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

AUGUST 2, 1995

Dear Mr. Secretary:

Since the Committee's last meeting with the Treasury in May 1995, the pace of economic activity has continued to moderate although recently consumer demand appears to have reaccelerated. Inflationary pressures, while not absent, appeared to remain modest. The Federal Reserve, nearly 18 months since it begin tightening monetary policy, lowered the Federal funds rate from 6% to 5 3/4% in July.

During the three month interval, yields on Treasury securities declined by 30 to 70 basis points. The drop was greatest for maturities from one to ten years; yields on bills and on 30-year bonds fell less. The present shape of the yield curve and forward prices for various fixed-income instruments indicate market participants expect only modest increases in interest rates in the coming months.

Within this context, to refund the $30.0 billion of notes maturing on August 15, 1995 that are privately held and to raise additional cash of $12.5 billion, the Committee recommends that the Treasury auction $42.5 billion of the following securities:

- $18.0 billion 3-year notes due August 15, 1998;
- $13.0 billion 10-year notes due August 15, 2005; and,
- $11.5 billion 30-year bonds due August 15, 2025.

Of the 14 Committee members present for the meeting, 11 voted in favor of this recommendation. The other three members favored the issuance of $41.0 billion of securities comprising $17.5 billion 3-year notes, $12.5 billion 10-year notes, and $11.0 billion 30-year bonds; this alternative would raise $10.5 billion of additional cash. The majority focused on the desire to continue the gradual increases in the sizes of coupon offerings in view of the need for larger issue sizes in 1996 and beyond as the 5-year note cycle reaches completion.

In considering whether to recommend issuing a new 10-year note or reopening the 6 1/2% note due May 15, 2005, Committee members observed that though the outstanding issue was in short supply in the repurchase agreement market, there was no compelling evidence that the shortage was unusual or acute. In any event, the shortage should be alleviated once a new 10-year note is auctioned. On this basis, the Committee voted 8 to 6 in favor of a new issue.

In considering the maturity of the long bond to be issued in the refunding, the Committee discussed the possibilities of a 29 3/4 year, a 30 year, and a 30 1/4 year (maturing, respectively, in May, August, and November 2025). There appear to be no shortages or market distortions associated with the components of stripped securities maturing in May or November. In the absence of convincing arguments for the alternatives, 12 members favored a 30 year maturity while two members favored a 30 1/4 year maturity.

With the aim of achieving a cash balance of $30 billion on September 30, the Committee unanimously recommends that for the remainder of the quarter the Treasury meet its borrowing requirement in the following manner:

- One 5-year note totaling $11.5 billion, to raise $11.5 billion of new cash;
- One 2-year note totaling $17.75 billion, to raise $0.9 billion of new cash;
- Two 1-year bills totaling $18.25 billion each, to raise $2.9 billion of new cash;
- Weekly issuance of 3- and 6-month bills through the remainder of the quarter, to reduce cash by $19.1 billion; and,
- Redemption on August 15 of the bonds called earlier, to reduce cash by $2.4 billion.

Including the $12.5 billion raised in the mid-quarter refunding as well as anticipated foreign add-ons of $2.2 billion, the proposed financing schedule will raise a total of $8.5 billion. This amount, when added to the $17.5 billion already raised or announced to date in the quarter, will accomplish the total net borrowing requirement of $26.0 billion. In addition, intra-quarter cash management bills of approximately $25.0 billion maturing on September 21 will be needed to cover the cash low point in early September.

For the October-December quarter, the Treasury estimates a net borrowing requirement in the range of $60 to $65 billion with a cash balance of $20 billion at the end of December. To accomplish the anticipated net borrowing requirement, the Committee recommends the following provisional financing schedule:

Auctions		Size ($billions)	Raising ($billions)
Refunding:	3-year note	18.5	
	10-year note	13.5	
	Subtotal	32.0	-0.8
Other:	5-year notes	3 x 12.0	36.0
	2-year notes	3 x 18.25	2.8
	1-year bills	3 x 18.75	4.4
	3- and 6-month bills		7.3
	Cash management bill (January maturity)		15.0
	Estimated foreign add-ons		5.0
	Subtotal		69.7
Less:	Redemption of 7-year notes		-7.2
	Total Net Market Borrowing		62.5

The Committee also notes the likely need for the issuance of intra-quarter cash management bills to cover cash low points during the quarter.

In formulating its recommendation for a financing strategy beginning in early 1996, the Committee began with the observation that the 5-year note cycle has been the Treasury's dominate source of new cash over the past five years. At the current size of $11.5 billion per month, the note contributes approximately $138 billion of new cash each year. Further, if the issue sizes of all coupon offerings were held at their current levels through 1996, only $17 billion of new cash would be raised

To meet the Treasury's borrowing needs, the Committee has consistently preferred first increasing the size of existing cycle offerings. This approach does not appear feasible, however, for meeting the net borrowing requirement faced in 1996 which likely will approach $190 billion. The size and pace of the increases in existing cycles that would be required to raise this amount would almost certainly be disruptive to the market and hence costly to the Treasury. The Committee believes therefore that the point has been reached where the Treasury needs to develop a new major borrowing source.

As its point of departure, the Committee returned to the two principles set forth in its report of February 1, 1995 that it believes should guide the Treasury's financing strategy beginning in January 1996. The first concerns the schedule of maturities and the second the average length of the debt.

With respect to the first concern, the schedule of maturities, the Committee stated in its February report that:

> For the past several years, the proportion of the debt maturing under two years, for example, has been reasonably stable at levels under 50 per cent. With the current borrowing strategy, the proportion is destined to rise, as it has been recently. While ... the Committee knows of no convincing case that points to some ideal schedule of maturities, a rise in the proportion of debt maturing within one or two years, especially in conjunction with a steady decline in the average length of the debt, seems bound ultimately to raise concerns among investors. In the inevitable periods of stress in the financial markets, it is likely that a heavy concentration of maturities to be refinanced in the near-term could add materially to the Treasury's cost of borrowing.
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> This concern led the Committee to the view that ... [one] objective of ... the Treasury's borrowing pattern beginning in January 1996 should be to ensure a more even spread in the schedule of maturities across the full maturity spectrum and a concomitant avoidance of undue reliance on short-term financing.

Regarding the average length of the debt, the second concern cited by the Committee, the report stated:

> Although the Committee is aware of no compelling study or argument that points to an optimal average length for the debt, the present pace of decline, if continued, will increase the Treasury's exposure to variations in the level of interest rates and could become a subject of worry to investors. From its recent peak of 6 years in June 1991, the average length of privately-held marketable debt has fallen to 5 years, 6 months. If the present borrowing strategy is continued into 1996 and beyond, the pace of the decline would continue unabated. Though it cannot say when, the Committee does believe that at some stage the trend will attract the notice of investors in the US and abroad and begin to raise concerns. The consequences are unknown, but it seems highly likely there would be a negative effect on the Treasury's cost of borrowing over the longer-term.
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> This concern led the Committee to the principle of having as one objective of its recommendations for adjustments to the Treasury's borrowing pattern beginning in January 1996 a slowing or an arresting of the pace of decline in the average length of the debt.

With these objectives in mind, the Committee recommends, as a general outline, the following strategy for raising cash beginning in early 1996:

1. Increase coupon issues sufficiently to ensure that the proportion of the total debt maturing within two years does not increase materially beyond the current level of approximately 50%.

2. Increase the frequency of the issuance of 10-year notes from quarterly to either eight or twelve times per year. The 10-year note has become the world

benchmark security and the primary hedging vehicle for dealers and investors. Further, because 7-year notes are no longer offered, demand for the maturity has increased and liquidity is exceptionally high. To ensure individual issues remain liquid, each new offering should be at least $8 to 10 billion in size.

As a complement or in addition, the frequency of the issuance 30-year bonds could be returned to four times per year. The current semi-annual frequency and reduced size has had a noticeable adverse impact on liquidity. In the view of some Committee members, the reduced liquidity has raised the yield at which 30-year bonds trade in the secondary market. Nevertheless, most believe that if the quarterly cycle were reinstated, with minimum issuance sizes of approximately $10 billion, the previous level of liquidity could be restored reasonably quickly.

3. Lastly, increase the offering amounts of 3-, 6-, and 12-month bills as necessary to make up the balance of the borrowing requirement.

With respect to the non-conventional financing alternatives which have been discussed recently--specifically, variable rate notes and inflation-indexed securities--the Committee continues to believe that while they warrant consideration, it is unlikely that a sufficiently large market for these instruments could be developed rapidly enough on attractive terms to the Treasury to afford substantial new sources of cash in 1996.

In response to the request for the Committee's views on possible market disruptions in Treasury borrowing if the statutory debt limit is not increased in a timely manner this fall, the statement of Richard M. Kelly, Vice Chairman of the Committee, delivered to the Senate Committee on Finance on July 28, 1995 is attached.

Finally, the Committee notes that the next meeting of the Federal Open Market Committee occurs on Tuesday, August 22. The heightened market uncertainty that is typically associated with a possible announcement following these meetings of a change in monetary policy could adversely affect the Treasury's cost of borrowing in any auction held immediately ahead of such possible announcements. As a consequence, the Committee recommends that the Treasury schedule the August auctions of 2-year and 5-year notes on Wednesday, August 23 and Thursday, August 24, respectively.

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

Respectfully submitted,

Stephen C. Francis
Chairman

Attachment