

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

July 31, 1996

Dear Mr. Secretary:

Since the Committee's last meeting on May 1, 1996, economic expansion has proceeded at a strong pace. Consumer spending rose briskly in the spring, reinforced by strength in employment and income. Manufacturing output has accelerated, and more recently the industrial-sector strength has broadened. While inflationary pressures have generally remained quiescent, signs of rising wage pressures are becoming evident.

During this period, interest rates on Treasury securities have increased uniformly by 20-30 basis points throughout the yield curve. Monetary policy has remained unchanged since January, although market participants perceive increased risks of the need for credit restraint. Eurodollar rates currently reflect expectations of a 25-50 basis point increase in the Federal Funds rate by year-end. While market participants expect a slowdown in economic activity, many are skeptical that the slowdown will be decisive enough to forestall a modest tightening in monetary policy.

Within this context, to refund the \$17.6 billion of privately-held notes maturing on August 15, 1996 and to raise \$21.4 billion of cash, the Committee recommends that the Treasury auction \$39.0 billion of the following securities:

- \$19.0 billion 3-year notes due August 15, 1999;
- \$10.0 billion re-opened 7 percent notes due July 15, 2006;
- \$10.0 billion 30-year bonds due August 15, 2026.

Of the 18 Committee members present for the meeting, 16 voted in favor of this recommendation. The other two members favored the issuance of \$39.0 billion of securities comprising \$19.0 billion 3-year notes, \$9.0 billion re-opened 7 percent notes due July 15, 2006 and \$11.0 billion 30-year bonds. While recognizing tradeoffs that are apparent from quarter to quarter, the majority preferred an approach which emphasized consistency in the sizes of the 10- and 30-year issues. The minority view sought to take advantage of a re-opened 10-year note to offer a somewhat smaller amount of 10-year securities in order to issue a larger bond offering. This approach would reflect the relative expensiveness of the 30-year maturity sector versus the 10-year sector and would promote increased liquidity in the bond sector.

The Committee voted unanimously to re-open the 7 percent notes due July 15, 2006. Such a re-opening would likely improve liquidity in this issue -- the first irregular cycle offering of 10-year notes. The Committee felt that if this issue was not re-opened, it may reduce the market's acceptance of additional 10-year notes issued with July 15 and October 15 maturity dates.

If the Treasury sought to issue a lesser amount of securities in the August refunding than the Committee's recommendation, by a vote of 16-2 the Committee prefers reducing the 3-year note. This is consistent with the Committee's long-held emphasis on longer-dated securities, as well as our earlier recommendation of a minimum size of \$10.0 billion for 10- and 30-year securities.

With the aim of achieving a cash balance of \$40.0 billion on September 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 \$12.5 billion each, to raise \$6.0 billion of new cash;
- Two 2-year notes totaling \$18.75 billion each, to raise \$0.6 billion of new cash;
- Two 1-year bills totaling \$19.25 billion each, to raise \$0.7 billion of new cash;
- Weekly issuance of 3- and 6-month bills through the remainder of the quarter, to pay down \$19.4 billion of cash;
- The issuance of intra-quarter cash management bills to cover the cash low point in early September; and
- Redemption on August 15 of the bonds called earlier, to reduce cash by \$727 million.

Including the \$21.4 billion raised in the mid-quarter refunding as well as anticipated foreign add-ons of \$5.3 billion, the proposed financing schedule will raise a net amount of \$13.9 billion. This amount, when added to the \$31.1 billion already raised or announced in the quarter, will accomplish the total net market borrowing requirement of \$45.0 billion.

For the October-December quarter, the Treasury estimates a net borrowing requirement in the range of \$50-55 billion with a cash balance of \$30.0 billion at the end of December. To accomplish the anticipated net borrowing requirement, the Committee unanimously recommends the provisional financing schedule attached to this report.

At the Treasury's request, the Committee considered a number of questions regarding the potential terms and conditions of inflation-protection securities. The Committee recognizes that the Treasury's review of these questions builds upon an extensive body of research and analysis, both prepared at Treasury and submitted as part of the public review and comment process. The Committee commends the Treasury for the thoroughness of its efforts and encourages the Treasury to continue to maintain an open dialogue with market participants as it moves toward final decisions on the plan to issue such securities.

In considering the specific question raised by the Treasury as to the relative market attraction of the so-called "Canadian-style" structure and a "current-pay" inflation floater, the Committee notes that there are a number of theoretical advantages and disadvantages to each structure, which will have different practical consequences for different segments of the investor marketplace. Since no one structure is likely to be ideally suited to all potential investors, the issue is perhaps best approached from the standpoint of which market segment is likely to provide the most significant, dependable long-term demand for inflation protected securities. In that regard, the Committee believes that pension funds and insurance companies represent the segments with the greatest natural interest. For these types of investors, the current tax liability and duration risk issues raised by the Canadian model pose fewer complications, while the reinvestment risk features of that model are relatively attractive. Also, the treatment of deflation risk is likely to be somewhat less complex with the Canadian structure, relative to the current pay model. Finally, there is the relative advantage of existing market experience with the Canadian model.

An important consideration with either model would be features which would enhance subsequent re-engineering via stripping. On this point, there were mixed views on the complexities of stripping either model and a clear sense that more analysis would be important. In this regard, the Committee noted favorably an idea advanced in comment letters that, were the Treasury to chose the Canadian model, it consider establishing an exchange mechanism whereby coupons with the same maturity date, but stripped from different inflation-indexed issues, could be exchanged on the basis of index factors which would equate the coupons. The Committee would emphasize the importance of enhancing stripping features of this security, as that would go a long way to providing market mechanisms to adapt the security to changing patterns of market demand.

The Committee also discussed the relative importance of devising a structure which would promote liquid secondary markets for such securities. Any structural features which would enhance secondary market liquidity, without diminishing investor interest, would be an obvious plus. However, the Committee would stress that even under the best of circumstances, these instruments will not have the degree of secondary market liquidity enjoyed by conventional U.S. Treasury securities. What is important is that they achieve adequate liquidity, given the needs of the investor base to which they will have most appeal. Those investors will most likely regard these assets as core holdings to protect against long-term inflation uncertainty risk, and as an attractive low-risk alternative to holdings of "real" assets. Thus, they are less likely to require the high liquidity typical of Treasury securities and more likely to evaluate the liquidity of these instruments relative to that of substitute assets, which are far less liquid than long-term Treasury securities.

The Committee also considered the trade-offs between issuance in a range of sectors of the yield curve relative to a more focused initial program designed to promote a reasonable degree of market liquidity. Given the limited prospects for liquid secondary markets for these securities, and the Committee's sense that the most promising sources of investor demand favor longer-term assets, the Committee preferred an initial approach focused on issuance of longer-term securities.

As to specific maturity, on balance the Committee favored initial issuance of a 10-year rather than 30-year security, with regular re-openings whenever feasible. The factors weighing in favor of 10-year debt were the lower relative degree of risk in a 10-year security, particularly given uncertainties on liquidity and duration risk; the increased degree of intermediate-term investment focus for defined contribution and 401(k) investment plans; the prospects for some broader appeal to individual investors; and the benchmark status of the 10-year sector for conventional Treasury debt securities. In time, and depending upon market acceptance of the instrument, there could well be demand for issuance of longer-term (20- to 30-year) inflation protection securities. Also, to the extent the Treasury develops practical solutions to the structural issues which would facilitate stripping of these securities, this would lessen the risk of longer-dated issuance by providing a market-based mechanism for balancing supply and demand across maturity sectors.

Regarding auction techniques, the Committee was strongly in favor of the use of single price auctions for these securities, as that technique works best in offerings where there is a significant degree of bidder information risk. This would be especially the case for such a new type of Treasury security. The Committee also believes that a longer-than-normal pre-auction when-issued trading period would facilitate price discovery and contribute to improved auction participation. As concerns the Treasury's right to award less than the full amount of securities being offered, the Committee notes that the Treasury has such a right in all existing offerings and would naturally want to retain it for a new type of security. That option would, of course, be reflected in the offering circular and other materials introducing the new security. In as much as the Committee would expect that the Treasury would only exercise that option in extreme and unusual circumstances, we see no need for the Treasury to make special efforts to highlight this aspect of the offering terms and conditions.

In terms of the choice of inflation index to be used in the inflation-protection securities program, the Committee unanimously recommends the CPI-U index. This index is the most widely known inflation index and is generally accepted as a reasonable indication of inflation. It is similar to indices which other countries use for inflation-linked securities. The CPI-U is also published monthly, which reduces the lag time in adjusting the accrual of principal.

The Committee did not have a strong preference for a seasonally adjusted or non-seasonally adjusted series. However, a finality in determining payment amounts is an important consideration. Therefore, the Committee supports the Treasury's position that revisions of an index reported at an earlier date should not be used for principal or interest calculations.

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

Respectfully submitted,



Richard M. Kelly
Chairman