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

January 31, 1990

Dear Mr. Secretary:

Since the Committee's last meeting in November, three factors have dominated changes in the U.S. Treasury market. First, there have been shifting opinions regarding the economy's current growth momentum and the likelihood that further Federal Reserve policy easing measures will be needed to bolster business activity. Second, market participants have grown increasingly concerned that tightness in labor markets and gains in world oil prices will keep inflation stubbornly strong through this year. And third, recent increases in bond yields abroad have given rise to worries that foreign investors' appetite for U.S. securities will be curtailed. With many economic statistics experiencing distortions from natural disasters, strikes, and volatile weather conditions, Treasury issue yields have lately been pressured upward as dealers and investors have tended to focus more on perceived inflation dangers and the substantial narrowing of international interest rate differentials. Since mid-November, discount yields on six-month Treasury bills have risen by about 30 basis points (from 7.45 percent to around 7.75 percent), but yields-to-maturity on Treasury notes and bonds have increased more substantially, by about 65 to 75 basis points. Three-year note yields have increased from 7.69 percent to 8.42 percent, while 10-year note yields have risen from 7.82 percent to 8.56 percent, and 30-year bond yields have gone from 7.87 percent to 8.60 percent.

The direction of changes in bond market yields over coming months will likely depend importantly on whether the U.S. economy experiences a re-acceleration in growth or slips closer to the edge of an outright downturn. At this juncture, it would appear that continued solid gains in consumer spending will be needed to maintain the expansion through this year. Fortunately, consumers would appear to have both the wherewithal and the desire to continue adding to outlays, based on solid real disposable income gains during 1989 and relatively high consumer confidence readings at year-end. But given the unusually precarious business outlook, the Federal Reserve is likely to continue the easing process that it began last spring as the year unfolds. This would probably lead to some additional steepening of the Treasury yield curve. Moreover, a further drop in U.S. short-term yields could tend to depress the dollar exchange rate, and this could cause some further erosion in foreign demand for dollar-denominated bonds. It is against this background that we have produced our recommendations for the February refunding.

The Committee unanimously recommends that the following new securities be sold at yield auctions to refund $18.1 billion of maturing securities and raise $11.9 billion of new cash:

- $10.0 billion 3-year notes due 2/15/93;
- $10.0 billion 10-year notes due 2/15/2000;
- $10.0 billion 30-year bonds due 2/15/2020.

For the remainder of the quarter, the Committee recommends:

- Sell $10.0 billion 2-year notes raising $.2 billion new cash;
- Sell $8.0 billion 5-year notes raising all new cash;
- Sell $9.5 billion 52-week bills at two remaining auctions, raising $.9 billion new cash;
- Sell $7.0 billion cash management bills for payment March 2 due April 26, raising all new cash;
- Sell $15.2 billion at each remaining 3- and 6-month bill auction, raising $.5 billion.

Summary of New Cash for Quarter

Refunding	$11.9 billion
3- and 6-month bill	.5
52-week bills	.9
Cash management bills	7.0
2-year notes	.2
5-year notes	8.0
Total additional market borrowing	$28.5
Already raised	12.0
Estimated Foreign Add-ons	1.0

Net Market Borrowing $41.5 billion

The Committee recommends a cash balance of $10.0 billion on March 31.

For the April/June quarter, the Committee suggests maintaining auctions for coupon securities, 1-year bills, and the refunding at the same levels as proposed for the January/March quarter. The appropriate cash balance for June 30 is $35.0 billion.

In order to meet the $35 billion cash balance at the end of the quarter, the Committee recommended paying down $11 billion in regular 3- and 6-month bill auctions by reducing the auction size to $14.5 billion at the start of the quarter and paying off all maturing cash management bills. The paydowns on the weekly series should be adjusted as the uncertainties associated with April tax receipts and the timing of RTC working capital demands become more certain. The Committee believes the size of coupon offerings should be adjusted as a last option; the Committee believes it is relatively more unsettling to the market than adjusting the bills. Finally, to cover a cash low point in early April, a short-dated cash management bill of up to $10 billion may be necessary.

With respect to the question "on the way in which Treasury should fund the working capital needs of the R.T.C. if they are financed through the F.F.B.", the Committee, after much discussion, considered two generalized options. The options are generic in nature since answers to questions about the timing of the need for the working capital and for the duration of that need might shape other responses.

The first option discussed could be labeled the "T-Bill" approach. This option would emphasize the pure working capital or short-term nature of the financing need, as well as its general character of substituting one short-term financing vehicle for another. That is, Treasury bills would replace existing short-term Home Loan Bank advances, brokered deposits, etc. This approach would have the quality of more clearly earmarking the funds for the working capital project. Many committee members felt this approach could be disruptive in certain circumstances because of the heavy pressure it could place on short-term markets. This was a particular concern when framed in a context of uncertainty about the timing of the need. They foresaw the potential for periods of serious market congestion.

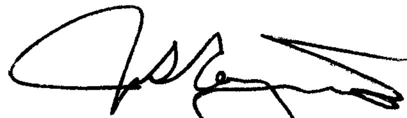
The second option could be labeled the "blended" approach. This option would blend the working capital need into the regular pattern of Treasury financing with a strong bias or tilt toward bills and short coupons. This suggestion acknowledges the reality that all Treasury debt issuance for practical purposes is fungible. The result of this proposal would lead to a marginal decline in the average maturity of the debt, but not as drastically as the T-bill option. The blended approach more realistically assumes that a portion of the financing need will be beyond the maturity structure of the Treasury bills.

The Committee voted 14 members to 3 in favor of the "blended" approach.

Lastly, the Committee would like to take this opportunity to strongly recommend that the REFCORP financing be included as a part of the regularly announced and auctioned Treasury debt schedule. Predictability is an important element of successful government finance. The Committee suggests, as we did in our previous report in November, that the REFCORP financing should be announced in the first week of the quarter and auctioned in the same week as the regular seven-year note. An early commitment to this schedule should improve the investor reception of the REFCORP financing. We also believe greater discussion of REFCORP as a credit by appropriate Government officials will enhance its market acceptance.

The Committee also would strongly endorse the continuation of the 40-year bond for REFCORP. While the Committee acknowledges the difficultly of its initial market reception, we believe that it is an attractive vehicle which will grow in market acceptance. That acceptance will lead to <u>additional</u> savings for the issuer.

Mr. Secretary, that concludes our report and we welcome questions and discussion.



Jon S. Corzine
Chairman