REPORT TO THE SECRETARY OF THE TREASURY
FROM THE
TREASURY BORROWING ADVISORY COMMITTEE
OF THE
PUBLIC SECURITIES ASSOCIATION

April 30,1997

Dear Mr. Secretary:

Since the Committee's last meeting on February 5, 1997, the pace of the expansion has remained vigorous. Growth in the first quarter was particularly strong due to a surge in consumer spending. The pace of consumption seems to have moderated in recent weeks, but the outlook remains positive due to continued job and income gains and high confidence levels. Strength was evident in most other sectors during the first quarter except for a wider net export deficit. The factory sector entered the second quarter on an upbeat note with business inventories at cycle lows. Broad price measures generally remained well-behaved, but persistent strength in aggregate demand and the tightness in labor markets raised concerns that, at some point, increased signs of inflationary pressure may emerge.

During this period, interest rates on Treasury securities rose sharply with the largest increases occurring in the 2-5 year maturity sector (approximately 40-50 basis points). The rise in Treasury bill rates was somewhat less, partially as a result of a reduction in weekly bill offerings. The increase in market yields occurred in response to above-trend growth and rising expectations of a Federal Reserve policy tightening move, which occurred on March 25. Present market levels reflect expectations of further modest tightening during the spring or summer. Foreign demand for Treasury securities continues to be strong, aided by a strong dollar and attractive yield differentials between Treasuries and overseas markets.

Within this Context to refund the $27.4 billion of privately-held notes maturing on May 15, 1997 and to raise $1.6 billion of cash the Committee unanimously recommends that the Treasury auction $29.0 billion of the following securities:

$17.0 billion 3-year notes due May 15, 2000;
$12.0 billion 10-year notes due May 15, 2007.

The Committee unanimously supported a modest reduction in the size of the 3-year note to $17.0 billion from the $17.75 billion level in the prior refunding. This recommendation is consistent with the Treasury's recent tendency to reduce modestly offering amounts of short-term coupon issues, reflecting the continued trend of lower budget deficits and related financing needs. The Committee also considered the new cash being raised through further issuance of inflation-indexed securities.

In terms of its recommendation on the 10-year note, the Committee felt that it would not be desirable to reduce the size of the offering from the prior quarter's level. As a result of an absence of a 30-year bond offering, this mid-quarterly refunding is particularly small. It is also consistent with the Committee's recommendation in its report of May 1, 1996 that it would be preferable to target a

minimum size of $12.0 billion for the 10-year note auctions in February and May.

The Committee unanimously recommends a new 10-year note rather than re-opening the 6 1/4 percent notes due February 15, 2007. The Treasury's original issue discount rules would seem to preclude a re-opening of this issue at current price levels. Also, there is no indication of unusual tightness of the 6 1/4 percent notes in the repurchase agreement markets.

With the aim of achieving a cash balance of $35 billion on June 30, the Committee unanimously recommends that, for the remainder of the quarter, the Treasury meet its borrowing requirement in the following manner:

Two 5-year notes totaling $12.0 billion each, to raise $2.8 billion of new cash;

Two 2-year notes totaling $16.5 billion each, to paydown $3.8 billion of cash;

Two I -year bills totaling $13.75 billion each, to pay down $1.3 billion of cash; and

Weekly issuance of 3- and 6-month bills through the remainder of the quarter, to paydown $27.8 billion of cash.

Including the $1.6 billion raised in the mid-quarter refunding, as well as anticipated foreign add-ons of $6.8 billion, the proposed financing schedule will result in a net paydown of $21.7 billion. This amount, when combined with the net paydown of $43.3 billion to date in the quarter, will accomplish the total net market paydown of $65.0 billion.

In addition, intra-quarter cash management bills totaling approximately $20.0 billion will be needed to cover the cash low point in early June.

The Committee discussed the implications of recent reductions in the size of weekly bill offerings. These reductions have occurred as a result of Treasury cash management decisions in light of an unexpected surge in revenues in the April-June period. Competitive awards in the 6-month bill auction have been as low as about $2.0 billion. Liquidity in the affected bills seems to have been modestly constrained. As yet, no notable price distortions have occurred as portfolio managers seem to have made sufficient adjustment in their investment preferences. Yield curve discrepancies may arise, however, if current offering sizes persisted for a protracted period. The Committee recognizes that a significant increase in Treasury bill issuance will likely be associated with the increased borrowing need during the July-September period and beyond.

For the July-September quarter, the Treasury estimates a net market borrowing requirement in the range of $40.0-45.0 billion with a cash balance of $40.0 billion at the end of September. To accomplish this requirement, the Committee recommends the provisional financing schedule attached to this report.

In considering its financing recommendation for this period and beyond, the Committee discussed the need for continued issuance of 10-year notes in mid-July and mid-October. These two new note offerings had been introduced into the regular cycle in

July 1996, thus raising to six the number of such offerings per year.

Since that time, the Treasury has initiated its inflation-indexed securities program with issuance targeted to the middle of the first month of each quarter. The additional cash raising potential of these new securities, together with the reduced size of expected financing needs, raise the possibility of eliminating these two additional nominal 10-year securities. By a vote of 13-to-4, the Committee recommended that the Treasury eliminate these securities, thus returning to a pattern of four nominal 10-year note offerings per year, the size of which would be enlarged in line with patterns prevailing pre-July 1996. This would focus the mid-July and mid-October slots on inflation-indexed securities which, over time, would tend to be longer term issues. The minority preferred continuing the current pattern of six nominal 10-year offerings until more experience is gained with index-linked securities and there is a clearer picture of longer term financing needs.

At the Treasury's request, the Committee considered a number of questions regarding further development of the inflation-indexed security program. The Committee recognizes that the program is in an early stage of development and that both the investor and dealer communities are still adapting to the program. On the whole, the market's reception of the securities has generally been good, and there has been some improvement in market liquidity following the April re-opening of the initial 10-year security. Of course, the product has not yet achieved full assimilation in the market, in part due to normal start up considerations related to any new product introduction--such as adapting investment and risk management parameters, modifying accounting and operations systems and developing targeted investment offerings. In addition, continued uncertainty regarding the valuation impact of potential changes in the computational methodology of the CPI have caused some investors to or limit participation in the program.

Against this background, the Committee considered whether the Treasury should continue to focus its issuance of inflation-indexed securities in the 10-year sector of the yield curve, or begin to develop a market in other yield curve sectors. The main reasons to stay focused on the I 0-year sector would be to further develop liquidity in that sector, especially given its global benchmark status, and to avoid premature experimentation until the program is more firmly established. The arguments for initiating a second maturity sector would be to broaden the base of investor demand, cultivate more active participation related to the development of a transparent real yield curve, and improve liquidity by providing additional benchmark issues for originating and hedging corporate and municipal securities. By a vote of 16-to-1, the Committee preferred initiating a new maturity sector with the July issuance of inflation-indexed securities. In addition to the factors noted above, the Committee felt that market liquidity in the 10-year sector would not be materially improved by additional issuance at this time.

As to which maturity sector to tap, there was considerable discussion of the relative advantages and disadvantages of 5-year or 30-year inflation-indexed securities. The general sense of the Committee was that, in the long run, the Treasury would want to develop a market in both of these sectors. The 30-year sector was favored by some as

offering the promise of tapping into the long-term defined benefit pension fund market, as well as other long-term investment pools. These investors would logically place a higher value on inflation protection. It was also seen as offering additional opportunities for developing a market in stripped inflation-indexed securities.

Those in favor of issuing a 5-year security in the next offering cited the greater risk and uncertainty of offering a 30-year product at an early stage in the program's development. In part this reflected sensitivity to the 4levels of auction participation in the most recent 10-year issue. In addition, it was noted that there has been more corporate issuance in the 5-year sector -- thus evidencing a base of investor demand --as well as a potential to capture benefits from what appears to be an overly steep 5- to 10-year real yield curve, relative to the nominal curve. Finally, and importantly, with CPI methodology definition risk still a factor in the market, it was felt that the premium to cover that risk would be greater in a 30-year rather than 5-year security. Once CPI methodology issues were resolved, and after gaining more experience, the Treasury could tap the 30-year sector, By a vote of 10-to-7, the Committee favored the next issuance in the 5-year sector. Regardless of which sector was chosen next, the Committee was strongly of the view that the subsequent issue should be a reopening of that sector, to further the development of liquidity. In term of potential issue sizes, the sense of the Committee was that an initial 5-year security should be about $8-10 billion, while an initial 30-year security should be smaller in size, around $5-7 billion.

Finally, the Committee considered if this was the appropriate time in the program's development to regularize the auction calendar for inflation-indexed securities in various maturity sectors. While recognizing that, in the long run, the Treasury would benefit from regularity and predictability in the auction cycle for these securities, the Committee felt it was more important, at this early stage of market development, to preserve flexibility. Once more experience is gained with the depth and breadth of demand for the product across key sectors of the curve, the Treasury could focus on fine-tuning or adjusting auction schedules to achieve the benefits of predictability.

Mr. Secretary, that concludes the Committee's report. We welcome any comments or questions.

Respectfully submitted,

Richard M. Kelly
Chairman

Estimated Treasury Marketable Borrowing
(billions of dollars)
July - September, 1997

	Amount Maturing	Amount Offered	Foreign Add-ons	Cash Raised
Treasury bills				
Regular weekly bills	$214.4	241.0	--	$26.6
52-week bills				
July 24	15.2	13.8	--	-1.4
August 21	15.4	13.8	--	-1.6
September 18	14.6	13.8	--	-0.8
Total bills	259.6	282.4		22.8
Treasury coupons				
July 7-year	7.4	--	--	-7.4
Inflation-indexed securities	--	9.0	--	9.0
July 2-year	18.7	16.5	1.6	-0.6
July 5-year	11.7	12.0	0.7	1.0
Aug. 3-year		17.0	1.6	
Aug. I 0-year		13.0	0.7	
Aug. 30-year		10.0		
Refunding subtotal	26.8	40.0		15.5
Aug. 2-year	18.7	16.5	1.6	-0.6
Aug. 5-year	10.5	12.0	0.7	2.2
Sept. 2-year	18.6	16.5	1.6	-0.5
Sept. 5-year	11.6	12.0	0.7	1.1
Total coupons	124.0	134.5	9.2	19.7
Total borrowing	383.6	416.9	9.2	42.5

*Assumes that intra-quarter cash bills will be needed to cover cash low points during the quarter.