REPORT TO THE SECRETARY OF THE TREASURY
FROM THE U.S. GOVERNMENT AND FEDERAL
AGENCIES SECURITIES ASSOCIATION

October 30, 1991

Dear Mr. Secretary:

Secondary market yields on Treasury securities declined steadily during most of the period since our meeting last July, although in recent days there has been some rise in long-duration issue yields owing to concerns about the possibility of increased fiscal policy stimulus. The rebound in economic activity which began last spring continued during the third quarter as real GNP registered its first growth in a year. At the same time, several recent reports suggest that some of the upward momentum was lost as the summer progressed. In particular, businesses continue to display unusual caution in their employment decisions, and the resulting slow job creation has dampened real income gains and consumer confidence. Should these patterns persist for much longer, they might pose a serious threat to the recovery's durability. These factors notwithstanding, there continue to be a number of reasons to expect a moderate expansion in total output over coming months. Improvement in housing investment should be stimulated by the lowest mortgage interest rates in over a decade, and a further increase in export volumes is likely given continued growth in foreign demand and favorable terms of trade. With business inventory-to-sales ratios still declining on trend, even modest increases in domestic spending should foster fresh increases in goods production. Moreover, monetary policy is expected to remain accommodative, and additional easing steps by the Federal Reserve may be forthcoming if business statistics remain sluggish and money-supply growth does not accelerate from its languid summertime pace.

Although economic growth has been relatively subdued for a recovery period, the fixed-income securities markets remain highly sensitive to developments which imply increased credit demands or inflation risks. This is why the recent discussions in Washington about potential fiscal stimulus through tax reductions have tended to push long-term bond yields upward and have contributed to an appreciable further steepening of the Treasury yield curve. With this perspective as background:

The Committee recommends that the following securities be sold to refund $20.2 billion maturing securities and raise $17.8 billion of new cash:

-- $14.0 billion 3-year notes due 11/15/94;

-- $12.0 billion 9 3/4-year and 7 7/8 percent notes due 8/15/2001;

-- $12.0 billion 29 3/4-year 8 1/8 percent bonds due 8/15/2021.

The Committee voted unanimously in favor of the size and composition of the refunding package. This package should convey a sense of continuity and normalcy on market matters at a time of environmental disruption and in light of recent changes in auction procedures.

The Committee strongly supported the reopening of the August 10-year (i.e., 7 7/8 percent of 8/15/2001) and the August 30-year (i.e., 8 1/8 percent of 8/15/2001). The Committee voted 11-5 and 13-3 in favor of reopening the two issues. This group continues to believe that creating large consolidated issues where practical is desirable. Consolidated issues are least disruptive to a congested marketplace, help avoid the potential for squeezes, and often capture scarcity value existent in a given market context.

For the remainder of the current quarter, the Committee recommends:

-- Sell $12.5 billion 2-year notes at two auctions, raising $2.9 billion of new cash;

-- Sell $9.0 billion 5-year notes at two auctions, raising $11.0 billion of new cash;

-- Sell $12.75 billion and $13 billion 52-week bills at two auctions, raising $1.4 billion of new cash;

-- Increase weekly 3- and 6-month bill auction size to $20.8 billion by the end of the quarter, raising no new cash.

Summary of New Cash for Quarter

Refunding	$17.8 billion
3- & 6-month bills	0.0
52-week bills	1.4
2-year notes	2.9
5-year notes	11.0
Total	$33.1 billion
Already raised	40.0
Estimated Foreign Add-ons	2.7
Net Market Borrowing	$75.8 billion

The Committee recommends a cash balance of $30.0 billion on December 31.

As a final point on Treasury financing in the first fiscal quarter, the Committee recommends that Treasury retain its regular auction announcement date for the November 2- and 5-year (i.e., 11/20). The Committee would recommend a Monday 11/25 auction for the 2-year and a Tuesday 11/26 auction for the 5-year. The Committee believes a 5-year auction held the day before Thanksgiving (i.e., 11/27) would cost Treasury participation and result in consequent interest expense versus the recommended rearranged schedule. The group sees no major market obstacle to a 12:00 noon/1:00 p.m. weekly bill/2-year note sale on Monday 11/25. Holding to the regular announcement schedule and rearranging auction dates would keep "when issued" trading compressed to 7 days as opposed to 14 days.

In December, however, the Committee believes the trade-off between the risk/reward of a longer WI period and the cost of auctioning 2- and 5-year notes on the two days before Christmas argues for pushing the auction announcement date back earlier in December. Where the Treasury positions that announcement date is somewhat flexible if Treasury chooses to cut down the extended WI period. A Friday or a Monday announcement (i.e., 12/13 or 12/16) is possible as opposed to the regular Wednesday announcement date for these two auctions.

As a general comment, the Committee recommends reasonably short WI trading periods as a means to narrow systemic credit exposures -- both for Treasury and market participants. This consideration is even more apt in light of the recently announced revisions to auction procedures by Treasury. As new participants access Treasury directly with their bids, Treasury is potentially exposed to a credit failure by bidding participants between auction date and the day prior to settlement. Apparently the participant's clearing bank only becomes responsible for the participant's financial obligation on the day prior to settlement in the "autocharge" process. This potential credit exposure should be fully reviewed and considered when Treasury sets WI periods for future auctions.

For the January/March quarter, the Committee concurs with the suggested $20 billion end-of-quarter cash balance. The Committee recommends that further incremental increases in the weekly bill, year bill, cycle coupon, and refunding auctions be instituted to achieve the funding of the $95-100 billion quarterly cash deficit. The Committee continues to believe that large increments in funding can be achieved through the year bill cycle. The Committee believes $500 million to $1 billion increases would easily be accommodated by this market on a month-to-month basis and should be instituted in the January/March quarter. The Committee also notes that a late February to early March cash management bill will be necessary to achieve the needed funding target. This bill could be either all April CMs or a balance of April and June CMs.

In response to the question of the 1992 refunding calendar, the Committee recommended unanimously that the Treasury shorten the period between announcement and settlement of the refundings in February, August, and November by one week so as to minimize WI exposure. The reasons for this recommendation parallel those previously noted in this report. Unfortunately, the May 1992 calendar does not lend itself to effectively cutting down on that time period because the 15th of the month would follow by one day the last refunding auction if the shortened WI period were followed. In short, the Committee recommends announcement dates for the 1992 quarterly refundings be as follows:

February 5
April 29
August 5
November 4

Auctions and settlements would follow on the subsequent week, with settlement on the 15th or the first business day after the 15th. Finally, the Committee members had a number of comments and observations with regard to the current review and the subsequent changes in the government securities market. As a group or individually, the Committee stands ready to be as helpful as the Treasury chooses to make us. We know we serve at your pleasure. Many of the Committee members have specific views on the many complex and evolving procedures and rules. Balancing the objectives of opening up the auction process with incremental costs and nuisance counterweights is an important goal. We accept both as responsible objectives, but on occasion, the goals can cut at cross purposes. If we can be helpful in sorting out those balances, we would welcome the opportunity.

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

Jon S. Corzine
Chairman