

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

**October 30, 2001**

Dear Mr. Secretary:

Since the August refunding, the economy has weakened further. The terrorist attacks on September 11 exacerbated what was already a deteriorating employment situation. Now, consensus economic forecasts envision two or possibly three calendar quarters of declining real GDP, with the unemployment rate rising towards six percent. These same forecasts anticipate that monetary and fiscal stimulus, lower oil prices, and a completion of the inventory cycle will lead to a resumption in growth in either the second or third quarter of 2002.

Interest rates have fallen since our last meeting. The federal funds rate has been cut by 125 basis points. Most of this reduction has passed through to Treasuries with maturities of two years and less. About two-thirds of the federal funds rate reduction has passed through to Treasury 5-year notes, one-half to 10-year notes, and about one-fourth to 30-year bonds. In short, the yield curve has steepened further. Spreads to Treasuries on agencies and swaps have narrowed somewhat over the past three months. However, spreads on 10-year Baa corporate bonds have widened by almost 60 basis points, so that yields are close to where they were three months ago. High yield and emerging market debt prices have deteriorated over the past few months.

On October 4, the Treasury announced and auctioned a \$6 billion reopening of the 10-year note, after consultation with the Committee, in order to help alleviate an acute shortage of that security in the financing market. Prior to the auction, daily fails to deliver collateral in financing markets for the 10-year were running in excess of \$15 billion. Within a relatively short time after the auction, fails fell to frictional levels, although financing rates have remained very low for the issue.

The outlook for Treasury financing has changed significantly over the past three months. At the time of the August refunding, the Treasury projected a tentative fourth quarter paydown of \$36 billion. Yesterday, the Treasury announced a fourth quarter net borrowing requirement of \$31 billion. Most of the change in the fourth quarter financing was caused by the deterioration in the economy, although some part is a result of spending programs enacted by Congress. Three months ago, consensus forecasts were for a surplus of \$120 billion to \$150 billion in fiscal year 2002. Now, the consensus is for a deficit of \$25 to \$50 billion or possibly higher, depending on the final outcome of ongoing Congressional negotiations on economic stimulus proposals.

Against this backdrop, the Committee considered the composition of financing to refund \$21.6 billion of privately held notes maturing on November 15. Prior to making specific recommendations for the upcoming refunding, the Committee discussed two questions posed by the Treasury.

In response to a question regarding the potential for more flexibility in the range of overall auction sizes and in week-to-week fluctuations in sizes of four week bills, the Committee noted that the program had to date been a resounding success with the bills regularly trading significantly lower in yield than

general collateral and effectively eliminating the premium. Treasury has in the past had to offer in yields for cash management bills. Most members felt Treasury could increase the program to \$24 billion without significantly affecting the market and over time auction sizes could be even larger. Additionally, Treasury could allow for weekly fluctuations of between \$4 billion and \$8 billion without significantly impairing liquidity in the sector.

The Treasury asked for the Committee's views on potential changes to Treasury borrowing for the current and upcoming quarters and going out the next one or two years in light of changes in the budget outlook caused by further weakness in the economy, increased government spending, and the economic shock from September 11.

The Committee noted that regardless of whether the changes in the budget outlook are of a temporary nature or represent a longer lasting structural shift, the Treasury does not appear to have to make dramatic changes in its current coupon offering frequencies or sizes in fiscal year 2002 or even in 2003. A significant part of the change in the deficit outlook is absorbed under current debt offering levels by the fact that maturing coupons decline by \$57 billion in fiscal year 2002 and by a further \$55 billion in fiscal year 2003. Thus for a given level of debt offerings, the Treasury raises more new cash each year. In addition, the Treasury has already raised the size of the monthly 2-year note by \$9 billion, to \$19 billion, from its low point in mid 2001 of \$10 billion. The extra money from this change, as well as extra issuance in bills, combined with the decline in maturing coupons, accomplishes the bulk of additional financing required in 2002 and in 2003 under most current budget projections. The Committee recommends some slight upward adjustments in auction sizes for 5-year notes and 10-year notes primarily because of the desire for improved liquidity in those issues. In addition, if the future path for the economy and budget turns out to be one of a return to surpluses, the date at which rising surpluses will become a problem for Treasury issuance has been pushed back by several years so that the relatively small increases in these two issues should not present a problem.

The Committee reviewed data that showed that if the move to deficit from surplus persists into 2004 and grows, the Treasury will have to take further action in the coupon sector, either by more significantly increasing issue size or increasing the frequency of offerings, or both, depending on the size of the deficits. At some point in late 2002 or in 2003, if the deficit outlook for 2004 and beyond appears to be deteriorating, the Treasury will probably have to begin a transition. However, such a decision need not be made at the present time.

On the question of buybacks, the Committee believes that under the current situation of anticipated small deficits or small surpluses the buybacks help improve liquidity for the 5-year, 10-year, and 30-year issues by making it possible to auction larger offerings than would otherwise be the case while keeping the average maturity of the debt from rising significantly. Also, under the current interest rate structure the buybacks have the side benefit of lowering the Treasury's cost of servicing the debt. However, the Committee notes that the buyback program was originally instituted as a debt management tool for a period of large and rising surpluses. Because that is clearly not the case at present and may or may not be the case in the future, depending on the economy and on budget policies, the Treasury may want to consider scaling back the program somewhat.

In discussing the composition of the November refunding, Committee members noted that 5- and 10-year current coupon securities, both of which suffered large and persistent fails in the financing markets after the September 11 tragedy would probably continue to be in short supply in the repo market. Additionally 5-year notes, because of both Treasury's reopening policy and the extreme steepness of the yield curve, was only a viable hedge for certain other asset classes during the pre-reopened quarter when, coincidentally, issue size was smallest. As a result the Committee felt strongly that Treasury

should initially issue both these securities in larger size with reopenings being somewhat smaller by comparison. For example, the difference in size between the initial issue and reopenings for the 5-year and 10-year note offerings has been \$2 billion over the past few quarters. The Committee believes that difference in size could be \$4 billion or more. This change would enhance liquidity during the three months prior to reopening.

The Committee recommends the following as the composition of the November refunding.

- \$16 billion of a new 5-year due November 15, 2006
- \$6 billion of a reopened 10-year due August 15, 2011

For the remainder of the quarter the Committee recommends:

- Two 2-year notes of \$19 billion
- Weekly issuance of 4-week, 3-month and 6-month bills throughout the remainder of the quarter, as shown in the attached schedule.
- Additional buybacks of \$6.5 billion

For the January-March quarter, the Treasury estimates a new borrowing requirement of \$59 billion with an end of quarter cash balance of \$30 billion. To accomplish this, the Committee preliminarily recommends the financing schedule in the attached table. The schedule anticipates retaining the 2-year note offering size at \$19 billion per month, increasing the first offering size of a new 10-year note to \$14 billion, and reopening the 5-year note at an amount of \$12 billion. For buybacks, the schedule includes a slight decrease, to approximately \$1 billion per operation.

While addressing other topics related to debt management, members overwhelmingly felt that Treasury should expand their ability to enhance liquidity in the Treasury market. To accomplish this, they could set up a repo facility to help alleviate protracted shortages, in particular, large and persistent fails, when for some reason emergency reopenings, large position reporting, and debt buybacks do not work. Some members also felt that creating an exchange facility where older issues could be periodically exchanged for current coupons would add to liquidity and reduce the likelihood of fails.

One additional topic raised by some members was whether Treasury could improve market liquidity by making some sort of policy statement regarding future borrowing plans. Some felt that the market would take comfort in the increased transparency caused by such a statement and ultimately draw in more participants. The majority, however, felt that any market benefits would be more than offset by reductions in borrowing flexibility at Treasury during a period of increasing economic uncertainty.

Respectfully submitted,

James R. Capra, Chairman

Timothy W. Jay, Vice Chairman