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

May 1, 1996

Dear Mr. Secretary:

Since the Committee's last meeting on January 31, 1996, economic growth has revived following a sluggish period marked by inventory adjustments, weather-related disruptions, and a partial Federal government shutdown. Stronger-than-expected growth in nonfarm payrolls and consumer spending has fueled the increased pace of business activity. Inflationary pressures have generally remained dormant, but significant increases have recently occurred in prices of grains and energy-related products due to lean inventories and increased world-wide demand.

Early in the year, interest rate levels anticipated a sluggish economy, restrained price pressures and agreement on a compromise 7-year budget-balancing plan. In turn, these events were expected to lead to further easings by the Federal Reserve. Subsequently, the economy's revival, the collapse of budget talks, and increased commodity inflation have led to significantly changed expectations. Forward eurodollar rates have risen by over 100 basis points, and intermediate and long-term Treasury yields have risen by 75-100 basis points since January. Market participants now seem to perceive the risks of unacceptably sluggish or rapid economic growth as evenly balanced. However, in light of full employment conditions and stepped-up hiring, fears of eventual modest upward pressure on wages appear to have increased.

Against this background, the Committee was charged with offering advice on the profile of Treasury marketable financing for the period through the July-September quarter. In framing its recommendations, the Committee took into consideration the Treasury's decision to increase the frequency of offerings of 10-year notes and 30-year bonds. Specifically, the Treasury has indicated its plans to introduce two new 10-year note offerings — in mid-July and mid-October — thus raising to six the number of such offerings per year; and to introduce one new 30-year bond offering -- in mid-November -- thus raising to three the number of such offerings per year. The Committee further understands that the Treasury plans to reduce the size of each such offering somewhat from current levels, such that overall issuance in these maturity sectors in future years does not change significantly from levels that otherwise would have occurred.

Within this context, to refund the $35.0 billion of privately-held notes maturing on May 15, 1996 and to raise $14.0 billion of cash, the Committee unanimously recommends that the Treasury auction $49.0 billion of the following securities:

- $19.0 billion 3-year notes due May 15, 1999;
- $14.0 billion 10-year notes due May 15, 2006;
- $16.0 billion cash management bills due June 20, 1996.

The Committee believes that $14.0 billion is the appropriate issue size for the 10-year note in the current mid-quarter refunding. This amount is consistent with market expectations and should not be affected by the increased frequency of 10-year offerings scheduled to begin in July.

With the aim of achieving a cash balance of $35 billion on June 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 $12.5 billion, to raise $3.3 billion of new cash;

- One 2-year note totaling $18.75 billion, to raise $0.6 billion of new cash;

- Two 1-year bills totaling $19.25 billion each, to raise $0.6 billion of new cash;

- Weekly issuance of 3- and 6-month bills through the remainder of the quarter, to raise $9.5 billion of new cash;

- The issuance of intra-quarter cash management bills to cover the low cash point in June; and

- The paydown on June 20 of $16.0 billion of cash management bills issued in conjunction with the May refunding.

Including the $14.0 billion raised in the mid-quarter refunding as well as anticipated foreign add-ons of $3.0 billion, the proposed financing schedule will raise a total of $15.0 billion. This amount, after subtracting the net paydown of $35.0 billion to date in the quarter, will accomplish the total net paydown of $20.0 billion.

For the July-September quarter, the Treasury estimates a net borrowing requirement in the range of $55-60 billion with a cash balance of $40.0 billion at the end of September. To accomplish the anticipated net borrowing requirement, the Committee took into consideration the planned increased but irregular cycle of 10-year note and 30-year bond offerings. The Committee reviewed the question of desired minimum issue sizes; that is, sizes which would facilitate liquid secondary markets and limit the risks of occasional acute and protracted shortages. For the 10-year notes, the Committee believes that the two sets of issues to be offered one month apart -- that is, the July-August and

October-November offerings -- could be set initially at a minimum size of $10 billion, reflecting the increased potential for more frequent re-openings. For the other two annual issues-- that is, the February and May offerings -- the Committee believes that it would be preferable to target an initial minimum size of $12 billion. For each of the planned three annual offerings of 30-year bonds, the Committee believes that initial minimum sizes should not be smaller than $10 billion.

Overall, this initial annual pattern of 10- and 30-year securities would increase only modestly the amount of issuance relative to that which would occur in future years with normal increases in coupon issue sizes. In the Committee's view, this would represent a reasonable initial balance between planned levels of issuance and considerations of market liquidity. Also, while the planned variations in the sizes of the 10-year note offerings could introduce some additional market uncertainty, that risk would be limited by transparency around the Treasury's announcement of its plans and intentions in introducing the new issue cycle. Longer term, the Committee remains supportive of the goal of more frequent and regular issuance of longer-term debt to temper somewhat the pace of the decline in the average length of the debt and the proportion maturing within two years.

The Committee supports the timing of the two additional 10-year note offerings -- that is, July 15 and October 15. Initially, these new issues can refund maturing 7-year notes. Also, the Treasury's borrowing need is typically larger in the July-December period. In addition, this financing pattern will modestly divert a portion of coupon payments away from the large mid-quarterly coupon payment dates.

In a similar vein, an additional bond offering on November 15 is well placed to meet Treasury cash needs. There is also a market related benefit of regularly increasing the strippable product with May 15 and November 15 maturities.

In light of the planned issuance of a new 10-year note in July, and the expected reduced size of the 10- and 30-year offerings in the August refunding, the Committee considered the question of the need for continual modest increases in size of other coupon offerings. By an 11-4 vote, the Committee preferred no further increases in the July-September quarter in the 1-year bills as well as 2-, 3- and 5-year note sizes. The majority felt that, given the additional financing in the 10-year sector during the quarter as well as continued reductions in the federal budget deficit, the Treasury could pause for a short time before resuming the gradual size increases in regular cycle offerings. The specific recommended profile of Treasury offerings for the July-September is set forth in the enclosed schedule.

The minority preferred continued incremental increases in issue amounts. This group felt that further increases would still be needed to offset in an orderly fashion the impact of the maturing 5-year note cycle. In this regard, they note that the more frequent but reduced size offerings in the long end will raise less net cash in the July-September quarter than the amount which would be raised by normal modest increases in regular cycle offerings.

In response to a request for its views, the Committee considered the significant variation of the sizes of weekly bills and the heavy reliance on cash management bills in recent months. The Treasury followed this course largely to manage cash and debt during the debt limit impasse. The Committee did not perceive any significant market impact as a result of this financing behavior. As the issue sizes varied, there were occasional small yield differences between the affected Treasury bills. But overall, the market adapted well to the uncertainty and unpredictability of Treasury bill financing during this period. Market participants recognized the constraints imposed on the Treasury as a result of the debt limit considerations and, as such, believed that the related uncertain financing behavior was temporary.

The Committee continues to believe that consistent and predictable financing operations are most effective in reducing the Treasury's cost of borrowing. Accordingly, in the Committee's judgment, weekly bill offering sizes should remain relatively stable and cash management bills should be relied upon to more efficiently meet temporary or seasonal cash needs.

Respectfully submitted

Richard M. Kelly
Chairman