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Summary of Observations and Recommendations

Benefiting from sustained economic growth and low inflation, the country's fiscal outlook has undergone a remarkable reversal. The trend toward large and growing budget deficits has given way to two straight years of budget surpluses and projections for a continued rise in surpluses over the next decade. Yet this solid fiscal performance poses challenges for the financial markets, which have had to adjust to the diminishing supply of new Treasury securities resulting from the surpluses.

To offer insight into these developments, the Federal Reserve Bank of New York hosted "Fiscal Policy in an Era of Surpluses: Economic and Financial Implications." The December conference focused on the forces behind the recent trends in federal receipts and outlays, the federal budget's effect on the overall economy, and the financial market consequences of the shrinking stock of U.S. Treasury securities. More than 100 academics, policymakers, and market participants attended the day's discussions.

Factors Contributing to the Improved Fiscal Situation

The first of the day's sessions focused on the economic forces and policy developments that have led to the nation's dramatic fiscal improvement over the past several years. Alan Auerbach provided a broad overview of the key economic trends shaping the federal budget over the past quarter-century and the main currents in fiscal policy, which to a large extent were reactions to those trends. For example, he explained that the across-the-board reductions of marginal tax rates and the indexing of the tax code in 1981 were mainly a response to the inflation-induced "bracket creep" of the 1970s, which pushed federal tax receipts as a percentage of GDP to very high levels. More recently, tax policy has been strongly influenced by the pronounced increase in the share of income going to those in higher tax brackets. Accordingly, efforts to boost tax revenues in 1990 and 1993 were directed primarily at these taxpayers.

With regard to outlays, Auerbach emphasized that the composition of federal spending has changed significantly over the past twenty-five years, with outright purchases of defense and nondefense goods and services yielding in importance to entitlement spending—particularly in the form of Social Security, Medicare, and Medicaid payments. Although defense and nondefense discretionary outlays as a percentage of GDP have fallen greatly over the period, Auerbach speculated that this trend was unlikely to persist. Indeed, he suggested that the trend could start to reverse itself, particularly now that the unified budget balance is in surplus. Auerbach stressed that the growing importance of entitlements—combined with demographic projections of a steep decline in the ratio of taxpayers to beneficiaries—makes the current unified budget surplus a poor indicator of the country's long-term fiscal position. Furthermore, over a longer time horizon, the federal budget will remain seriously in deficit, and recent policy proposals could exacerbate that situation considerably.

In the ensuing panel discussion, Barry Bosworth built on the themes of Auerbach's paper. He noted that over the past twenty-five years, fiscal policy's role in short-run economic stabilization has nearly disappeared because of an inability to

reach political agreement on how to eliminate persistent deficits. Consistent with that development, legislative changes have played a relatively minor role in the improvement in the federal fiscal balance over the past several years. Bosworth suggested that much of the improvement can instead be traced to the rapid growth of individual income tax receipts resulting from the shift in the distribution of income and from substantial capital-gains realizations. Yet he acknowledged the potential for deficits in the long run, particularly given the fact that entitlements for the elderly claim a growing share of the federal budget. He proposed that entitlement programs be budgeted and funded according to principles that differ from those applied to day-to-day government operations. Eugene Steuerle reiterated Auerbach's concerns about the emergence of future deficits as well as Bosworth's concerns about entitlement funding. He observed that the current surplus might be seen as "the eye of the storm" between two periods of chronic large deficits.

The Budget and the Macroeconomy

In the second session, the focus shifted to the federal budget's effect on the performance of the macroeconomy. Darrel Cohen and Glenn Follette offered a theoretical and empirical analysis of how the federal tax code and expenditure policy work to stabilize the economy automatically. Cohen and Follette began by presenting new theoretical findings using the modern two-period, representative agent model. They showed that, even in the case of forward-looking consumers, automatic stabilizers in the form of progressive income taxes and income-support programs should reduce the volatility of consumption by providing insurance against income uncertainty. In the empirical part of their paper, Cohen and Follette outlined the results of experiments involving the FRB/US econometric model—results suggesting that the automatic stabilizers play a real, but surprisingly modest, role in reducing the impact of demand shocks on the economy. Moreover, their FRB/US model experiments indicated that automatic stabilizers have virtually no effect on supply shocks, such as changes in oil prices. Cohen and Follette also presented updated estimates of the responsiveness of various federal taxes and spending programs to fluctuations in total output.

Olivier Blanchard, commenting on the Cohen-Follette paper, noted that much economic theory disputes the effectiveness of automatic stabilizers. Although Blanchard expressed his own view that stabilizers do work, he questioned the evidence from large-scale econometric models such as FRB/US. These models, he suggested, are constructed in such a way that they will invariably show that the existence of a progressive income tax and income-support programs dampens output fluctuations. Blanchard then offered alternative evidence supporting the effectiveness of stabilizers. For instance, he explained that in international data, output volatility tends to vary inversely with government expenditures as a percentage of GDP.

In an address to the conference, Rudolph Penner reviewed the passage of the fiscal year 2000 budget and presented his views on the near-term outlook for fiscal policy. He described the ongoing pressures to increase spending, which have led to a significant increase in discretionary spending for fiscal year 2000, as well as some of the political forces potentially at work in the budget process over the next few years. Although he agreed that it is difficult to project the budget and Treasury debt supplies, Penner was optimistic that the next decade will see a continued reduction in Treasury debt as a share of GDP.

Treasury Market Liquidity

The afternoon sessions addressed the implications of a shrinking supply of Treasury debt for the Treasuries market in particular and for the financial markets in general. In his keynote address, Treasury Department Under Secretary Gary Gensler described the ongoing changes in the auction schedule for debt as well as the Treasury's plans to repurchase existing debt and reopen issues. He acknowledged that Treasuries might lose their importance as financial market benchmarks and that other instruments might take over this role.

The following session was devoted to the preservation of Treasury market liquidity in the face of the declining volumes of new issues. Paul Bennett, Kenneth Garbade, and John Kambhu explored ways in which liquidity might be enhanced. For example, they proposed increasing the homogeneity of stripped Treasury coupon and principal components by allowing any stripped instruments of the proper maturity to reconstitute any issue. Bennett, Garbade, and Kambhu also recommended issuing 104-week Treasury bills and allowing market participants to create new stripped instruments by exchanging with the Treasury coupons or principal payments of similar maturities.

Vaughn O'Regan, drawing on his experience with similar innovations in Canadian debt management, mentioned the potential hurdles that these proposals could face. Charles Parkhurst cited some peculiarities in the current market for STRIPS that suggest that further expansion of the STRIPS

program may not enhance Treasury market liquidity greatly. However, Parkhurst did support the idea of a 104-week bill.

The Treasury Market's Benchmark Status

In the closing session, the participants considered the Treasury market's benchmark role. Michael Fleming examined the implications of the market's recent performance for the use of Treasury securities as a pricing and hedging tool. He observed that some of the attributes that have made the Treasury market a useful benchmark were weakened by the financial crisis of 1998 and have not yet fully recovered. Fleming also spoke about the possibility that federal agency debt issues, corporate debt issues, and interest-rate swaps would ultimately displace Treasuries as benchmarks.

In the panel discussion, Lou Crandall noted that the Treasury market lost its benchmark status on the short end of the yield curve some time ago because of the unpredictable supply of issues and the fact that the credit risk inherent in Treasuries differs markedly from the credit risk of the instruments hedged with Treasuries. For these same reasons, Crandall expected that Treasury coupons would eventually lose their benchmark status and be replaced by interest-rate swaps. Voicing a differing opinion, Thomas Glaessner contended that the Treasury market has in fact retained many of the important features of a benchmark market and that any deterioration in its benchmark role would consequently be slow. Moreover, Glaessner noted that a number of the alternatives to Treasuries lack some of the major attributes desirable in a benchmark security. Adding to the debate, Stan Jonas argued that swaps would eventually take over the benchmark role. He emphasized that Treasuries' lack of credit risk is only a relatively minor advantage; during financial crises, other sources of risk—such as a lack of liquidity—can be far more important.

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