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

FEBRUARY 2, 1994

Dear Mr. Secretary:

Since the Committee's last meeting with the Treasury three months ago in November 1993, data for the economy have revealed a marked acceleration in activity. A sustainable expansion now seems firmly in place. At the same time, the rate of inflation appears to have stabilized near its low point for the cycle with few signs yet of resurgence.

From the levels that prevailed at the time of the last meeting, yields on Treasury securities have moved in divergent directions. Yields on maturities of one year and under and have fallen by 5 to 20 basis points, while those on maturities of 10 years and over have increased by 5 to 15 basis points. For securities of intermediate maturity, yields are little changed. As a consequence of these movements, the yield curve has steepened at its most extreme by approximately 35 basis points.

Within this context, to refund the $24.0 billion of the securities maturing on February 15, 1994 that are privately held and to raise additional cash of $16.0 billion, the Committee recommends that Treasury auction $40.0 billion of the following securities:

- $17.0 billion 3-year notes due February 15, 1997;
- $12.0 billion 10-year notes due February 15, 2004; and,
- $11.0 billion 6 1/4% 29 1/2-year bonds due August 15, 2023.

The 16 members of the Committee present for the meeting voted unanimously in favor of the total size and composition of the refunding.

On the question of whether to reopen the 6 1/4% bond due August 15, 2023 which was auctioned six months ago in August 1993 or to issue, as the main alternative discussed, a new 29 3/4-year bond due November 15, 2023, the vote was ten in favor of reopening the outstanding issue, with four in favor of a new issue and two abstaining on the basis that either alternative was equally acceptable.

The principal reasons cited by the majority in support of a reopening were the evident protracted shortage of the outstanding issue in the collateral market and its relative expensiveness compared to surrounding issues, which together appear to have diminished its liquidity. These members believed that the benefits associated with the improved liquidity of a reopened issue outweighed the possible, but not certain, interest savings that might result from issuing a new bond. It was also noted that a reopening of the outstanding issue was clearly the predominant market expectation.

Members who favored offering a new 29 3/4-year security noted that there was developing, as result of the Treasury's new cycle for issuing long bonds, a relative scarcity of May and November maturities available for stripping. These Committee members argued that the added attraction of a new long bond with a November corpus and May and November coupons, when combined with a possible premium associated with a new benchmark issue, could result in a material though difficult to quantify saving to the Treasury. The potential saving, it was acknowledged, could likely be realized later in August when the Treasury next issues long-term debt.

In any event, Committee members noted that the decision to reduce the issuance of long bonds and resultant concentration of offerings in the February and August refundings seems likely to effect adversely the liquidity of stripped components which are due in May and November. Some expressed the view that the Treasury should take this consideration into account as it develops its longer term financing strategy.

For the remainder of the quarter, with the aim of achieving a cash balance of $20 billion on March 31, the Committee unanimously recommends that the Treasury auction:

- Two 5-year notes of $11.0 billion each, to raise $22 billion of new cash;
- Two 2-year notes of $17.0 billion each, to raise $3.5 billion of new cash;
- One 1-year bill of $16.5 billion, to raise $1.7 billion of new cash;
- Weekly 3- and 6- month bills totaling approximately $25.2 per week, to reduce cash by $1.3 billion; and,
- A cash management bill to mature April 21, 1994, to raise $10.0 billion of new cash.

The net new cash raised in the quarter by this recommendation would be as follows:

Refunding	$	16.0 billion
Five-year notes		22.0
Two-year notes		3.5
One-year bill		1.7
Three- and six-month bills		(1.3)
Cash management bill		10.0
Estimated foreign add-ons		5.0
Subtotal	$	56.9 billion
Less: Four-year note maturity		(8.2)
Already issued or announced		(2.7)
Total Net Market Borrowing	$	46.0 billion

For the April-June quarter, the Committee felt that a cash balance modestly in excess of $30 billion on June 30, 1994 would help redistribute the uneven financing requirements of the second and third calendar quarters. Assuming nevertheless a end-of-quarter cash balance of $30 billion, the Committee recommends the following financing schedule for the period:

Auctions		Size	Raising
Refunding:	Three-year note	$ 17.0	
	Ten-year note	12.0	$ (0.2) billion
Five-year notes		3 x 11.0	33.0
Two-year notes		3 x17.0	5.9
One-year bill		4 x 16.5	7.2
Three- and six-month bills		13 x 25.2	(9.4)
Estimated foreign add-ons			5.8
Subtotal		$ 42.3 billion	
Less:			
Cash management bill (April 21)			(10.0)
Seven-year note maturity			(6.9)
Four-year note maturity			(7.9)
Net Total Market Borrowing			$17.5 billion

The Committee notes the likely need for the issuance of a cash management bill to mature in late June to cover the May 15 coupon payments in the absence of a 30-year bond in the quarterly refunding. Additional intra-quarter cash management bills will likely be needed to cover the cash low points in early April and June.

Finally, in the category of other topics, the Committee is pleased to have been asked to discuss further the proposal to the Treasury that it consider the issuance of floating rate notes which the Committee first advanced in the special meeting held on June 24, 1993. Given the reduced reliance on longer-term borrowing, the Treasury will face in the coming years substantial growth in the amount of short- and intermediate-term debt which it will need to issue. Floating rate notes may afford the Treasury access to substantial amounts of funds from investors who prefer this investment vehicle but are limited to the floating rate instruments offered by private borrowers and government sponsored enterprises. Furthermore, by issuing floating rate notes with final maturities of 5 to 7 years, the Treasury would be able to mitigate the effect its current debt management strategy will have on shortening the average life of the debt, which some believe could become a matter of serious concern in the future as on occasions it has in the past. At the same time, floating rate notes could enable the Treasury to capture the interest rate savings it seeks in its current strategy from the tendency over time of the yield curve to have a positive slope. Additional savings may also be gained from apparent further tendency of the yield curve to be the steepest for maturities under 90 days, at present the shortest maturity offered by the Treasury.

The specific terms of floating rate securities, as is evident in the draft terms provided by the Treasury, are typically complex. Substantial technical input from both dealers and investors active in these instruments will clearly be useful to the Treasury as it contemplates the range of choices and the possible consequences of each. The Committee would be pleased to offer its views on the attractiveness to the Treasury of the detailed elements of the various alternatives which might be considered, but given the brief time available and the technical complexity involved, Committee members did not believe that at this stage they could adequately analyze and evaluate the specific terms of the draft proposal . With additional time and the opportunity for careful consideration, the Committee would be pleased to offer its views on the full range of issues that are associated with the issuance of floating rate notes.

Committee members did express the conviction that, whatever the specific terms, sufficient liquidity to sustain a viable market in Treasury floating rate notes would be assured as long as the Treasury issues the securities in sufficient volume and on a regular and predictable basis. A clear indication of the Treasury's issuance plans would be certain, in the minds of most Committee members, to attract an adequate number of dealers and investors to sustain a liquid market.

The Committee urges the Treasury, as part of its announcement later today, to indicate that it would welcome written comment from any who are interested in presenting their views to the Treasury on the subject. To avoid misleading market participants and risking unwarranted speculation about the imminence of a decision to issue floating rate notes and the possible impact the decision would have on the issuance of other debt, the Committee strongly urges the Treasury make clear that considerable further study will be undertaken before any decisions are made on whether to issue floating rate securities and on what the nature of their terms and the frequency and size of their issuance might be.

In response to the request for comments on effects that might be expected from the charges for daylight overdrafts which will implemented in stages beginning April 1, 1994, Committee members offered the following observations:

1. The proportion of repurchase agreements executed on an overnight basis is expected to decline, while those executed on an open, term, pre-arranged, and tripartite basis is expected to increase.

2. A tiering in financing according to the time of delivery during the day is expected.

3. Dealers are likely to become less willing to defer the financing of positions securities which previously had been held in the hope selling them later in the day for cash settlement, including to the Federal Reserve for the open market account and for customers.

4. Yield spreads between Treasury securities and competing money market instruments with different clearance procedures may widen.

5. Pre-set delivery times may evolve, and netting arrangements may become more common.

6. To date investors, as distinguished from dealers, do not appear to have focused on the daylight overdrafts and it is unclear how they and their custodians will eventually respond.

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

Respectfully submitted,

Stephen C. Francis
Chairman