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

January 30, 2001

Dear Mr. Secretary:

Since the Committee's last meeting in November, what had appeared to be a smooth deceleration in economic activity appears to have turned into something somewhat more serious. The precipitous decline in manufacturing activity has been the most pronounced feature of the current slowdown. Industrial production in manufacturing declined by 0.5% in the fourth quarter and manufacturing hours worked fell by 2.4%. Some manufacturing indicators, like the National Association of Purchasing Managers survey, are sitting at levels that have traditionally been associated with recession. Chairman Greenspan's comment to the Senate Budget Committee last week probably best expresses the economic consensus when he said, "As far as we can judge, we have had a very dramatic slowing down, and indeed we are probably very close to zero at this particular moment." As far as the future is concerned, most economists tend to agree with the Chairman's view that "We're in a period where we are observing the beginnings of what is probably a major inventory correction. The critical issue ..... is whether the degree of contraction is enough to break the fabric of consumer confidence."

On the inflation front, prices have remained relatively stable as a drop in petroleum prices has offset sharp increases in electricity and natural gas. Core consumer price inflation is stable and pipeline pressures on goods inflation are dissipating. Finally, the most recent ECI report showed a lower than anticipated increase in the fourth quarter. Indeed, last week Chairman Greenspan said "inflationary pressures are exceptionally well contained at this stage."

Subsequent to our last meeting, projections of the budget surplus have been revised upward. The 10-year projection for the cumulative surplus under current policies has been revised to between $5 trillion and $6 trillion from around $4 trillion, largely because of increased optimism about long run trends in productivity. On the legislative front, the Congress enacted legislative provisions that removed the remaining obstacles to the elimination of the 1-year bill and opened up the way for centralized clearing of swaps.

In the financial markets, a pervading gloom enveloped the equity and high yield markets in the latter part of the fourth quarter. Companies, one by one, began reassessing their earnings prospects and capital spending plans and investors began to reassess the companies. The surprise easing of 50 basis points by the Federal Reserve on January 3 appears to have changed investor sentiment for the time being as some stock indexes and credit spreads have reversed their late year declines and now stand at the levels of early December. Issuance in both the high grade corporate bond market and the high yield market has been robust in January. Nevertheless, companies continue to scale back their assessments of the near term outlook while expressing confidence about a rebound in the second half of the year.

In the Treasury market, yields have fallen sharply since the Committee's last meeting. The yield on the two-year note has declined by over 100 basis points. Yields at the long end of the curve fell by much less. Part of the decline in short-term yields was the result of anticipation of further cuts in the federal funds rate, but part was also a flight to safety because of concern about credit problems associated with the electricity crisis in the Far West.

Against this backdrop, the Committee considered the composition of a financing to refund $25.1 billion of privately held notes and to raise $6.9 billion of new funds.

The Committee unanimously recommends a total financing of $32 billion consisting of the following offerings:

- $11 billion reopening of the 5-year notes due November 15, 2005
- $11 billion of 10-year notes due February 15, 2011
- $10 billion of 30-year bonds due February 15, 2031

In regard to the composition of Treasury market financing for the remainder of the current quarter, the Committee recommends that the Treasury meet its requirement in the following manner:

- A 2-year note of $11.0 billion,
- Weekly issuance of 3- and 6-month bills throughout the remainder of the quarter,
- Cash management bills totaling $67 billion to mature next quarter and a $25 billion, intra-quarter bill, and
- Buybacks totaling $5.0 billion.

This recommendation includes a proposed elimination of the one-year bill offering consistent with the Committee's past views and the Treasury's stated intentions. Members continue to believe that the 52-week bill provides the least utility to the Treasury and the market relative to other regular offerings. Also, there are substantial secondary market alternatives in the one-year maturity that satisfy most investor needs. Elimination of the 1-year bill is less disruptive to the Treasury's monthly cash flows then other alternatives such as reducing the frequency of 2-year note offerings. Finally, by increasing the sizes of 3- and 6- month bills over the past several months the Treasury has already largely offset the potential lengthening of the maturity of the debt that would have resulted from solely eliminating the 1-year bill.

For the April-June quarter, the Treasury estimates a new borrowing requirement of -$197.0 billion with a cash balance target of $60 billion on June 30. To accomplish this requirement, the Committee preliminarily recommends the financing schedule in the attached table. The recommended level of debt buybacks for the second quarter is $10.0 billion to $12 billion. The Committee recommends that the Treasury continue the policy of announcing its buyback intentions for the upcoming quarter.

The Treasury asked the Committee for a recommendation on actions that might be taken to dampen increasingly large swings in cash balances it has been experiencing over the past three years. To date, the approach has been to use cash management bills to offset swings that cannot be accommodated by the regular 13- and 26-week bill program. For example, in the current quarter the Treasury will have offered four cash management bills that total over $120 billion, with $67 billion maturing after the April tax date. Cash management bills are generally one of the most costly to the Treasury of its various funding instruments in terms of interest expense. Thus the Treasury sought the Committee's advice on possible alternatives or, at a minimum, supplements to the current structure.

The primary suggestion made by Committee members was that the Treasury consider the institution of a 4-week bill program. The issuance could be scaled up or down depending on cash needs and could respond more quickly than the 13- and 26-week bill program to a changing cash situation. Members were of the opinion that a program that auctioned a minimum of $6 billion per week and a maximum of approximately $16 billion would be received most favorably by the market. Evidence from the secondary market yields for regular bills with a remaining maturity of four weeks suggests that the Treasury would save in interest expense from such a program relative to cash management bills. Finally, if at some point the Treasury decides to reduce the frequency of 2-year notes to eight issues per year and ultimately to four, as suggested by the Committee in the past, a 4-week bill program could offset the cash drain on the Treasury at the end of the months when old 2-year notes would be redeemed without any offsetting new issue. One potential disadvantage of the program is that in the year it is instituted, the program would raise new cash that would have to be offset by cutbacks in other marketable issues. For that reason, it may be desirable for the Treasury to time the introduction of such a program to coincide with a change in the frequency of 2-year notes.

In light of Chairman Greenspan's recent comments regarding Treasury debt and in light of the gradual lengthening of Treasury marketable debt, which stands at 5 years 11 months, the Committee discussed the appropriateness of long-dated Treasury issuance.

Proponents of continued bond issuance felt that because of the inherent uncertainty surrounding budget projections and the potential social security liabilities in 2020-2025, the near-term elimination of long-dated issuance seemed premature. Some felt that 30-year issuance served a distinct public function by providing a risk free 30-year security to the capital markets, that replicating it could prove difficult, and consequently benchmark issuance should be preserved for long as possible. A number of the Committee members supported the elimination of long-dated issuance preferably in the near term. Some cited Chairman Greenspan¹s recent comments regarding the magnitude of Treasury debt maturing after 2011 (approximately $750 billion), the date when projections have all Treasury debt potentially retired. The Chairman expressed concern about the expense and feasibility of buying back that long-dated debt. Those supporting the elimination of the bond believed it was inconsistent for the Treasury to issue new 30-year debt that matures after most projections predict all debt will be retired and at the same time to buyback similar maturities. Most opponents felt that 30-year elimination would save the Treasury a significant amount of money at present and that the inherent flexibility in the capital markets would allow the reintroduction of long-dated issuance if needed, either because of a change in the budget outlook or to pay for social security benefits at a later date. Finally, discussion turned to 30-year Treasury Inflation Protected Securities, where a majority of members supported elimination. They cited three factors: TIPS contribution to the lengthening of the average maturity of the debt; their excessive cost to the Treasury; and the potential that buybacks in the out years could prove more costly and difficult than with nominal long-dated securities.

To summarize the discussion of long-dated issuance:
(1) The Committee recognizes that with the changing administration the Treasury might not be ready to make a policy decision relative to 30-year debt, but that policy should be formulated and communicated as quickly as practical.

(2) Most members believe that if the budget outlook does not change, elimination of long-dated issuance is inevitable at some point. A majority felt that there was sufficient evidence to justify elimination in the near future while a sizable minority remained skeptical about the budget and policy outlook and believe that near-term elimination was not justified.

(3) Most members felt that the 30-year TIPS program should be eliminated as soon as possible.

(4) Members suggested that the Treasury seriously consider instituting an exchange offering program. For those who advocated retaining the benchmark new issuance of long bonds, an exchange offering

would provide a method of continuing new issuance until the budget and policy outlook become more certain while not increasing the size of 30-year liabilities outstanding. Those who supported elimination of the bond thought an exchange offering in the 10-year sector might become a requirement within the next few years if the budget outlook did not change and 10-year issuance was to be retained for a certain period of time.

Respectfully submitted,

James R. Capra, Chairman
Timothy W. Jay, Vice Chairman

2000 Financing Schedule

2001 Financing Schedule