REPORT TO THE SECRETARY OF THE TREASURY FROM THE TREASURY BORROWING ADVISORY COMMITTEE OF THE BOND MARKET ASSOCIATION

May 1, 2001

Dear Mr. Secretary:

Since the Committeeís last meeting in January, the economy has slowed further by most economic measures. Private payroll employment over the last three months grew at its slowest rate since late 1992. The slowdown is most apparent in manufacturing where activity has fallen to levels not seen since the last recession. Specifically, manufacturing production fell an annualized 5.6% in Q1 while the key NAPM index fell to 42.1, its lowest level since early 1991.

The Fed responded aggressively to the slowdown that has emerged, cutting rates four times by a total of 200 basis points since the start of the year. Perhaps in response, consumer confidence—while well off its highs—remains above levels that have typically been associated with recessions in the past. The resilience of the consumer sector early in the first quarter, and to a lesser extent construction spending, more than offset a decline in corporate spending for equipment and software, so that the initial estimate of first quarter GDP of 2 percent exceeded the growth rate for the fourth quarter.

Inflation at the producer level remained in check, but accelerated at the consumer level in Q1 with the CPI rising at a 4% pace. Only some of that pickup was in food and energy, as core CPI rose 3.5%, its largest advance since early 1995. Employee compensation also showed signs of picking up. Hourly earnings rose 4.3% on a year over year basis in the most recent employment report, a level that was exceeded just once in the last year. A broader measure of compensation, the employment cost index, rose at a more benign 4% annual rate.

Interest rates on shorter-dated Treasuries have fallen over the past three months, with 2-year notes down 40 basis points in yield. Rates on longer-dated Treasuries initially fell in the period after the last Committee meeting but subsequently rose. They are now about 35 basis points higher than they were three months ago. Equities fell sharply in February and March in response to numerous earnings warnings but recovered somewhat in April as most companies met or exceeded the reduced earnings targets and the Federal Reserve surprised the market with a 50 basis point cut in rates between FOMC meetings.

Against this backdrop the Committee considered the composition of a financing to refund $21.4 billion of privately held notes maturing on May 15 and to pay down approximately $1.2 billion.

The Committee unanimously recommends a total financing of $20 billion consisting of the following offerings:

- A 2-year note of $10 billion
- Weekly issuance of 3- and 6-month bills throughout the remainder of the quarter
- An intra-quarter cash management bill of $20 billion, auctioned near the end of May and maturing near the middle of June

- Additional buybacks of $4 billion (As was the case in the first quarter, the last buyback of the 2nd quarter will settle in the 3rd quarter and, consequently, is not included in the $4 billion)

For the July-September quarter, the Treasury estimates a net pay down of $57.0 billion with a cash balance target of $60 billion on September 30. To accomplish this requirement, the Committee preliminarily recommends the financing schedule in the attached table.

The Committee recommends that the Treasury discontinue the TIPS program. The program, while popular among some investors, has proven to be an expensive adjunct to the Treasury borrowing program. To date, calculations suggest the Treasury has made $1.5 billion extra in coupon payments under the program compared to what would have been paid if nominal securities had been issued. Other estimates of the incremental cost of the program are even higher. Continued issuance of indexed securities in an era of large budget surpluses only exacerbates the liquidity problems in the benchmark nominal debt programs.

Committee members also urge the Treasury to clarify its views on long-term debt issuance and exchange programs as soon as possible. In that vein, the Committee encourages the Treasury to proceed with settling any regulatory and tax issues that may be involved with an exchange program. Most members believe that such a program is a way to preserve some issuance of benchmark securities for a time without sharply increasing the average maturity of the debt.

Concerning Committee recommendations regarding 4-week bill issuance, most members feel that auctions should occur weekly on Tuesday, settling Thursday of the same week along with regular 3- and 6-month bills. To increase liquidity the majority also feel that the bills should be fungible with previously issued bills with the same end dates. The ideal issuance size range for the program is $5-6 billion minimum and no maximum. While some are concerned that providing no maximum auction size might make the bills trade higher in yield like traditional cash management bills, most feel that market participants could quickly ascertain relative auction size based on cash management projections and prepare in advance for these sometimes large size variations. Ultimately the new bill will probably trade in yield somewhere between cash management bills and regularly issued Treasury bills. Additionally the Committee recommends that the new 4-week bill program replace rather than supplement the CM bill program. Removing inconsistencies with CM issuance will decrease costs for the Treasury by broadening the investor base and eliminating uncertainty with respect to timing of issuance. In response to the Treasuryís question regarding the viability of holding all three bill auctions on one day, most members think that this schedule will impact Treasury financing negatively by increasing auction award risk with dealers.

Under current Treasury auction procedures, the so-called ì35-percent-ruleî limits the sum of a bidderís net long position in the when-issued security plus competitive award to 35 percent of a Treasury auction. In the case of a reopening, holdings of the outstanding security are counted toward the limit in the calculation of the net long position, while the calculation of the dollar amount of the limit is only based on the announced reopening size. In its current form, the inconsistency of this rule has adversely affected the ability of certain market participants to bid in Treasury reopening auctions. With the Treasury having moved to a regularized schedule of reopenings of Treasury securities, the rule over time could result in weaker auction coverage and potentially higher borrowing costs. As a result, the Committee recommends that the 35 percent rule be altered so that the net long position used in the calculation of a bidderís position refer only to the position in the when-issued security. This would make the calculation of the bidderís net long position plus competitive award consistent with the calculation of the 35 percent limit.

With respect to the 35 percent limit itself, a strong majority of the Committee believes some sort of limit is important in order to reduce the possibility of inconsistency and non-economic behavior in auctions. Members have no strong opinion whether a 35 percent limit is the optimal limit or some other percent is better. The Committee also suggests that the Treasury modify its regulations so that the rule applies to positions at the time of submission of auction bids even if reports of the net long position are as of thirty minutes prior to the auction. Some members suggest shortening the interval between the submission of the net long position and the auction while others suggest a second submission, after the auction, that gives the position at the time of the auction.

James R. Capra, Chairman

Timothy W. Jay, Vice Chairman

2000 Financing Schedule

2001 Financing Schedule