indexed securities. In fiscal year 1999, however, the Treasury used more of the cash from the surplus to reduce outstanding debt held by the public by operating with lower cash balances. Seventy-two percent ($68 billion) of the fiscal year 1999 unified budget surplus through June 1999 has been used to reduce debt. In contrast, in a comparable period in fiscal year 1998 only 33 percent ($22 billion) of the surplus was used to reduce debt.

[4]A budget surplus does not translate dollar-for-dollar into debt reduction because the cash obtained from surpluses can be used to increase cash balances, to finance federal direct loan and loan guarantee programs, and for other transactions (largely changes to accrued interest and checks outstanding). See *Federal Debt: Debt Management in a Period of Budget Surpluses*, GAO/AIMD-99-270, for more detail.

Figure 3: Allocation of Unified Budget Surpluses, October to June, Fiscal Years 1999 and 1998

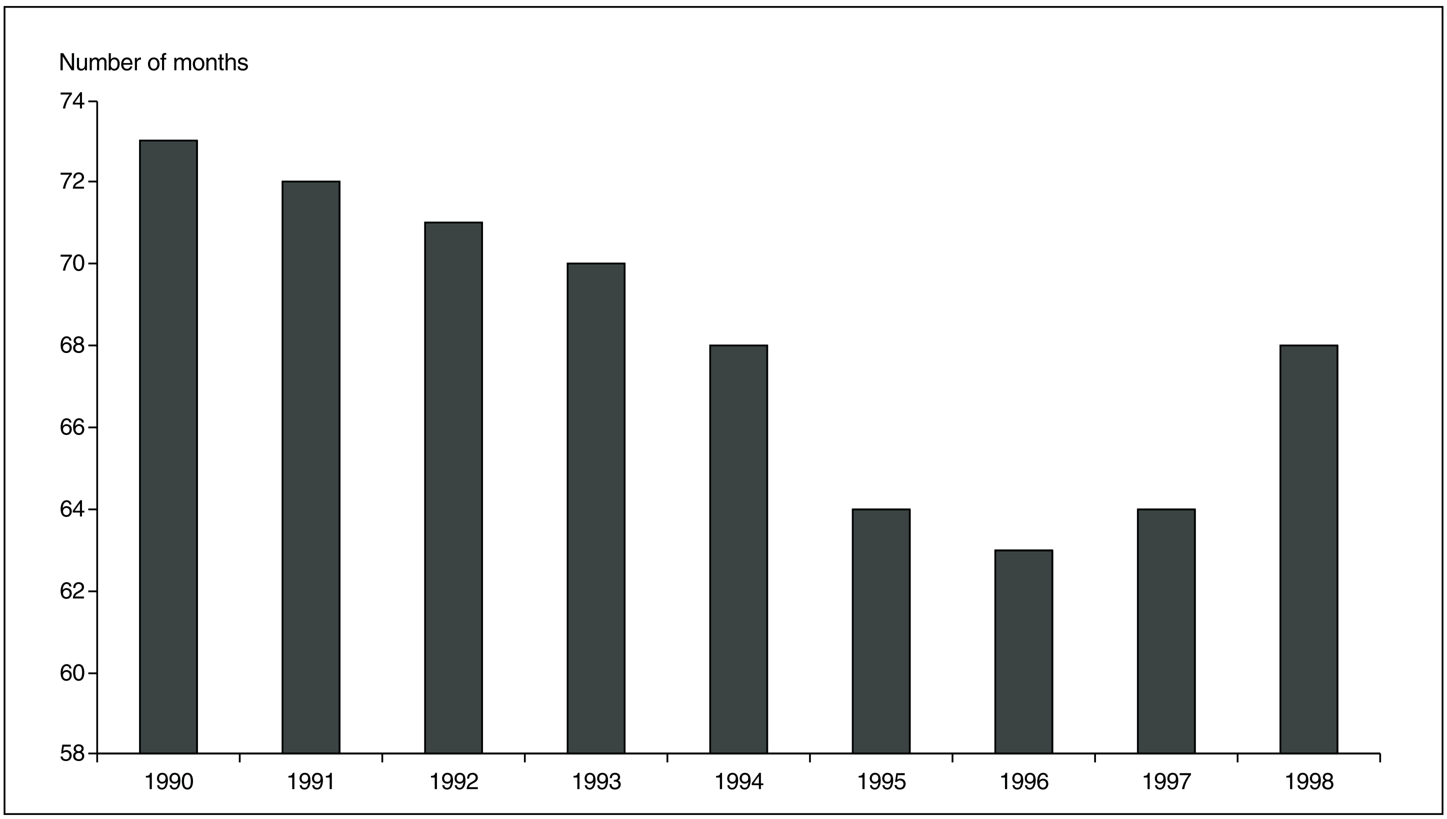




Source: *Monthly Treasury Statement*, Department of the Treasury.

The average maturity of outstanding debt has lengthened from 5 years and 3 months in 1996 to 5 years and 9 months in February 1999. The Treasury's actions in fiscal year 1999–reducing relatively more notes than bills–have been aimed at partially offsetting this trend, and in March 1999 the average maturity of outstanding debt stood at 5 years and 6 months. Nevertheless, if the Treasury continued to sell new securities on the May 1999 auction schedule, the average maturity of the outstanding debt would continue to grow. This would happen because the Treasury would redeem short-term securities as they mature and longer-term securities would remain outstanding. Figure 4 shows the trend in average maturity of outstanding debt from 1990 to 1998.

Figure 4: Average Length of Marketable Debt, 1990-1998



Source: *Treasury Bulletin*, Department of the Treasury.

The Treasury announced in August 1999 that it will reduce the frequency of issuance of 30-year bonds from three times a year to twice a year. This will allow the Treasury to continue to concentrate on fewer but larger benchmark issues[5] and to partially counter the current lengthening of the average maturity of outstanding debt. Treasury officials also announced that they are considering reducing the frequency of issuance of 1-year bills and 2-year notes. This move would allow the Treasury to increase the liquidity of the remaining benchmark issues. Continuing to issue new debt across the maturity spectrum and especially in certain benchmark securities is key to supporting the Treasury's current goals of obtaining the lowest financing cost and maintaining a broad, deep market for U.S. securities.

Tools to Increase the Treasury's Flexibility in Managing the Debt

As total debt held by the public continues to fall, the Treasury may take other actions to enhance a broad, deep market for Treasury securities and lowest cost financing while still ensuring adequate cash balances. These actions include re-opening the most recent securities issues (selling more of the most recent issue rather than opening a new issue), repurchasing outstanding debt before it matures, and redeeming callable securities as they become callable.

Re-Open Current Issues

The Treasury can increase the liquidity of outstanding issues by continuing to sell debt from the most recent issue (re-opening) rather than opening new issues. This strategy is useful when the Treasury wants to issue a small amount of a given type of security and it determines that the overall cost of re-opening is lower than it would be for new issues. The Treasury uses re-openings regularly for bills and has used this tool in the past for notes and bonds. Re-opening allows the Treasury to concentrate its new debt into larger, more liquid issues.

Two other tools–advance repurchase of securities and redeeming callable bonds–would target one segment of outstanding debt by either inviting or requiring investors, respectively, to redeem securities they currently hold. Reducing the amount of outstanding debt through advance repurchase of noncallable and callable securities allows the Treasury to reduce specific,

[5]The most recently issued Treasury securities, known as “benchmark” issues, are used by other financial services to price their products.

less liquid debt issues and to issue new, more liquid (and generally lower cost) benchmark securities across the maturity spectrum and in greater volume than would otherwise be possible.

Advance Repurchase of Debt

Repurchasing debt in advance of its maturity is one way for the Treasury to use the cash obtained from budget surpluses to retire outstanding debt. This would allow the Treasury to maintain a higher volume of new, more liquid benchmark securities. Repurchasing high-interest outstanding debt could also reduce the government's interest costs.

On August 4, 1999, the Treasury published proposed rules that would establish a reverse auction–where primary dealers submit offers to sell (rather than buy) a security. Comments on these proposed rules are due on or before October 4, 1999.

Repurchasing debt could necessitate the payment of a premium since most of the Treasury's older securities were issued with interest rates higher than those of securities issued today. Any premium paid to buy back debt might be treated as an interest outlay in the budget year when the securities are repurchased.

Since the Treasury would repurchase using existing legal authority and no legislation would be required, the Treasury's actions would not constitute a “scorable event” under the Budget Enforcement Act. Therefore, even if the premium were shown as an outlay in the budget year when the repurchase occurred, no offsetting cuts would be required although the amount of the surplus would be affected.

Callable Bonds

In some years, the Treasury has the option to redeem certain securities before their maturity dates without paying a premium. Before December 1984, the Treasury issued bonds that can be redeemed at face value at the Treasury's option 5 years in advance of the maturity dates (or on any interest payment date thereafter, after providing 4 months notice). A number of outstanding callable bonds with relatively high interest rates could be redeemed beginning in 2000. There are $87.6 billion in high-interest rate bonds that can be called from May 2000 through November 2009. Redeeming bonds would reduce the amount of debt held by the public and may reduce interest costs.

Future Debt Challenges

Budget surpluses offer the prospects of significant benefits for both the budget and the economy in the near and longer term. However, surpluses pose challenges to the Treasury's debt management. Declining levels of debt prompt the need to make choices over how to allocate debt reduction across the full maturity range of securities used.

The stakes associated with debt reduction strategies are considerable. As debt declines, the Treasury faces more difficult trade-offs in achieving broad and deep markets for its securities and the lowest cost financing for the government. Moreover, a wide variety of government and private sector participants both here and abroad have come to rely on Treasury securities to meet their investment needs. Both declining amounts of Treasury securities as well as shifts in their composition affect the interests of these participants. These changes, for instance, may very well affect the use of Treasury securities as benchmarks to price other financial transactions. Although markets tend to adjust to these shifts over time, changes may not be seamless or without cost.

Projections of continuing and increased unified budget surpluses suggest that the challenges to debt management experienced in 1998 and 1999 are a harbinger of more difficult decisions yet to come. The CBO July 1999 baseline projected that debt held by the public would decrease from $3,618 billion in fiscal year 1999 to $865 billion in fiscal year 2009, assuming compliance with discretionary spending caps through 2002, growth at the rate of inflation thereafter, and that all projected surpluses are used to reduce debt. To gain an appreciation of the size of the projected reduction, consider that the level of debt held by the public projected by CBO for 2009 is less than the dollar amount of federal securities owned by the Federal Reserve and state and local governments combined at the end of fiscal year 1998. The particular allocation of securities will be determined by a number of factors, but the comparison above gives a sense of the size of the continuing and more extensive adjustments by both the Treasury and market participants.

As debt held by the public continues to shrink, there will be greater pressure on the Treasury to further concentrate debt in fewer issues to maintain deep and liquid markets. Moreover, the Treasury will need to reassess its issuance of nonmarketable securities such as state and local government securities series and savings bonds. In a similar situation, Canada has begun a pilot program to consolidate its portfolio by buying back outstanding smaller, less liquid issues, allowing a simultaneous auction of new, larger replacement benchmark issues. The U.S. Treasury has taken a number of actions to concentrate its portfolio already and is considering other strategies to enable it to issue new and more liquid issues as overall debt declines, such as buying back outstanding, less liquid debt.

Mr. Chairman, this concludes my prepared statement. I will be glad to respond to any questions you or other Members of the Committee may have.

Contacts and Acknowledgments

For information about this testimony, please contact Paul. L. Posner at (202) 512-9573 or by e-mail at *posnerp.aimd@gao.gov*. Individuals making key contributions to this testimony included Thomas James, Jose Oyola, and Carolyn Litsinger.

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