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

May 6, 1998

Dear Mr. Secretary:

Since the Committee's last meeting on February 4, 1998, the economy has continued to perform quite well. Indeed, the Commerce Department recently reported that GDP expanded at an impressive 4.2 percent pace in the first quarter. To this point, consumer-led demand strength, gains in construction activity, and a rebound in business capital spending have more than offset any headwinds in the trade sector arising from the financial crisis in Asia. While growth may moderate somewhat in Q2, the underlying fundamentals of the U.S. economy still appear quite supportive. Specifically, real disposable personal income growth is running at an above 4 percent clip on a year/year basis providing a good deal of fuel for continued gains in domestic demand.

On the inflation front, the news remains quite favorable. A further decline in quotes for energy products has contributed to a deceleration in headline readings for both PPI and CPI, and, core price readings have remained benign. Meanwhile, despite tight labor markets, wage pressures have been slow to build as reflected in the first quarter employment cost index report recently released by the Labor Department.

For the most part, fixed income markets have traded in a relatively narrow range during the past few months with the yield curve slightly flatter than at the time of the Committee's last meeting. This reflects a modest adjustment in the market's assessment of the future course of Federal Reserve policy. While the Fed is widely expected to leave policy unchanged in the near term, the market is now priced for a small amount of tightening over the next several months in contrast to the expectation of very slight easing that was evident three months ago.

Before considering recommendations as to the composition of a financing to refund $25.4 billion of privately held notes maturing on May 15, the Committee reviewed at length alternatives for changes in Treasury market financing activity in light of the improvement in the Federal budget situation.

In this regard, the Committee considered two longer-term financing outlooks, one involving a continuation of the current size of net marketable debt paydown and the other reflecting a gradual decline in net debt paydowns. The Committee reviewed the impact these financing outlooks would have on the profile of Treasury bill and coupon issuance, the maturity composition of the outstanding debt and the weighted average maturity of the debt. This began with an assumption based on the existing pattern and size of coupon offerings—with all size adjustments made in the bill market—and then extended to include reviewing the impact of various scenarios for altering the size, composition and frequency of coupon offerings.

In evaluating all the various scenarios, the Committee was of the view that the Treasury's longer-term interest would be best served by modifications to the composition and frequency of existing Treasury coupon offerings, rather than by continued downward adjustment to the sizes of those offerings, as well as further cutbacks in bill issuance. Indeed, there was a strong consensus on the Committee that the Treasury should shift its financing program in a fashion that would:

- limit further contraction in net bill issuance by moving to gradually increase the size of regular bill offerings;

- concentrate future net paydowns in the coupon sector; and

- refocus coupon offerings around less frequent larger offerings of benchmark securities, to help preserve the attractive liquidity features of the Treasury coupon market.

To achieve these objectives, the Committee was unanimous in recommending the following changes to the existing coupon offering cycle: (1) elimination of the existing quarterly offerings of 3-year notes; (2) reducing the frequency of 5-year note offerings from a monthly to a quarterly cycle replacing the 3-year note, with each such quarterly offering to be significantly larger than the current monthly issues; and (3) enlarging the remaining benchmark coupon offerings, as opportunities permit, balancing the Treasury's overall reduced issuance needs with the issuance capacity created by the elimination of 12 existing annual coupon offerings.

In recommending these changes, the Committee felt that this would serve to enhance liquidity in both the bill and coupon sectors of the market and restore the market focus on the Treasury's quarterly refundings. This was judged to be the most effective way to ensure the Treasury market's status as the world's most liquid capital market, particularly in light of changes in issuance patterns in other government debt markets. It would also facilitate effective Treasury cash management by increasing the relative size of the quarterly offering cycles—thus better matching interest and maturity coupon payments.

As regards timing, the Committee was unanimously of the view that these changes should be introduced in the July-September fiscal quarter. Specifically, the Committee recommends discontinuing quarterly issuance of 3-year notes following the May refunding and discontinuing monthly issuance of 5-year notes following the June offering.

At the Treasury's request, the Committee also discussed the possibility of changing the treatment of foreign official account "add-ons" in current note and bond offerings, such that those amounts sold would, in the future, be included within the announced amounts sold to the public—as they are now for the bill offerings—rather than added-on to the size of the coupon offerings—as is the current practice. Should such a change be made, it was noted that it would impact the maximum auction size awarded to any one bidder, thus necessitating the need for disclosure of the amount of such awards prior to the day of the auction. It was suggested that procedurally this information was available to Treasury on the day before each auction, so it could presumably be disclosed before the auction.

The Committee was almost evenly divided on this issue, with ten members preferring this change and nine members being opposed. Those in favor of the change felt that the Treasury could shift this risk to the market, with the market able to make reasonable estimates of the size of these awards prior to the announcement of actual amounts one day before the auction. They also noted that the awards would be at market clearing prices for lower effective auction sizes, thus marginally lowering costs to the Treasury. Finally, they felt there should be consistency in treatment between coupon and bill offerings.

Those opposed felt this would further reduce issue sizes in an ad hoc fashion and was at odds with the desire to have large benchmark issues. They also felt the announcement of the size of these awards after the commencement of when-issued trading, but before the auction, could be disruptive to the market. In effect, they felt the Treasury could better manage the risks of these awards as add-ons to their offerings by modestly adjusting announced issue sizes, than could the market, in adjusting to the new procedures.

In terms of timing of implementation, should such a procedural change be made, it was agreed that it should be no earlier than the start of the July-September quarter, to allow sufficient time to develop and implement new procedures for the dissemination of needed information to the market. Given the divided views on the merits of this change, and the uncertain timing for implementation were it to be implemented, the Committee's financing recommendations for the current and next quarter assume continuation of the existing add-on practice.

Finally, the Committee briefly discussed the potential for the use of buying back Treasury securities from the secondary market. As noted in its last report, the Committee felt that this technique was potentially most useful to the Treasury when it was premature to consider changes in the number or frequency of regular coupon offerings and when there was limited scope for further reductions in existing issue sizes. In light of the extensive changes being recommended in the regular coupon offering cycle—and given opportunities to raise regular issue sizes as a result of those changes, the debt buyback tool would apparently have limited usefulness to the Treasury at this time. That said, there may still be circumstances where the Treasury would find it advantageous to have such a capability, although it was again noted that there were some complex government accounting policy issues that would have to be addressed, were it to be utilized.

Within this context, to refund $25.4 billion of privately-held notes maturing on May 15, 1998 and to pay down $3.4 billion of cash, the Committee recommends that the Treasury auction $22.0 billion of the following securities:

- $10.0 billion 3-year notes due May 15, 2001;
- $12.0 billion 10-year notes due May 15, 2008;

In its refunding recommendation, an 18-1 majority of Committee members felt that the Treasury could reduce the 3-year note by $3.0 billion to the $10.0 billion level. The relatively small auction size was viewed as acceptable within the overall recommendation which included the elimination of 3-year notes in future financing. The recommendation of a $12.0 billion 10-year note reflects the continued desire of Committee members to reinforce this sector with large issue sizes.

The Committee recommends Treasury financing for the remainder of this quarter of the following composition:

- Two 2-year notes totaling $13.0 billion each and two 5-year notes totaling $11.0 billion each, with these four auctions paying down a net of $15.1 billion in cash;
- Two 1-year bills totaling $10.0 billion each, to pay down $9.1 billion of cash;
- Weekly issuance of 3- and 6-month bills through the remainder of the quarter, to pay down $10.7 billion of cash; and
- One cash management bill totaling $15.0 billion to cover a cash low point in early June and mature during the quarter.

This proposed financing schedule, as well as anticipated foreign add-ons of $7.7 billion, would result in a net paydown of $102 billion. The Committee believes strongly in the proposed schedule, and particularly the importance of a smooth transition in the 5-year sector with a June offering marking the last of the monthly issues. This would limit the time gap before the first quarterly 5-year auction in August, and thus minimize any negative impact on liquidity in this sector. If, despite these considerations, the Treasury felt it necessary to meet the $110 billion paydown in the current quarter, the Committee would eliminate the June 5-year note, rather than further reduce other issue sizes. For the July-September 1998 quarter, the Treasury estimates a borrowing need of $0 to $5 billion, with a cash balance of $40 billion at the end of September. To accomplish this requirement, the Committee recommends the attached provisional financing schedule, which is at the low end of Treasury estimates, in order to balance the proposal to have a somewhat smaller net paydown in the second quarter.

In discussing the schedule for next quarter, the Committee focused on the initial size for the first quarterly 5-year note and the appropriate sizes for the 2-year and 10-year notes in the quarter. A majority of the Committee members favored an $18 billion initial quarterly 5-year note, while raising the two-year notes to $16 billion. A further group of five members would prefer a slightly smaller initial 5-year offering in order to further enlarge the 10-year note. A minority of three members favored an initial 5-year note of $20 billion to maximize the potential liquidity in that sector, given the cutback in the number of offerings. In turn, they would prefer a somewhat smaller 2-year note. All members of the Committee recognized that should the recommended new coupon offering cycle be implemented, there would be ongoing opportunities to judge and rebalance the issue sizes in light of both market experience and updated information on financing needs.

As a final matter, the Committee also discussed the appropriate maturity of the inflation-indexed security to be auctioned in July. In this regard, the Committee was nearly unanimous in the view that it should be a reopening of the recently issued 30-year security. While recognizing that the program was still in developmental stages, there was a strong sense that the 30-year issue had received solid underlying market interest, especially in comparison to the 5-year offerings, and that it would be in the Treasury's interest to further develop the long-end of this market, since that is where there is most demand for inflation protection. In making this recommendation, the Committee felt that this would not prejudge when to move to a regular cycle of inflation-indexed offerings and what that cycle should be.

Respectfully submitted,

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Chairman