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William J. McDonough

Opening Remarks

I am very happy to welcome you this morning to our conference "Fiscal Policy in an Era of Surpluses: Economic and Financial Implications." It is gratifying that so many distinguished scholars, policymakers, and market participants have taken the time to attend at this very busy time of the year—and century!

Our topic today is federal fiscal policy and the market for U.S. Treasury debt. Only a few years ago, a conference such as this would have been devoted to the problems associated with large deficits and mounting debt. As recently as fiscal year 1992, the federal deficit was $290 billion—nearly 5 percent of GDP—and the stock of debt held by the public was fast approaching 50 percent of GDP. The prospect of "deficits as far as the eye can see" kept policymakers searching for ways to slow the growth of spending and increase the growth of receipts while the financial markets struggled to absorb a stream of massive new Treasury debt issues.

Over the past several years of surprisingly strong real growth and low inflation, our fiscal situation has improved dramatically. In the fiscal year just ended, federal receipts exceeded outlays by $123 billion (0.8 percent of GDP). This achievement came on the heels of a $70 billion surplus the previous year, giving the country its first two consecutive surpluses since the late 1950s. Moreover, under consensus projections, surpluses will continue to rise over the next decade. Accordingly, policymakers today debate the wisest use of this bounty while financial markets learn to cope with a rapidly shrinking supply of new issues of Treasury debt.

In the less prosperous years of the late 1980s and early 1990s, research interest in fiscal policy and the debt market centered on objectives such as containing the explosive growth of the federal health care programs, ensuring the long-term viability of Social Security, identifying the optimal tax structure for long-term growth and well-being, and extracting information from the shape of the Treasury yield curve. Of course, these remain topics of vital interest. But to our mind, the dramatic improvement of our fiscal balance has shifted the spotlight to the topics we will be dealing with today:

- First, how did we come to the very enviable situation in which we find ourselves? Has it been the result of brilliant policymaking, or simply good luck? This year, which marks the twenty-fifth anniversary of the Congressional Budget Act, is a good time to review how the budget process has evolved over the past twenty-five years and to assess how well it has worked.
- How has the interaction between the budget and the economy changed? More specifically, how do we measure the stance of fiscal policy? Years ago, we talked about the full-employment balance as a guide to the government's effect on the economy. However, both the outlay and the receipt sides of the budget have changed significantly over the years. Entitlement outlays have

William J. McDonough is the president of the Federal Reserve Bank of New York.

grown as a share of the budget while discretionary spending and net interest have declined. On the revenue side, payroll taxes and taxes on capital gains have grown in importance.

- How do we measure the full-employment balance when a very large portion of federal spending consists of indexed entitlement payments and a significant portion of revenues comes from taxes on capital gains? At a time when we are more focused on the fundamentals required for sustainable long-run economic growth, is the full-employment balance still the best measure of fiscal impact?

We at the Federal Reserve have been studying how monetary policy should be conducted to achieve and maintain a low-inflation environment. We see a low-inflation environment as the central bank's major contribution to sustainable long-run economic growth. There are important parallel issues for fiscal policy as well.

As the federal budget has moved from large deficits to surpluses, new issuance of Treasury debt has fallen off quite dramatically. For example, from fiscal year 1996 to fiscal year 1999, new issuance of Treasury notes and bonds declined by nearly one-third. And if the consensus projections turn out to be true, or even if they turn out to be optimistic, new issuance will decline a great deal further in the near future. In contrast, financial markets have come to rely on a plentiful supply of newly auctioned "on-the-run" Treasuries to use for trading and collateral. What does this mean for our debt management policy? Closer to home, what does this mean for management of the System Open Market Account?

Furthermore, with this decline in new issuance, will the Treasury market lose its special role in the financial system? Moreover, what role will the Treasury market play in the price-discovery process determining the general level of interest rates? What changes should we expect in the Treasury market's position as the benchmark against which many fixed-income yields are evaluated? Finally, will the Treasury market's "safe haven" role be shared with other markets, or will safety become more scarce in the financial system?

The troubled state of financial markets last year following the Asian crisis and the Russian default illustrates our concerns. Traditionally, financial crises have precipitated a flight to quality—credit spreads widen and Treasuries become the "market of last resort" as investors seek a safe haven. But a year ago, Treasuries were scarce. Volumes in the Treasury market thinned and bid-ask spreads ballooned. The price-discovery process did not work well, and the uncertainty in the Treasury market amplified the troubles in the rest of the financial system. Certainly, I do not want to repeat that experience.

Of course, we can say that the best way to avoid repeating it is to eliminate the underlying problems, which were not based in the U.S. government debt market. However, history has shown that episodes of this kind can and do happen. When they do, the existence of a liquid market for default-free securities is extremely helpful in seeing us through them.

Ironically, the issues we are addressing are, to a great extent, by-products of the extremely successful performance of the American economy. I believe that to sustain that success, we need to make every effort to understand these issues.

We are indeed fortunate to have assembled today an esteemed group to consider these issues from a variety of perspectives. In looking over the list of conference participants and attendees, I am struck by the diversity of our backgrounds and interests. We have experts in public finance, macroeconomics, and capital markets from universities, the Federal Reserve System, scholarly institutes, and the private sector. In addition, the group includes public officials from the United States and other nations, representatives from international agencies, and active participants in the financial markets.

Your presence here confirms the importance of these issues in our economy and in our financial markets. I encourage your active participation in today's conference and your continued good work in this area.