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

May 4, 1999

Dear Mr. Secretary:

Since the Committee's last meeting on February 3, 1999, the U.S. economy has performed strongly. The Commerce Department recently reported that GDP expanded at a 4.5% pace in the first quarter of 1999. Consumer demand, as measured by gross domestic purchases, accelerated to 6.8 percent from the 5.4 percent rate of the fourth quarter of 1998. Gains in consumption, construction activity and continued momentum in business capital spending continue to offset the headwinds from the trade sector.

Treasury yields have risen significantly and the yield curve is somewhat steeper than at the time of the Committee's last meeting. Yields on Treasury bills are 10-30 basis points higher, and for Treasury coupons they are 30-50 basis points higher, as the market has adjusted to stronger global growth prospects and apparent investor preferences for credit instruments and equity securities.

Within this context, the Committee considered the composition of a financing to partially refund $28.9 billion of privately held notes maturing on May 15, and to pay down approximately $2 billion. The Committee unanimously recommends a total financing size of $27.0 billion consisting of the following offerings:

- $15.0 billion 5-year notes due May 15, 2004
- $12.0 billion 10-year notes due May 15, 2009

The Committee did not feel that a reopening of the 10-year note was warranted due to original issue discount (OID) considerations, the size of the existing issue, and a lack of significant tightness in the financing market.n regard to the composition of Treasury market financing for the remainder of the current quarter, the Committee recommends that the Treasury meet its borrowing requirement in the following manner:

- Two 2-year notes of $15.0 billion each,
- Two 1-year bills of $10.0 billion each,
- Weekly issuance of $15.0 billion of 3- and 6-month bills through the remainder of the quarter, and
- One cash management bill of $45.0 billion to be issued June 1 to mature within the quarter.

For the third quarter of 1999, the Treasury estimates a net market paydown of $10 billion with an estimated cash balance of $45 billion on September 30. To accomplish this requirement, the Committee preliminarily recommends the financing schedule in the attached table, without making a judgment about the optimal mix of coupon offerings in the next refunding. Specifically, in the event of a reopening of the 10-year issue, the bias of the Committee would be to look to increase the size of the 5-year note offering.

At the Treasury's request, the Committee revisited questions related to the range of tools available to the Treasury to help meet its debt management objectives in an environment of continuing, sizable budget surpluses. The Committee reaffirmed its views on what those objectives should be, as set out in its report of February 3, 1999. The Committee also discussed and reaffirmed its view that the Treasury should have available to it a full range of policy options, in order to distribute the impact of its debt retirement activity in a way which preserves as much of the cost efficiency and liquidity of the Treasury market as is practical. Specifically, the Committee was of the view that the Treasury should pursue policy action on two initiatives: greater flexibility in the application of original issue discount (OID) rules as it relates to decisions on coupon re-openings, and development and issuance for public comment of policies and procedures which would guide the execution of secondary market debt buy-backs.

With regard to OID rules, the Committee felt that the Treasury would benefit over the long term if it was less restricted by secondary market price discount limitations in deciding when it was in Treasury's interest to re-open previously issued benchmark coupon securities. While decisions on when to favor re-openings relative to new issues would and should still be made on a case-by-case basis, having greater flexibility to carry out more re-openings would be a useful policy adaptation.

There was especially strong sentiment in the Committee as to the desirability of the Treasury moving ahead expeditiously to develop rulemaking proposals to guide execution of a secondary market debt buyback program. Those rules should address both the potential to use debt buybacks as a short-term cost saving measure when significant market price anomalies develop, as well as rules for its use as a longer term tool to manage the impact of debt reduction actions on various maturity sectors of the market; to balance the impact of changes to regular offering cycles and sizes on the average maturity profile of the debt; and to preserve flexibility should less favorable economic or fiscal policy outcomes develop. Recognizing that it would take time to develop those rules and receive and evaluate public comment, the Committee felt that it was important to begin the rulemaking process soon, as the use of a buyback tool could well be preferable to further cutbacks in the size and frequency of regular bill and coupon offerings.

The Committee then turned to consideration of the trade offs between the potential for reduced issuance in the regular 2-year and 30-year coupon offerings, relative to the potential for changes in the pattern of regular Treasury bill offerings. The Committee was generally of the view that liquidity had already been negatively impacted in the bill sector and that it was important, therefore, to preserve regularity and predictability in the size of the weekly three and six-month bill offerings, even if that necessitated continued volatility in the size and frequency of cash management bills. The Committee also discussed the relative attractiveness of maintaining the existing annual program of 13 offerings of 52-week bills, compared to adjustments in other weekly bills or 2-year note offerings.

In this regard, there was a broad consensus on the Committee that it would be preferable to consider moving to four fewer annual offerings of 52-week bills, with a shift in relative issuance to more 3- and 6-month bills and to maintaining, if possible, monthly offerings of 2-year notes. The timing of any such shift would, of course, depend on when debt reduction needs called for further changes in the regular issuance program, as well as whether the Treasury had in place, and was inclined to make active use of, a secondary market debt buyback program. The preference for fewer 52-week bills relative to 3- and 6-month bills and 2-year notes reflected the following considerations: (1) the 52-week bill was viewed as providing the least utility to the Treasury and the market, relative to other regular offerings; (2) there was substantial secondary market alternatives, in terms of the supply of short coupons, to meet investor needs in the 1-year maturity; and (3) the timing of the Treasury's monthly cash flow requirements favor preserving monthly issuance of 2-year notes to help meet the pattern of sizable early month cash drawdowns for regular benefit payments, as well as the monthly retirements of the previously issued 5-

year notes. Moreover, this adjustment to fewer 52-week bill offerings in favor of more 3- and 6-month bills and 2-year notes could be accomplished without any material impact on the average maturity of the debt. Should the Treasury decide to move to less frequent issuance of 52-week bills, the decision on which bills to eliminate should be based on an evaluation of monthly patterns of Treasury cash management needs. The Committee recognized that, longer term, it may still prove necessary to consider reduced offerings of 2-year notes and 30-year bonds, but felt that the Treasury should first pursue these other alternatives.

Finally, at the Treasury's request, the Committee considered the proposition of shortening the when-issued period for 2-year notes. In this regard, it was noted that the Committee had recently recommended, and the Treasury had decided to implement, a shortening of the when-issued period for regular Treasury bill offerings. In evaluating this possibility for 2-year notes, there was recognition that there was no precise way to determine the optimal length of when-issued periods. Moreover, it was probably feasible to shorten those periods slightly, without adversely impacting pre-auction price discovery and distribution or post auction re-distribution and settlement preparation. When considering instead whether this might be viewed as desirable, there was concern among members of the Committee that the message implicit in shortening this period was the higher likelihood that there would be short-term variability in the size of these coupon offerings, to fine tune them relative to recent cash flows. This was viewed as somewhat at odds with other efforts to preserve predictability and regularity in the regular coupon offering cycle. For this reason, the Committee was not inclined to recommend this change.

Respectfully submitted,

Stephen G. Thieke

Chairman