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

April 29, 1992

Dear Mr. Secretary:

Since our last meeting expectations of a recovery, more sustainable than 1991, have been the primary factor moving Treasury yields higher and the curve steeper, though occasional weak data has precipitated brief sharp rallies.

Importantly, with Fiscal Policy initiatives at a political impasse, it is believed Monetary Policy is freed to assure sustainable GDP growth of 2% or more. To date, recovery expectations have been based mostly on consumer spending data as retail sales have increased at a 12% annual pace since December. But a clear picture is still lacking with the payroll survey indicating employment virtually unchanged. Recovery level job growth and income gains to support present and rising consumer spending are required to place the expansion on firmer footing.

Generally, corporate treasurers and households, having a burdensome level of liabilities outstanding at significantly higher yields, perceive interest rates to be low, which has lead to refinancings, paydowns and shortening of final maturities. As well, equity issuance has surged, with high stock prices encouraging firms to deleverage or to go public. Such activities have re-liquified balance sheets and improved cash flow.

Lastly, fiscal 1992's Federal budget deficit has receded somewhat with present estimates around $330 billion, largely because RTC spending has failed to keep pace with plan. Nonetheless, fixed income supply remains a serious problem as the market, on an issue by issue basis, often requires a considerable discount from current levels to successfully finance new offerings. This is especially relevant as hopes for recovery imply some future increases in private credit demands and the potential for possible demand-driven inflationary price pressures.

It is within this framework that the Committee recommends that the following securities be sold to refund $27.5 billion of maturing securities, and to raise $9.5 billion of new cash for delivery on May 15:

- $15.500 billion 3-year notes due May 15, 1995;
- $11.250 billion 10-year notes due May 15, 2002;
- $10.250 billion 29 1/2-year 8% bonds due Nov.15, 2021.

The Committee voted 16-0 in support of the total refunding size, the new maturity auctions for both 3 and 10 year offerings and the reopening of the 8% bonds of Nov. 15, 2021. Twelve of the members supported the specific recommendation sizes for the 3, 10 and 30 year offerings while 4 members were in favor of slightly larger offerings for both the 10 and 30 year auctions. It remains the Committee's view that large consolidated issues are desirable. Such issues are generally the least disruptive, help reduce the potential for squeezes and possibly afford the Treasury some of the scarcity value extant in the market. Current market financing rates and the continuing need for the long bond to be of significant size encourage the recommended bond reopening. Further it is the Committee's view that the Treasury should maintain or seek to extend the average life of the national debt through steady increases in each of the regular auction cycles, and particularly in the quarterly refunding as a market focus, since prospective borrowing needs seem likely to require eventual increases in all cycles.

Lastly, the market environment may become less hospitable than it has been in the last year or so as Monetary Policy has encouraged positive carry and price appreciation in the context of a persistently positively-sloped curve. It is thus important to maintain a predictable and consistent pattern of growth in existing cycles and a smooth step-up in specific cycle sizes to keep market uncertainty to a minimum while achieving the lowest possible borrowing costs for the Treasury. This is best accomplished within this quarter by seeking a quarter-end balance approaching $40 billion even though it would be possible to maintain somewhat smaller cycle sizes for a brief period through the use of a longer dated cash management bill that matures in a later quarter.

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

-- 2-year notes of $15.0 billion and $15.250 billion at auction, raising $6.3 billion of new cash;

-- 5-year notes of $10.5 billion and $10.750 billion at auction, raising $13.7 billion of new cash;

-- A $14 billion, 52-week bill at auction, raising $1.7 billion of new cash;

- Hold the weekly 3 and 6 month bill auction sizes at $22.8 billion through quarter end, raising $9.3 billion new cash.

<u>Summary of New Cash for Quarter</u>

Refunding	$9.5 billion
3 & 6 month bills	11.3
52-week bill	1.7
2-year notes	6.3
5-year notes	13.7
Total	$42.5 billion
Already raised	3.5
Estimated Foreign Add-ons	4.0
Net Market Borrowing	$50.0

In view of the heavy anticipated needs in the subsequent quarter, the Committee supports the resulting cash balance which should approximate $38-$40 billion on June 30.

The Committee anticipates the need for up to $15 billion of cash management bills in late May or early June. It is recommended, should this need develop, that the final maturity date be within the current quarter so as to permit the continuing smooth expansion of existing cycles without enlarging this quarter's ending balance further.

For the July/September quarter, the Committee agrees with the targeted $30 billion end-of-quarter balance, but given the potential for continuing large requirements in the following quarter, a higher balance by $10 billion or so would again not be inappropriate. To fund this anticipated cash deficit and marketable borrowing of approximately $ 110-115 billion, further incremental increases in the weekly bills to approximately $25 billion, the use of a large long-dated cash management bill proposed to mature April 22, 1993, year bills to approximately $15 billion, 2 year notes to approximately $16 billion, 5 year notes to approximately $11.5 billion, 7 year notes to approximately $10.5 billion, and the refunding issues will be necessary. The Committee in particular notes its continuing belief that there is a market appetite for significant growth in the year bill cycle.

On the remaining two topics of the Committee's charge - (1) The way to experiment with sealed-bid, uniform-price auctions before fully automating the auction process, appropriate ways to measure the success of this experiment and the selection of securities which would be most appropriate to introduce to this auction change first, and (2) Whether or not auction awards should be made on a uniform-price basis in the case of a reopening of a security that is subject to an acute, protracted shortage - the following recommendations are offered.

It remains the Committee's view that the Treasury has in the main been well served by the present auction method. But, recognizing that improvements are possible and there is now, in any case, a call for change, principally growing from the concerns associated with the Salomon disclosures of last year, carefully conceived experiments are needed and the specific steps to be taken should be clarified soon. In ideal circumstances, Treasury would first want to fully automate existing auction practices to be followed by a reasonable period of testing and experience-gaining. Awaiting full automation, however, is not advised since the market presently expects experimentation and prolonged speculation will serve no useful purpose. Thus, the Treasury should move promptly to experiment with sealed-bid, single-price auctions (commonly referred to as Dutch auctions). The aim of this experiment should be to gain information about the efficacy of sealed-bid, uniform-price auctions without damaging the current sealed-bid, multiple-price system. The Committee's specific suggestions are as follows:

1. Wait until after the June 3 conference, scheduled for Washington, to announce Treasury's decision. New insights may be gained during this meeting, and it would be unwise to undermine the conference in advance.

2. Begin experimentation as soon as is practical thereafter even as early as July.

3. Specify the length of the test period, which the Committee believes should be at least 6 months.

4. Maintain present permissible non-competitive tenders at $5 million to better facilitate comparisons with present data.

5. Nine of the Committee members favored simultaneous experimentation with the 2 and 5 year cycles over the entire test period, while seven of the members favored using only the 5 year cycle for experimentation thus enabling Treasury to gain information as to differences and/or similarities with the 2 year cycle under existing rules on a side-by-side basis.

6. Bills were excluded for experimentation as the Committee felt less could be learned from this largely professional market. The selected coupons are closer to the average life of existing public debt and, though entailing greater risk, should provide more meaningful data over the life of the experiment.

In measuring the success of the experiment the Committee noted at the outset the difficulties that may attend moving from a bullish market environment to one that may at best be neutral while simultaneously having coupon cycles grow to new higher levels during the experiment period. Nevertheless, the following measures are proposed to assist in gauging results:

1. Comparison of the number of participants, direct and through dealers, versus existing results.

2. Changes in aggregate when-issued trading volumes relative to total market turnover (source govpx).

3. Changes in aggregate net primary dealer short positions the day before auctions.

4. Number of small bidders (i.e., change in the size distribution of bids, direct and indirect, from sealed-bid, multiple-price auctions).

5. Volatility of WI issues, pre and post auction, normalized to overall market volatility as compared to previous sealed-bid, multiple-price auctions.

6. Comparisons of proportions awarded to non-competitive bidders under existing and experimental auction procedures.

7. Comparison of the dispersion of unsuccessful bids with existing auctions.

As an introduction to answering which auction award which is preferred in the reopening of a security that has been subject to an acute and protracted squeeze, two paragraphs from the Committee's March 11 report are offered again:

"Squeezes are risky undertakings of uncertain success in existing circumstances. The mere existence of a credible threat- of a sudden increase in the supply of the issue over which control is being exerted- could well add sufficient further risk to a squeeze strategy to diminish to perhaps negligible levels the willingness of any operator to attempt a squeeze. To be an effective deterrent, the reopening threat must be real and employed, if necessary."

However, "Once a Treasury decision to reopen has been reached, there is general Committee support for the following: the process should be simple and clear; the time for the financing action should be specifically stated; the size should have a stated minimum and maximum; the existing 35% limit or some lower percentage should be applied; the Federal Reserve should act as the Treasury's agent in a process similar either to regular auctions or "go-rounds", participation rules should be the same as for regular auctions; there should be adequate publicity to reach all significant potential participants; and, consideration should be given to an over-allocation policy similar to the "Green Shoe" in private underwritings."

The Committee recommends that auction awards for reopenings be made on a sealed-bid, multiple-price basis so that the Treasury captures the full premium that short sellers are willing to pay in order to cover their exposures.

The rationale for using an award basis in reopenings that differs from regular auctions is that the objectives are different. In regular auctions, the primary objective is to raise a given amount at the lowest market-clearing yield. In a reopening, the primary objective is to relieve an "acute, protracted shortage". The amount sold may be uncertain since the aim is essentially to bring the specific issue back into relative line with surrounding issues on the yield curve.

In a real sense, the Treasury is seeking to take advantage of a technical market misalignment, with the justification that in so doing the Treasury improves the market's efficiency which over the long term should lower borrowing costs. Thus in sum, employing a sealed-bid, multiple-price auction for reopenings does not seem incompatible with a sealed-bid, single-price auction for regular cycles.

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

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Chairman