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

May 1, 1991

Dear Mr. Secretary:

Recessionary business conditions and substantial additional Federal Reserve monetary easing measures have been the primary economic factors setting the tone in the market since our meeting in January. Declining personal consumption spending and factory orders last quarter encouraged business firms to aggressively cut their production and shed workers. As a consequence, personal income has been virtually stagnant for the past six months. In response to this weak economic tone, Fed officials have lowered both the Federal funds rate and the discount rate. Not surprisingly, these fresh policy steps by the central bank have helped pull down discount yields on 3-month Treasury bills since late January, from 6.20 percent to 5.60 percent. Yields on longer-maturity Treasuries have not fallen by as much over the period, however; 3-year note yields have dipped only from 7.34 percent to 7.30 percent, while 30-year bond yields have been flat at about 8.25 percent. To a large degree, the relative stickiness of yields on long-term issues can be traced to improving assessments of U.S. economic prospects among financial market participants. Falling energy prices and heavy individual income tax refunds have bolstered consumers finances since mid-January, which encouraged consumers to increase their volume of purchases as confidence surged following the successful conclusion of the Gulf war. In addition, a more upbeat reading of the U.S. economic outlook triggered a sharp rise in the dollar against other G-7 currencies, and that in turn led to some liquidation of Treasury note holdings by foreign central banks and official institutions as part of their coordinated foreign exchange intervention activities. Over the period ahead, information and developments relating to the economy's health will undoubtedly remain the key factor in determining the direction of Treasury market yields. Should business activity stage an early recovery, as the Administration and many private analysts believe, then market yields would probably come under some moderate upward pressure from the unusually high market financing needs that are expected for the balance of this fiscal year. With this perspective as background:

The Committee unanimously recommends that the following securities be sold at yield auctions to refund $19.0 billion maturing securities and raise $18.0 billion of new cash:

-- $13.0 billion 3-year notes due 5/15/94;

-- $12.0 billion 10-year notes due 5/15/2001;

-- $12.0 billion 30-year bonds due 5/15/2021.

For the remainder of the quarter, the Committee recommends that the Treasury:

-- Sell $12.5 billion 2-year notes raising $2.3 billion of new cash;

-- Sell $9.25 billion 5-year notes, raising all new cash;

-- Sell $12.25 billion 52-week bills, raising $1.6 billion new cash;

-- Raise weekly 3- and 6-month bill auction sizes to $20.0 billion by early June, leaving a paydown in bills of $850 million;

-- Sell $10 billion cash management bills, to mature April 1992;

-- Sell $11 billion cash management bills due June 20, 1991, with intention of extending all or part into a June 1992 maturity as necessary to reach the targeted end-of-quarter cash balance.

Summary of New Cash for Quarter

To be done:	
Refunding	$18.0 billion
3- and 6-month bill	(0.85)
52-week bills	1.6
Cash management bills (2 series)	21.0
2-year note	2.3
5-year notes	9.25
Total	$51.3 billion
Already done	(3.5)
Estimated Foreign Add-on	2.2
Net Market Borrowing	$40.0 billion

The Committee recommends and the schedule provides for a cash balance of $35 billion on June 30.

The Committee's April/June schedule contemplates two substantial offerings of cash management bills to tide the Treasury over low points in the cash balances in late May and early June. The first cash management bill would be a short-dated bill maturing in June 1991, followed as cash needs dictate with a cash management bill maturing in April 1992. The short-dated June bill could then be rolled at its maturity into an April 1992 cash management bill or, more likely, a June 1992 cash management bill to top up the cash balance to the targeted end-of-quarter level. This last cash management bill should be flexible to take into account cash flow contingencies brought on by uncertain "Desert Storm" payments, RTC demands, or tax receipt shortfalls.

The Committee unanimously believes the refunding size should be as large as possible to release as much pressure from future bill issuance as practical, given the large forward borrowing needs. We again emphasize the Committee's preference to use a full measure of long bonds. We are comfortable that the current market will readily accept the increase of $1 billion from the February refunding. Two points are particularly supportive of this view. First, fifty percent of all long bonds are stripped, which spreads the maturity concentration over the yield curve. Second, the market no longer has access to long-dated Refcorp or other Treasury bonds in the 20-30 year sector. In sum, the enormous foreseeable Treasury auction calendar argues forcefully for both a large and long-duration bias to the refunding structure.

The Committee believes the Treasury should use the quarterly announcement to publicly dispel market concerns about a near-term move to a monthly cycle of 10-year notes. A repetition of the stated view that current cycles can readily absorb near-term projected needs will clarify lingering market discussions on a monthly 10-year note, and therefore improve participation in the current offering.

For the July/September quarter, the Committee recommends a minimum end-of-quarter cash balance of $30 billion, which would produce a marketable borrowing requirement of roughly $105 billion. Again, the aforementioned uncertainty of Desert Storm, etc., make the latter call speculative. Under most circumstances, however, the Committee would call for a minimum August refunding of $39 billion. The Committee also would turn to substantial increases in the year bill cycle in the next quarter, as it is currently a relatively untapped source of funds. The Committee believes it is logical that, over time, the year bill size could be several billion dollars larger than 2-year note offerings. Therefore, in the July/September quarter, the group would recommend that auctions of year bills be at least $14 billion. More modest increases of $250-500 million should be adequate for the coupon cycles, while weekly bills should rise to $21-22 billion. Finally, a long-dated cash management bill will also be likely by mid-August. The key recommendations for the quarter, however, are continuing emphasis on the refunding and growth in year bill offerings.

Moving on to other matters --

The Committee unanimously believes it is in the best interests of the Treasury to take forceful action to prevent the growth of pre-announcement, when-issued market trading for notes and bonds. The Committee believes the Treasury should use its authority to accept or reject auction tenders to dissuade participants from developing this activity.

There are two primary bases for this point of view. First, the Committee believes the practice would potentially diminish the full discretion of the Treasury with regard to financing options if significant growth in open exposure were to occur in a specific expected issue. The concern is that if a systematic credit or market exposure existed because of the WI activity, the Treasury might feel a de facto obligation to issue a specific maturity which it might otherwise choose not to issue in order to resolve market problems.

Second, the group sees the potential for a build-up of significant unregulated or minimally supervised credit risk. The Committee is concerned that current system checks are not organized in a way to permit the Treasury, the Fed, or others to effectively monitor or manage this exposure. As opposed to futures and forwards, most OTC markets lack standardized legal remedies for problems which might arise where the security is not available. Similarly, effective and consistent mark-to-market rules do not exist for OTC issues, let alone for those not yet officially identified.

With regard to this issue, the Committee also believes the Treasury should be clear with the public in making its policy known. The recent market discussion of this issue has made very unclear the framework regarding constraints on pre-announcement, WI trading. Frankly, the Committee members by institutional memory believed before recent discussions that such activity was expressly precluded by the Treasury. Whatever your position may be, and we have a clear preference, this issue should be decided and the policy publicly disclosed.

On the question of an earlier time for the announcement of the quarterly refunding, the Committee unanimously supports moving the announcement to a point when maximum market liquidity is available. This recommendation assumes that the earlier time frame is a matter of operational indifference for Treasury. The Committee believes that the announcement should be arranged so that, when the wire services carry the announcement to the public, at least 15 minutes of Chicago futures trading is still available -- 30 minutes would be preferable. It is also the sense of the Committee that the Treasury should implement the release procedure in subsequent announcements, so that all participants are prepared for the change. The group also believes it would be best if the announcement time were standard for both refunding and regular auctions.

On a final matter, the Committee recommends that the Treasury use today's announcement as an opportunity to clarify that it has not foregone by law or policy its option to call securities. Each call option should be evaluated in the context of what is best for the taxpayers. The Committee feels that the press may not have properly or broadly conveyed this view and the consequent risks that might exist in holding callable Treasuries. A clear public statement in an official forum would be beneficial for Treasury market participants.

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

Jon S. Corzine
Chairman