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

November 2, 1999

Dear Mr. Secretary:

Since the Committee's last meeting on August 3, 1999, the US economy has continued to expand at a brisk pace. Indeed, the Commerce Department recently reported that GDP posted a 4.8% annualized growth rate in the third quarter. Solid gains in consumer demand and business capital spending were responsible for the bulk of the elevation in Q3 GDP. While there are recent signs that a higher interest rate environment is helping to cool activity in some sectors – like housing – the burgeoning global recovery points to a likely near term rebound in exports. On balance, the outlook for the US economy continues to appear quite favorable.

In the weeks immediately following our last meeting, Treasury yields fluctuated in a relatively wide range. At its August 24 meeting, the FOMC raised short-term interest rates 25 bp, and shortly thereafter rates began to rise across the yield curve. The increase accelerated beginning in early October, as evidence of continued strength in the domestic economy, further signs of global economic healing, and elevation in headline inflation readings led to a reassessment of the outlook for monetary policy. For the most part, the trend toward higher rates continued through much of October, but the higher rate trend has partially reversed in recent days after the quarterly labor cost data were released. Market participants are uncertain regarding the likelihood of near-term Fed action, although market price structures still discount moderate Fed tightening over the next several months.

Within this context, the Committee considered the composition of a financing to refund approximately $29.3 billion and to pay down about $4.3 billion.

The Committee considered its recommendation for the size of the financing in the context of a discussion of the issues related to a reopening of the 10-year note. Those members who favored a reopening cited the long-run benefits associated with the increase in liquidity of benchmark offerings, as well as the potential short-run advantage of improved market liquidity in advance of Y2K. Those members who favored a new 10-year security felt that the cost savings to the Treasury outweighed the uncertain short-term liquidity effects. The Committee voted by a 13-5 margin for a total financing of $25.0 billion consisting of the following offerings:

- $15.0 billion 5-year notes due November 15, 2004
- $10.0 billion of the 6% notes due August 15, 2009.

Members who favored a new 10-year security supported an issue size of $12 billion, and a total refunding size of $27 billion.

During this discussion on the merits of a reopening in this specific financing, the Committee reiterated its view that a regularized schedule of reopenings for longer-term debt offerings would be the most effective approach to creating liquid benchmark issues at the lowest interest cost to the Treasury. Scheduled reopenings would also provide the Treasury with additional debt management flexibility in an environment of sustained fiscal surpluses.

In 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 $18.0 billion of 3- and 6-month bills through the remainder of the quarter, and
- Three cash management bills totaling $67.0 billion, with $20.0 billion to mature within the quarter, and the balance to mature in January.

For the first quarter of 2000, the Treasury estimates a net market paydown of $12 billion with a cash balance of $20 billion on March 31. To accomplish this requirement, the Committee preliminarily recommends the financing schedule in the attached table.

The Committee was asked by the Treasury for its views on the increasing swings in the Treasury cash balance over the past few years, and the accompanying growth in the size of cash management bills. The Committee was asked about potential alternative methods for dealing with these cash balance fluctuations, recognizing that although weekly bill sizes have been altered significantly in the past to respond to cash balance swings, there are limits to this approach in the current environment of bill offerings that are perceived to be near the minimum size necessary to maintain market liquidity.

The Committee believes the Treasury should continue to use weekly bills to respond to the consistently high cash balances evident in the second calendar quarter of each year. However, the Committee presently views cash management bills as the best alternative for the Treasury in dealing with most of the cash balance fluctuations.

Members noted that if the Treasury were to implement a reduction in the frequency of 1-year bill offerings in the future, an increase in the size of the weekly bills would provide the Treasury with more flexibility to use changes in the levels of bill offerings to offset cash balance fluctuations.

Comments over the past few months on the Treasury's proposed rules for buy backs focused on the lead time of announcements, whether to conduct buy backs on a regular and predictable basis, settlement dates, the targeting of specific CUSIPs versus maturities, and limits on the purchases of any given security. The Treasury sought the Committee's views on these questions.

The Committee’s overriding view is that within the context of sound debt management practices, savings to the Treasury from debt buy backs would best be served by a framework that gives the Treasury maximum flexibility. It is in the Treasury’s interest to give global investors the opportunity to assess their potential participation in the purchase program, but the Committee expressed a preference for a relatively short lead time between the announcement and the submission of offerings, not unlike the process for a Federal Reserve coupon pass. The buy back operation would optimally be conducted in New York morning hours, in order to enhance the participation rate of overseas holders of Treasury securities. We believe that investor participation would additionally be enhanced by extending settlement to T + 3, the corporate settlement standard. The Committee believes that the Treasury should request offerings in specific maturity ranges, but not for specific securities or CUSIPs. The Treasury could then purchase securities that best satisfied its debt management and savings objectives at that time. The Committee also felt that there was no reason to state a limit on the specific amount of any given security that the Treasury can purchase. The Committee believes that while it is important to clearly state the rules for the program at the earliest possible date, the rules should give the Treasury maximum flexibility in its execution of the program.

Respectfully submitted,

Kenneth M. deRegt