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

MAY 3, 1995

Dear Mr. Secretary:

Since the Committee's last meeting with the Treasury in February 1995, the pace of economic activity has moderated. Price increases for final goods are still subdued, although inflationary pressures in raw materials and intermediate goods continue to intensify. After raising the Federal funds rate 0.5% to 6.0% early in February, the Federal Reserve has made no further changes in monetary policy.

During the last three months, yields on Treasury securities have declined. The drop was only a few basis points on short-term bills but ranged between 60 to 70 basis points for maturities from two to ten years; the yield on 30-year bonds fell less, with a drop of approximately 40 basis points The present shape of the yield curve and forward prices for various fixed-income instruments indicate market participants expect modest further increases in interest rates in the coming months.

Within this context, to refund the $32.1 billion of notes and bonds maturing on May 15, 1995 that are privately held and to raise additional cash of $18.9 billion, the Committee recommends that the Treasury auction $51.0 billion of the following securities:

- $18.0 billion 3-year notes due May 15, 1998;
- $13.0 billion 10-year notes due May 15, 2005;
- $10.0 billion cash management bills due June 22, 1995; and,
- $10.0 billion cash management bills due September 21, 1995.

Of the 18 Committee members present for the meeting, 17 favored the issuance of $18.0 billion 3-year notes and $13.0 billion 10-year notes. The recommended increase of $1.0 billion for both offerings from the levels in the last refunding was based on the absence of a 30-year bond in this quarterly cycle and the belief that, because of the substantial diminution of the cash raising potential from the issuance of 5-year notes beginning in 1996, the Treasury should continue

the gradual building of the sizes of its coupon offerings. The vote of the Committee on the sizes and maturities of the cash management bills was unanimous.

In considering whether to recommend issuing a new 10-year note or reopening the 7 1/2% note due February 15, 2005, Committee members observed that the tightness of the outstanding issue in the repurchase agreement market was neither unusual nor acute. Also, the three point premium in the current market price of the outstanding issue materially exceeds the premiums of previously reopened issues. Without compelling reason to recommend a break with existing precedents, the Committee voted 15 to 3 in favor of a new issue.

With the aim of achieving a cash balance of $45 billion on June 30, the Committee unanimously recommends that for the remainder of the quarter the Treasury meet its borrowing requirement in the following manner:

- Two 5-year notes totaling $11.5 billion each, to raise $23 billion of new cash;
- Two 2-year notes totaling $17.75 billion each, to raise $2.4 billion of new cash;
- Two 1-year bills totaling $17.25 billion each, to raise $1.8 billion of new cash;
- Weekly issuance of 3- and 6-month bills through the remainder of the quarter, to raise $1.1 billion of new cash; and,
- The paydown on June 22 of $10.0 billion of cash management bills issued in conjunction with the May refunding.

Including the $18.9 billion raised in the mid-quarter refunding as well as anticipated foreign add-ons of $4.5 billion, the proposed financing schedule will raise a total of $41.7 billion. This amount, after subtracting the net paydown of $15.9 billion to date in the quarter, will accomplish the total net borrowing requirement of $25.8 billion. In addition, an intra-quarter cash management bill maturing on June 22 of approximately $17.0 billion will be needed to cover the cash low point in early June.

For the July-September quarter, the Treasury estimates a net borrowing requirement in the range of $40 to $45 billion with a cash balance of $30 billion at the end of September. To accomplish the anticipated net borrowing requirement, the Committee recommends the following provisional financing schedule:

Auctions		Size ($billions)	Raising ($billions)
Refunding:	3-year note	18.5	
	10-year note	13.5	
	30-year bond	12.0	
	Subtotal	44.0	14.0
Other:	5-year notes	2 x 12.0	24.0
	2-year notes	2 x 18.25	3.0
	1-year bills	3 x 18.25	4.2
	3- and 6-month bills	13 x 27.4	12.7
	Cash management bill (September maturity)		(10.0)
	Estimated foreign add-ons		4.5
	Subtotal		38.4
Less:	Redemption of 7-year notes		(6.8)
	Bonds called for redemption on August 15, 1995		(2.3)
	Subtotal		(9.1)
	Total Net Market Borrowing		43.3

The Committee also notes the likely need for the issuance of intra-quarter cash management bills to cover cash low points during the quarter.

In the discussion of alternative ways of meeting the marketable financing requirement through the remainder of the fiscal year, some members of the Committee raised the possibility of the Treasury issuing foreign currency denominated debt. In particular, these members expressed the view that the combination of the current exchange rate for the US dollar and the Japanese yen and the differential in current interest rates between the two debt markets offers an opportunity to obtain funding on terms which they judge will likely prove attractive. The discussion touched on a number of points in connection with issuing debt denominated in foreign currencies, including past experiences of the Treasury, practical considerations associated with the actual issuance, debt management policy objectives to be served, and potential market reactions. While the Committee makes no recommendation on this matter, several members expressed the view that the issuance of debt denominated in Japanese yen warrants consideration by the Treasury at this time, preferably in the context of broader public policy considerations.

The Committee's discussion of whether the Treasury should issue inflation-indexed debt was wide-ranging. The proposal, it was noted, has been raised numerous times over the years and has had sufficient merit to attract a number of thoughtful and respected proponents. The Committee welcomed the opportunity to offer its views on subject.

From the debt management standpoint, all Committee members agreed that the foremost criterion for judging any borrowing initiative by the Treasury should be the potential contribution to raising substantial amounts of funds on favorable terms. The Committee's deliberations focused on this objective and not on other possible policy objectives, however worthy, such as providing a more direct gauge of inflation expectations than is now available or discouraging the government from pursuing inflationary policies.

The Committee recognized that there are conceptually sound reasons for believing that the issuance of inflation-indexed debt could lower the cost of borrowing over the longer term. Academic research often cites the existence of some inflation risk premium in the yields on conventional debt that the Treasury might capture through the issuance of inflation-indexed debt. By issuing both conventional and inflation-indexed securities, the Treasury might be able to segment to its advantage the market for its debt. The magnitude of any potential saving is uncertain, however, and could be offset in some degree by the comparatively low level of liquidity that typifies inflation-indexed securities in other countries and the consequent negative effect the illiquidity would have on the price of the securities.

The recent and prospective substantial growth in self-directed retirement plans, which to date have evidenced a strong preference for safe, conservative investments, may offer the potential of significant demand for inflation-indexed securities, either in marketable or savings bond forms. The uniqueness of the instrument would mean, however, a major educational effort would likely be needed before the market reached meaningful proportions.

Defined benefit pension plans might also be a source of demand for inflation-indexed securities. An asset class with an assured real return together, in all likelihood, with low correlations with other standard asset classes is virtually certain to permit attainment of a higher level of "portfolio optimality" and hence be an attractive investment to defined benefit plans.

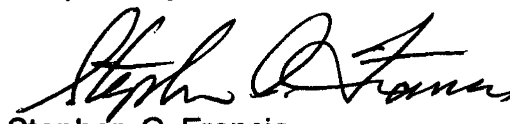
While there is an intriguing case, which necessarily is largely conjectural, for there being a reasonable long-term potential for the Treasury in issuing inflation-indexed securities, there are considerable short-term problems to developing the product. To begin, recent debate about the accuracy of the Consumer Price Index has to a degree politicized the issue and brings to the fore concerns about the integrity of the price index to be used for the inflation adjustment. More important, there is a need to pace the process of innovation in debt management techniques; in the view of the Committee, other initiatives--for

example, floating rate notes--offer greater immediate potential in terms of raising substantial amounts of funds on attractive terms.

On the basis of its discussion, the Committee concluded that at the present time it does not see sufficient evidence that the Treasury would meet the criterion of raising substantial funds on favorable terms to justify initiation of an inflation-indexed debt program in the immediate future. It is unlikely that in deferring the introduction of inflation-indexed debt the Treasury would forego any unique opportunity to establish a market niche for itself. The failure to date of a market for privately-issued inflation-indexed securities to develop, which some cite as an indication that the demand for such investments may be limited, at least among institutional investors, suggests that taking additional time to analyze the potential more thoroughly would entail little risk to the Treasury. In any event, before initiating a program to begin the issuance of inflation-indexed debt, the Committee believes there is a need to undertake extensive market analysis of both defined contribution and defined benefit pension plans as well as other major investor groups in order to better determine the prospective demand and appropriate terms.

Mr. Secretary, that concludes the Committee's report. We welcome any questions or comments.

Respectfully submitted,



Stephen C. Francis
Chairman