

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

AUGUST 3, 1994

Dear Mr. Secretary:

During the three months since the Committee's last meeting with the Treasury in May 1994, the economy has continued to expand at a solid pace. Though faint so far, evidence of some cyclical acceleration of inflation is growing. Monetary policy has continued to become less stimulative, and the Federal funds rate was raised a further 0.50% during the period to the present level of 4.25%.

Over the three-month interval, yields on Treasury securities have increased by approximately 5 to 35 basis points. The largest increases have been for maturities under one year, and as a consequence the yield curve has flattened. Along with forward prices for various fixed-income instruments, the present shape of the yield curve indicates that market participants expect additional increases in interest rates in the coming months.

Within this context, to refund the \$29.6 billion of securities maturing on August 15, 1994 that are privately held and to raise additional cash of \$10.9 billion, the Committee recommends that the Treasury auction \$40.5 billion of the following securities:

- \$17.0 billion 3-year notes due August 15, 1997;
- \$12.0 billion 7 1/4% notes due May 15, 2004; and,
- \$11.5 billion of 30 1/4 year bonds due November 15, 2024.

Fourteen of the 20 Committee members present for the meeting favored this recommendation. Five members favored a composition of \$17.0, \$12.0, and \$11.0 billion for the respective three offerings, and one member favored a composition of \$17.5, \$12.0, and \$11.0 billion.

Given the composition favored by the majority, the Committee unanimously recommends the reopening of the 10-year note issued in the last refunding. The recommendation is based on the premium the current 10-year issue commands in both the secondary market and the repurchase agreement market.

With respect to the bond, the Committee by a vote of 16 to 4 recommends that the Treasury auction an issue that matures either in May or in November because of the relatively greater demand currently for the components of stripped securities maturing in these two months. In considering the consequent choice between a 29 3/4 year and 30 1/4 year issue, a majority of the Committee believes that, on the margin, there may be somewhat greater

demand for the longer alternative that would mature in November 2024. The principal reason for this view is the prospect that when stripped the lower dollar price would make the longer issue more attractive to defeasance programs, thereby maximizing its premium in comparison to surrounding issues. In addition, looking ahead to February 1995 when the next 30-year bond is scheduled to be auctioned, the Treasury would be able to assess the relative attractiveness of reopening and thus enlarging the issue.

With the aim of achieving a cash balance of \$40 billion on September 30, the Committee unanimously recommends that for the remainder of the quarter, the Treasury meet its borrowing requirements in the following manner:

- Two 5-year notes of \$11.0 billion each, to raise \$22 billion of new cash;
- Two 2-year notes of \$17.25 billion each, to raise \$3.6 billion of new cash;
- Two 1-year bills of \$17.0 billion and \$17.25 billion respectively, to raise \$3.7 billion of new cash;
- Weekly 3- and 6-month bills totaling \$25.2 billion for each week during the remainder of the quarter, to reduce cash by \$1.2 billion;
- Redemption of the outstanding cash management bills maturing September 22, to reduce cash by \$6.0 billion; and,
- Redemption of the outstanding 4-year note maturing September 30, to reduce cash by \$8.3 billion.

Including the \$10.9 billion raised in the mid-quarter refunding as well as anticipated foreign add-ons of \$5.2 billion, the proposed financing schedule will raise a total of \$29.9 billion. When added to the \$15.1 billion of net borrowing already raised or announced during quarter, this amount will accomplish the total net borrowing requirement of \$45.0 billion. The Committee also recommends that additional intra-quarter cash management bills totaling approximately \$16.0 billion be issued to cover the cash low points in mid-August and early September.

For the October-December quarter, the Treasury estimates its net market borrowing in the range of \$45 to \$50 billion with a cash balance of \$30 billion at the end of December. The Committee notes that this borrowing estimate is significantly below most private forecasts. To accomplish the Treasury's anticipated market borrowing requirement, the Committee recommends the following provisional financing schedule:

<u>Auctions</u>	<u>Size (billions)</u>	<u>Raising (billions)</u>
Refunding: 3-year note	\$ 17.0	
10-year note	<u>12.5</u>	
	\$ 29.5	\$ 0.6

5-year notes	2 x \$11.0	22.0
2-year notes	2 x \$17.5	4.2
1-year bills	3 x \$17.5	4.2
3- and 6-month bills	13 x \$25.2	3.3
Cash management bills (January maturity)		15.0
Estimated foreign add-ons		<u>5.3</u>
	Subtotal	\$ 54.6
Less: 7-year note maturity		<u>(7.1)</u>
	Total Net Market Borrowing	\$ 47.5

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 response to the request for its further views on whether to continue the single-price auction technique for 2- and 5-year notes after August 1994, the Committee reviewed the analysis presented to it by the Treasury staff which materially augmented the preliminary data presented at the Committee's previous meeting in May.

The Committee is mindful that conclusions drawn from the analysis need to be tempered by the comparatively brief period covered by the data and the variability, and thus reduced statistical significance, of much of the data within this period. Of particular concern is that throughout most of the period interest rates were stable or falling and therefore little experience has been gained during episodes when interest rates are rising. Despite the limitations on potential significance of the available data, the analysis seemed fully in concert with the comments offered in the Committee's last report (an excerpt of the pertinent section is appended for reference). Certain points from the analysis are worth highlighting:

- Consistent with theory, the single-price auctions seemed to have reduced the concentration of awards among dealers and increased awards to customers. Though in absolute terms the shift can be seen as small, in proportionate terms the shifts are reasonably substantial. Moreover, growing familiarity with single-price auctions could lead to additional growth in the participation by customers in future auctions.
- While the data do not yet provide a compelling case that single-price auctions have lowered the cost of borrowing to the Treasury compared to multiple-price auctions, there is no evidence in the data that single-price auctions have raised the cost.
- Transaction volumes on days of single-price auctions have increased notably, suggesting that the technique has contributed to improved liquidity, which in turn should lower the cost of borrowing.
- The dispersion pattern of bids in single-price auctions, as compared to those in of multiple-price auctions, suggests that dealers, and perhaps others, perceive a potential for underwriting profit in single-price auctions. Over

time as bidding techniques evolve, this perceived opportunity for profit may provide greater confidence in the robustness of the single-price auction technique during periods of rising interest rates and associated market stress.

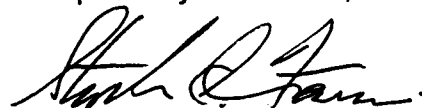
On the basis of its review of the analysis and the judgments expressed in its May report, the Committee recommends by a vote of 17 to 3 that the Treasury continue the single-price auction for 2- and 5-year notes and, furthermore, that it extend the experiment with technique to the auction of 10-year notes. The choice of the 10-year note for extension of the technique was made on the basis that there is now sufficient evidence of success with the technique to warrant a trial with a longer maturity. The 10-year was preferred because of its status as a global benchmark security and because the 30-year bond is now auctioned just twice a year and therefore would afford an inadequate number of observations to provide sufficient data for analysis. The Committee recommends that, in addition to the 30-year issue, the 3-year note continue to be auctioned on the existing multiple-price basis in order to provide a useful standard of comparison for continued evaluation of the single-price auction technique.

The three Committee members who voted against this recommendation favored a continuation of single-price auctions for 2- and 5-year notes but opposed at this time extension of the technique to 10-year notes. In their reasoning, the members cited the inconclusiveness of the existing data on single-price auctions and the desire for an opportunity to evaluate the data more rigorously. Further, although they concurred with the majority's view that there was no evidence that single-price auctions raised the cost of borrowing in the 2- and 5-year notes, these three Committee members were concerned that extension of the technique to the longer maturity could have a less successful outcome and perhaps be costly to the Treasury.

The Committee's view on 3-decimal yield bidding was unanimous in favor of the change. Consistent with the view expressed in its report of August 1, 1990, all Committee members thought that smaller yield increments would, on the margin, induce some market participants to bid more aggressively in coupon auctions, thus potentially lowering slightly the Treasury's financing costs. Also, 3-decimal yield bidding would bring auction price increments into line with those in the secondary market. The Committee could identify no disadvantages to the change.

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

Respectfully submitted,



Stephen C. Francis
Chairman