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

October 29, 1997

Dear Mr. Secretary:

Since the Committee's last meeting on July 30, 1997, the pace of economic activity has accelerated, though preliminary evidence points to some moderation early in the fourth quarter. Consumer spending rebounded sharply in the third quarter after a pause in the spring, and factory output stayed robust, despite evidence of a slower rate of inventory accumulation. Resource utilization pressures tightened further in labor and product markets, but inflation measures remain subdued and there is little evidence of building price pressure in early stages of production.

Interest rates on Treasury securities are currently similar to those prevailing at the time of the Committee's last meeting. Initially, rates increased modestly on signs of economic strength. The early increase in rates subsequently reversed amid an absence of inflation pressures and expectations of some moderation in economic activity. More recently, Treasury securities have benefited from turmoil in global equity markets and a sharp widening in credit spreads. Monetary policy has remained steady since last March, and Eurodollar rates reflect market expectations of a steady policy at least through year-end.

Within this context, to refund the $26.5 billion of privately-held notes maturing on November 15, 1997 and to raise $10.0 billion of cash, the Committee unanimously recommends that the Treasury auction $36.5 billion of the following securities:

- $15.0 billion 3-year notes due November 15, 2000;
- $11.5 billion re-opened 6 1/8 percent notes due August 15, 2007;
- $10.0 billion 30-year bonds due November 15, 2027.

The Committee supported a further reduction in the size of the 3-year note to $15.0 billion from the $16.0 billion level in the prior refunding. This recommendation is consistent with the Treasury's recent practice of reducing offering amounts of short and intermediate-term issues, reflecting the continued trend of lower budget deficits and related financing needs.

The Committee unanimously recommends a re-opening of the 6 1/8 percent notes due August 15, 2007. Such a re-opening would relieve the persistent tightness of this issue in the repurchase agreement market. This recommendation also takes into account the relative expensiveness of this issue on the yield curve. In light of its recommendation to re-open the 6 1/8 percent notes, the Committee supported a modest reduction in the size of the issue to $11.5 billion from the $12.0 billion level in the prior refunding. (The Committee's continued preference for larger, liquid issues in this important benchmark maturity is reflected in its provisional recommendation to issue $12.0 billion of new 10-year notes in the January-March quarter.)

The Committee also recommends a new 30-year bond. This would enable the Treasury to further increase the strippable product with May 15 and November 15 maturities.

With the aim of achieving a cash balance of $35.0 billion on December 31, 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 $11.0 billion each, to pay down $1.0 billion of cash;
- Two 2-year notes totaling $15.0 billion each, to pay down $6.2 billion of cash;
- Two 1-year bills totaling $12.5 billion each, to pay down $4.5 billion of cash; and
- Weekly issuance of 3- and 6-month bills through the remainder of the quarter, to pay down $2.3 billion of new cash.

Including the $10.0 billion raised in the mid-quarter refunding as well as anticipated foreign add-ons of $5.0 billion, the proposed financing schedule will raise a net amount of $1.0 billion. This amount, when added to the $19.0 billion already raised or announced in the quarter, will accomplish the total net market borrowing requirement of $20.0 billion. In addition, intra-quarter cash management bills totaling approximately $23.0 billion will be needed to cover the cash low point in early December.

For the January – March, 1998 quarter, the Treasury estimates a net market borrowing requirement of $15-20 billion, with a cash balance of $20.0 billion at the end of March. To accomplish this requirement, the Committee recommends the provisional financing schedule attached in Table 1.

In considering its financing recommendation for the January to March period, the Committee favors the issuance of a significant amount of cash management bills with April 1998 maturities. This financing approach will better enable the Treasury to offer consistent amounts of weekly bills throughout the April to June quarter, a period when a substantial net market paydown is likely.

At the Treasury's request, the Committee also considered the scheduling of Treasury inflation-indexed securities during calendar 1998, taking into consideration the Treasury's announced plans to sell 10-year inflation-indexed notes in January and a 30-year inflation-indexed bond during 1998. In this regard, the Committee evaluated three dimensions of the Treasury's request: first, the question of regularizing the maturity offerings in the existing quarterly inflation-indexed offering cycle; second, the relative market interest in 30-year relative to 5-year inflation-indexed securities; and third, the potential for introducing a fifth inflation-indexed security into the offering calendar, most likely in the context of the May refunding.

In evaluating these issues, the Committee took into account the impact of the continued improvements in the fiscal outlook, with attendant diminished financing needs, as well as the still generally benign inflation expectations. The Committee sought to balance these considerations against the Treasury's longer term interest to foster the development of these instruments as an alternative financing mechanism, to compliment the Treasury's regular nominal coupon offerings.

Finally, the Committee considered primary and secondary market experiences during the first year of introduction of these instruments, including the low price correlations between nominal and inflation-indexed securities and the types of institutional investor activity in the securities.

Following its discussion, the Committee was unanimous in recommending: (1) that the Treasury should announce its intention to have four inflation-indexed securities offerings during calendar 1998, utilizing the existing January, April, July, and October offering schedule; (2) that the Treasury should indicate it's intention to introduce a 30-year inflation-indexed security in the April offering, following the already announced plan for a 10-year issue in January; and (3) that the Treasury should preserve flexibility on the maturity of the July and October offerings, pending evaluation of the experiences with the new 30-year security. In this regard, it was expected that at least one of these issues would be another 10-year security, but that the decision on the maturity of the other offering need not be made at this time.

In the Committee's view, this offering program, including the introduction of a new 30-year security, would serve as a confirmation of the Treasury's commitment to the development of a meaningful market for these securities, while balancing the scale of the program with the somewhat reduced expected size of net new borrowing needs. In supporting the introduction of a new 30-year maturity, the Committee was generally of the view that the market is demonstrating a clear preference for longer term inflation-indexed securities, reflecting both the longer duration of inflation sensitive pension fund liabilities as well as the benign near-term inflation outlook. Once the Treasury had the benefit of a second full year's experience with the product across a broader spectrum of the maturity curve, it would be in a better position to evaluate opportunities for further regularizing the offering maturities or possibly expanding the number of annual offerings.

Based upon these recommendations, which would not entail the issuance of an inflation-indexed bond in the May refunding, the Committee considered the schedule of dates for that midquarter refunding. Taking into account the desire for shorter post auction when-issued trading periods, when feasible, the Committee was unanimous in the view that the refunding announcement should be scheduled for Wednesday, May 6, with the auctions to be held on May 12th and 13th.

At the Treasury's request, the Committee also discussed the question of market participants' preparedness for the computer conversion to the year 2000, including steps which the government might take to heighten awareness of this potential problem. In the Committee's discussion, there was a consensus that there is already a very high level of awareness of this issue among large U.S. financial institutions, including banks, broker-dealers, insurance companies and asset mangers. There was also a high degree of sensitivity to this issue on the part of Federal banking and securities regulators. Awareness, however, is only the first step and it was clear that much work remains to be done, with only limited time for making changes, testing changes and certifying readiness. It was also clear that there are only limited available skilled programming resources to do this work, with attendant increased costs and scheduling pressures in lining up these resources. There are the added complications of similar adjustment problems in planning for the 1999 introduction of the new European Monetary Union.

In terms of areas for possible further government focus, suggestions for consideration included: (a) ascertaining the level of readiness of smaller financial institutions, for whom the relative costs may be significant; (b) focusing on industry-wide infrastructure service providers, including clearing and settlement systems and central depositories, as well as key information vendors; (c) raising awareness among foreign financial market participants, particularly in developing country markets, where preparedness for this change may not be as advanced as it is in the United States; and (d) ensuring the readiness of governmental entities themselves, where there is less transparency on the scale of needed efforts and the timetables for making changes, including securing funding authorization for the costs of such changes.

Of these, the readiness of key depository, clearing and settlement services is viewed as especially important, particularly since major financial institutions must be ready for comprehensive testing of year 2000 changes by year-end 1998. Should industry service providers not be similarly ready for testing, it will add further costs, complications and risks to the conversion effort.

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

Respectfully submitted,

Richard M. Kelly
Chairman