

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

October 30, 1996

Dear Mr. Secretary:

Since the Committee's last meeting on July 31, 1996, the pace of economic expansion has moderated. Consumer spending paused in the summer months following a brisk advance during the first half. Consumption continues to be supported, however, by continued solid gains in employment and personal income as well as a relatively high level of consumer confidence. While in a very mature stage, the economic advance continues unencumbered by any significant excesses or imbalances. Inflationary pressures have generally remained subdued. Although tight labor markets have led to modestly rising wage pressures, there is little evidence as yet of any adverse effects on final prices.

During this period, interest rates on Treasury securities have declined by 25-50 basis points. Monetary policy has remained unchanged since January, and market participants' earlier fears of a modest move toward credit restraint have diminished. Eurodollar rates currently reflect expectations of a steady monetary policy in the near term. Treasury securities have also been supported by broad based private and official foreign demand. Rallies in global bond markets have increased the relative attractiveness of Treasury securities versus most other G-7 countries. This has been buttressed by market expectations of a stable to firmer dollar. Also, trade related dollar recycling has led to continued net foreign central bank purchases of Treasury securities.

Within this context, to refund the \$36.7 billion of privately-held notes maturing on November 15, 1996 and to raise \$1.8 billion of cash, the Committee unanimously recommends that the Treasury auction \$38.5 billion of the following securities:

- \$18.5 billion 3-year notes due November 15, 1999;
- \$10.0 billion re-opened 6 ½ percent notes due October 15, 2006;
- \$10.0 billion 30-year bonds due November 15, 2026.

In conjunction with the refunding, the Committee also recommends that the Treasury auction \$13.0 billion of cash management bills due December 19, 1996.

In formulating this recommendation, the Committee considered the Treasury's financing need for fiscal 1997. While the financing requirement in the current fiscal year will likely exceed that of fiscal 1996, the Committee noted the substantial progress toward deficit reduction in recent years. The Committee was also mindful of the Treasury's recent decision to increase the frequency of issuance of 10- and 30-year securities as well as Treasury's intentions to begin issuing inflation-indexed securities on a regular basis commencing in early 1997. For these reasons the Committee supported a modest reduction in the size of the 3-year note to \$18.5 billion from the \$19.0 billion level in the prior refunding. These combined actions contribute to a debt management policy which avoids undue reliance on short-term financing and arrests the decline in the average length of the debt.

The Committee voted unanimously to recommend a re-opening of the 6 ½ percent notes due October 15, 2006. Such a re-opening would promote increased liquidity in this issue in both the secondary market and the repo market. In addition, it would modestly divert a portion of coupon payments away from the large November 15 coupon payment date.

The Committee also voted unanimously to recommend a new 30-year bond. This would enable the Treasury to increase the strippable product with May 15 and November 15 maturities.

With the aim of achieving a cash balance of \$30 billion on December 31, the Committee unanimously recommends that for the remainder of the quarter, the Treasury meet its borrowing requirement in the following manner:

- Two 5-year notes totaling \$12.5 billion each, to raise \$5.9 billion of new cash;
- Two 2-year notes totaling \$18.25 billion each, to pay down \$0.5 billion;
- Two 1-year bills totaling \$19.25 billion each, to raise \$0.8 billion of new cash;
- Weekly issuance of 3- and 6-month bills through the remainder of the quarter, to raise \$20.6 billion of new cash;
- The issuance of intra-quarter cash management bills to cover the cash low point in early December; and
- The paydown on December 19 of \$13.0 billion of cash management bills issued in conjunction with the November refunding.

Including the \$14.8 billion raised in the mid-quarter refunding as well as anticipated foreign additions of \$6.9 billion, the proposed financing schedule will raise a net amount of \$35.5 billion. This amount, when added to the \$12.5 billion already raised or announced in the quarter, will accomplish the total net market borrowing requirement of \$48.0 billion.

For the January-March quarter, the Treasury estimates a net borrowing requirement in the range of \$50-55 billion with a cash balance of \$20 billion at the end of March. To accomplish the anticipated net borrowing requirement, the Committee unanimously recommends the provisional financing schedule attached to this report.

In its discussion of the financing schedule for the January - March quarter, the Committee considered possible adjustments if the Treasury's net borrowing need was somewhat smaller than expected. In such a case, a majority of members preferred a further small reduction in the recommended amounts of shorter-term coupon issues.

In response to the Treasury's request for its views on improving investor awareness of the new inflation-indexed securities ahead of the first auction in January, the Committee first noted that, although the extent of investors' interest is unknowable at this juncture, the range of investors who may have a meaningful interest in the securities is broad. Included are both defined-benefit and defined-contribution pension funds, university and foundation endowments, state and local government pension funds, foreign central banks, mutual funds, and individual retirement accounts. Treasury officials have met or will be meeting with various groups representing these investors, in addition to dealers and other investment organizations in the U.S. and abroad. The Treasury is also planning to meet with writers who will be producing studies in various publications that will appear in December and January. The Committee commends these efforts by the Treasury to raise the awareness of the new inflation-indexed securities throughout all segments of the investor community.

The Committee discussed the research on inflation-indexed securities that has been produced and distributed by dealers since the Treasury's announcement last May. Opinions differed on the general quality of this research to date. Efforts to encourage further research of increased depth were urged. The importance of ensuring the creation of indices embracing inflation-indexed securities was stressed by several Committee members. The contribution that pension and other investment consultants could make to increasing the awareness of the role inflation-indexed securities in both institutional and individual portfolios was also noted.

In answer to the question on the best way to proceed toward a determination of the appropriate size for the first auction, Committee members noted that recommendations from dealers and other market participants ranged from under \$3 billion to over \$10 billion. In the Committee's view it is premature to reach a firm judgment at this time and the Committee stated its willingness to hold a special meeting close to the announcement date in order to formulate and offer a recommendation when more information is available to help gauge the level of prospective interest among investors. Because these are new securities, all Committee members agreed with the objective of doing all that is feasible to maximize the likelihood of success.

The Committee also discussed the appropriate length of the when-issued trading period as well as the timing of the initial offering of inflation-indexed notes. There were mixed views on the length of

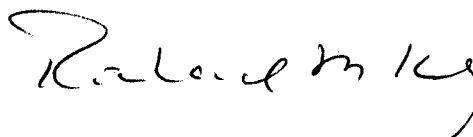
the when-issued trading period. Some members felt that a longer-than-normal pre-auction trading period would facilitate price discovery and contribute to improved pre-auction distribution. Other members felt that, because this is an initial offering of an untested security, many investors would prefer to wait until the price was determined in the auction before trading actively in the securities. These members preferred a somewhat longer trading period between the auction and settlement dates.

On the question of timing, the Treasury intends to issue inflation-indexed notes on January 15, 1997 and on a quarterly basis thereafter, settling on the fifteenth of the first month of each quarter. This approach would allow offerings of inflation-indexed securities to refund outstanding 7-year notes which mature on the same dates. The Committee concurs with this financing schedule. However, the Committee suggests that the Treasury consider postponing the settlement date of the first issue until January 22, 1997. The additional time would likely be beneficial in view of the New Year holiday period as well as a desire for a somewhat longer when-issued trading period.

At the Treasury's request, the Committee considered changing the treatment of awards to the Federal Reserve in Treasury bill auctions. Specifically, the awards to the Federal Reserve would be treated as add-ons to the amounts sold to the public. Committee members favored this approach as it would be consistent with the treatment of awards to the Federal Reserve in coupon auctions.

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

Respectfully submitted,

A handwritten signature in cursive script, appearing to read "Richard M. Kelly".

Richard M. Kelly
Chairman