

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

**February 5, 1992**

Dear Mr. Secretary:

Reflecting the state of the economy and the associated changes in monetary policy, yields on Treasury securities declined significantly throughout 1991. The drop culminated with the fourth quarter's 100 basis point cut in the discount rate on December 20. Over the year, the discount rate and Fed Funds declined by approximately 250 basis points, 2-year notes by just over 200 basis points, and the 30-year bond by less than 60 basis points, producing a sharply steeper yield curve. Low end-of-day yields for the 3-month bill occurred on December 23, 1991, at 3.85 percent, on January 8, 1992, for the 2-year at 4.66 percent, and on January 7, 1992, for the 30-year were at 7.39 percent. Since then, the market has weakened considerably with the yield curve modestly flatter as short rates have increased by about 50 basis points and the 30-year bond just over 40 basis points. This weakness occurred because it was the market's view that:

- 1) The end of Fed easing may have been seen;
- 2) An economic recovery of modest proportion is generally forecasted and perceived to be within view;
- 3) The supply of corporate debt came at a record \$32 billion pace in January;
- 4) Politics are dominating the timing, need, and degree of fiscal stimulus; and, lastly,
- 5) The absolute size of Treasury debt to be issued is large and will grow larger, particularly in the last fiscal quarter.

While market traders and investors focus on forecasts for recovery, recent economic data paint an uncertain picture of this and next quarter's GDP, particularly if coupled with slowing trade with our principal partners and their restrictive monetary policies. Meanwhile, U.S. monetary policy has or will produce interest rate levels that should provide economic stability and gradual recovery. This likely will coincide with generally low inflation reports. Further, low interest rates should allow cities, counties, states, and individual households to gradually improve their financial positions, and with the strong stock market, allow businesses to move their capital structures away from debt and toward equity. This financial relief should, over time, show its way through in terms of increased retail sales and improved consumer and business confidence.

Fiscal 1992's Federal budget deficit is varyingly estimated to approach \$400 billion. The Treasury market is highly sensitive to this prospect and the related potential for abandonment of the 1990 budget accord, which could begin to have economic impact in the second calendar quarter. Given the Government's already large financing needs, proposals which widen the deficit in the short run will likely prompt an adverse market response.

It is within this framework that the Committee recommends that the following securities be sold to refund \$22.0 billion of maturing and called securities, and to raise \$17.0 billion of new cash for delivery on February 18.

- \$14.5 billion 3-year notes due 2/15/95;
- \$12.5 billion 9 3/4 year 7 1/2% notes due 11/15/2001;
- \$12.0 billion 29 3/4 year 8% bonds due 11/15/2021.

The Committee voted 17-0 in support of the size, composition and two reopenings in our refunding recommendation. As it relates to the issue of reopenings, current market levels put the 10 and 30 year issues well within price ranges where both are solid candidates for reopening. It remains our view that large consolidated issues are desirable. Such issues are the least disruptive in a crowded marketplace, ameliorate the potential for squeezes, and possibly afford the Treasury some of the scarcity value existent in the market. Like most on-the-run Treasuries, 10 and 30 year securities attract "special" RP rates well below general collateral further attesting to their scarcity.

The relative size of the refunding and the quarterly refunding cycle are and should remain a key market focus. The Committee continues to endorse predictability and consistency as a means to lessen undesirable public speculation and associated market volatility. The recent protracted speculation over the Treasury's views on the role and size of the long bond are a clear example. The following points are offered in support of the view that no material change in the 10 and 30 year cycles is appropriate now:

- Federal deficits of \$400 billion this fiscal year and only slightly less next fiscal year mask the roughly \$200 billion structural deficits projected into the future. Further, all existing Treasury cycles will have to be increased to meet this and next quarter's needs before the anticipated \$150 billion deficit of the third calendar quarter. Reducing any cycle only further increases the burden on others.
- By holding the 10 and 30 year essentially unchanged, the Treasury would be effectively reducing their relative role in debt issuance.
- In earlier years, the 20 year cycle was dropped and recently Refcorp issuance has ended. Simultaneously, over the last three years, 30 year bonds as a percent of total coupon sales have declined from 12.1 percent in 1989 to 11.4 percent in 1990 and 10.5 percent in 1991.
- The 30 year plays a key role in the maintenance of the approximately six year average life of privately held marketable debt. The virtues of this specific average can be debated, but it is worth noting that it is similar to a number of other major foreign nations and approximates results typical in the United States during the 1950's and 1960's, a period of generally strong economic performance. Further, the Treasury is already a major beneficiary of low interest rates as 34 percent of the debt matures within one year and 49 percent within two years, down from comparable figures in the early 1980's.

- In addition, it is possible that existing rollover risk is high, given that 30 year absolute rate levels near 7.70 percent are low compared with the period from 1977 to the present. It is noted that large numbers of corporations, other taxable and tax-exempt issuers, and individuals are extending the average life of their debt with this possibility in mind.
- The 30 year cycle is a unique maturity slot exclusive to the Treasury. Its efficacy should not be put at risk or politicized to other considerations.
- Shifting a greater portion of financing to intermediate maturities would, in fact, put the Treasury in more direct competition with business and mortgage borrowers.

In closing our comments on this subject, the Committee notes that the public debate concerning the prospective role of the 30-year bond in the quarterly refunding, and hence, in the entire pattern of Treasury borrowings, has not worked to the Treasury's benefit. Any material change at this time runs the risk of being viewed as politically motivated, undoing the gains earned over years that routine and consistency have contributed in reducing the "uncertainty premium" in Treasury issues. More substantially, there appears little historical or theoretical evidence to support the view that shifting the pattern of Treasury borrowings would actually have any positive or lasting impact on overall yield levels or the overall shape of the yield curve. From year-end, as of 2/3/92, spreads from 1 to 2 years have increased by 27 basis points, 2 to 5 years by 21 basis points, and 2 to 10 years by 27 basis points, in part over concern that it is in this range that long-bond reductions would be made up. As the volume of debt issued in the above maturity ranges greatly outweighs the 30-year sector, the cost to the Treasury and taxpayer could, over time, become substantial. The 5, 7, and 10 year range yield back-up can additionally have a damaging impact on corporate and mortgage issuers which focus in this sector. Lastly, the 10 to 30 year spread has narrowed by 24 basis points since year-end, driven by the potential for long-bond reductions. Our recommendation and the cessation of the public debate could produce a one-time reversal of the recent, modest 10 to 30 year relative yield spread change, at the expense of the intermediate sector.

For the remainder of the current quarter, the Committee recommends that the Treasury sell:

- 2-year notes of \$14.25 billion and \$14.5 billion at auction, raising \$8.4 billion of new cash;
- 5-year notes of \$9.75 billion and \$10.0 billion at auction, raising \$12.5 billion of new cash;
- A \$13.5 billion 52-week bill at auction, raising \$2.4 billion of new cash;
- Increase the weekly 3 and 6 month bill action sizes to \$23.4 billion by end of quarter, raising \$14.3 billion new cash;
- A cash management bill of up to \$10 billion to mature 4/16/92, raising \$10 billion of new cash.

Summary of New Cash for Quarter

Refunding	\$17.0 billion
Cash management bills	10.0
3- & 6 month bills	14.3
52-week bill	2.4
2-year notes	8.4
5-year notes	<u>12.5</u>
Total	\$64.6 billion
Already raised	14.3
Estimated Foreign Add-ons	<u>5.8</u>
Net Market Borrowing	\$84.7

The Committee recommends a cash balance of \$20 billion on March 31.

The Committee anticipates the need for up to \$10 billion of short cash management bills in early March to mature April 16. If the need is less or does not materialize fully, small further increases to the bills and coupon cycles would be appropriate in satisfying Treasury borrowing needs.

For the April/June quarter, the Committee agrees with the targeted \$30 billion end-of-quarter balance. Given the potential of an unusually large following quarter marketable borrowing requirement, a higher balance by \$10 billion or so would not be inappropriate. To fund the cash deficit and marketable borrowing of approximately \$70 billion, further incremental increases in the weekly bills, year bills, coupon cycles, and refunding issues will be necessary. The Committee notes our continuing belief that there is a market appetite for significant growth in the year bill cycle. We as well support the continuance of consistency in the size and composition of the quarterly refunding.

On the remaining three topics of our Committee Charge -- (1) conditions leading to a reopening; (2) type of offering for distributing a reopened issue; and (3) our comments on the proposed single-price open auction technique -- the sharing of the differing views held by the Committee members lasted several hours, touched and raised broad issues, and raised and left unresolved several questions. The Committee welcomes the opportunity to play a role in addressing such topics and believes it could contribute to a thorough assessment if asked to participate in an off-cycle meeting with the Treasury focused on these large topics.

Some general thoughts were broadly supported. On the issue of determining whether a security shortage is sufficiently "prolonged and acute" to warrant reopening, the following points were made:

- the issue must trade significantly off of the implied cash market yield curve;
- the issue must be unusually expensive to recently issued older issues of the same maturity (i.e., the old and old, old off-the-run issues of the same maturity);

- there must be a clear reduction in the issue's trading liquidity;
- the clearing mechanism must evidence fails and other delivery problems;
- it is noted that "a special" financing rate below general collateral even approaching one percent for a protracted period of time is not necessarily sufficient evidence by itself of a disruptive shortage.

It was further noted that concentration information would first be seen by the Treasury, not the marketplace.

Providing securities through the likes of a "Bond Bank" could provide the Treasury with added income by charging a penalty rate when meeting outsized market needs. However, because Treasuries are now used for hedging exposures in a wide range of financial instruments, providing more collateral might simply lead to much more hedging in the securities being lent. Constructive ambiguity in the terms and circumstances of availability may be an advantage.

Concerning the question as to the best way to distribute reopened issues, there was general support for a Treasury reopening following broad public notification. The Federal Reserve, through a "go around", should set the time of bidding and the delivery date but leave open the amount to be awarded. It is important that investors, arbitragers, hedgers, and dealers have equal information and time to make a reasoned decision. The Committee believes that more discussion of this issue would be productive.

Lastly, the Committee recognizes that the eventual automation of the auction process may provide the Treasury with greater flexibility in pursuing alternatives to the present auction procedures. One such alternative is an ascending price, open auction technique. An objective of this technique would be to broaden direct investor participation in Treasury securities auctions. A number of sophisticated investors may have a higher level of comfort participating directly in an auction process that is open and perceived to be a fairer process. Also, such an auction process should make an attempt to corner an issue more difficult. In the event that such a corner were attempted, the Treasury would receive the benefit of the higher auction bids.

While not reaching a conclusion and supporting further study, the Committee discussed some questions and concerns with such an auction technique. Among those are:

- 1) Sequential bidding at fixed time intervals will initially be unfamiliar to all investors and may be somewhat confusing to all but the most sophisticated. Lesser sophisticated or impatient investors may prefer the certainty of the when-issued market and transfer the auction risk to dealers, defeating the aim of broader auction participation.
- 2) If larger, more sophisticated investors develop a preference for direct auction participation in an open bidding environment, pre-auction when-issued trading activity may then diminish. As a result, the price discovery, when-issued process would become less efficient. This, in turn, could subject the Treasury's initial price determination effort to start the auction to more uncertainty.

- 3) A greater level of uncertainty among dealers about investors' intentions in the new auction process may reduce dealer willingness to establish pre-auction short positions in the new issue. Such an outcome could reduce dealers' participation in the auction process.
- 4) The new auction proposal would introduce a role for the Treasury in setting the initial auction yield. This raises several related concerns.

First, in a more volatile and uncertain market environment, the Treasury could set the initial bid yield at a level that does not draw enough interest to cover the size of the auctioned security. Thus, the specter of a failed auction might then become a possibility, however remote, as compared to the present auction system.

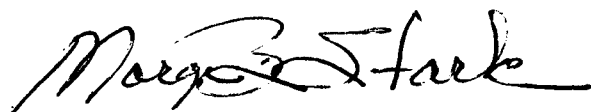
Second, as a result of significant changes in the market environment, the Treasury may decide to vary the spread between the initial bid yield and the current market yield available in pre-auction trading. Such adjustments could increase market uncertainty and cause market participation to speculate on any possible meaning or message inherent in this yield spread variation.

Third, because of the possible reduction in when-issued trading and associated impairment of the price discovery mechanism, the Treasury may not enjoy a high enough level of confidence that sufficient dealers will bid for a reasonable amount of the new issue at the yield level which is initially established by the Treasury.

More generally, the ascending price, open auction technique introduces auction variables which the present system does not contain. Specifically, these include a Treasury yield setting function and an uncertain number of bidding rounds before a single auction is completed. Also, open bidding may increase the uncertainty about the quantity and yield level of direct investor bids. This combination could have a tendency to increase volatility surrounding security auctions and could result in unintended increased risks for auction participants.

In conclusion, the prospect of automating the auction process, which the Committee welcomes, offers the Treasury the opportunity to improve the manner in which it sells its securities and in consequence to lower its cost of borrowing. There is ample time, however, for more thorough consideration of any particular technique, a phasing process or other auction initiatives before the automation process is implemented. We hope to work closely with Treasury in studying these matters.

Mr. Secretary, that concludes our report and we welcome questions and discussion.



Morgan B. Stark  
Chairman