REPORT TO THE SECRETARY OF THE TREASURY
FROM THE
TREASURY ADVISORY COMMITTEE
OF THE
BOND MARKET ASSOCIATION

February 4, 1998

Dear Mr. Secretary:

Since the Committee's last meeting on October 29, 1997, the pace of economic activity has continued to be relatively brisk. However, the situation in Asia and the accompanying appreciation in the dollar are widely expected to have a negative effect on U.S. trade performance leading to some moderation in economic growth during 1998. On the inflation front, the news continues to be quite favorable. While job growth has accelerated of late and labor market conditions appear to be extremely tight, wage pressures have been slow to build and the rate of increase in both consumer and producer prices has been trending lower.

The Asian crisis and credit quality concerns prompted strong demand for the US dollar and Treasuries which drove yields as much as 50 basis points lower in early December. Recently, the stabilization in Asia has reversed this trend somewhat with yields now 25-35 basis points lower and the yield curve somewhat flatter than at the time of the Committee's last meeting. While the Federal Reserve is widely expected to leave policy unchanged in the near term, forward rate structures are priced for a modest easing over the next several months.

Within this context, to refund $25.9 billion of privately-held notes maturing on February 15, 1998 and to raise $9.1 billion of new cash, the Committee recommends that the Treasury auction $35.0 billion of the following securities:

- $13.0 billion 3-year notes due February 15, 2001;
- $12.0 billion 10-year notes due February 15, 2008;
- $10.0 billion 29 3/4-year bonds due November 15, 2027.

The Committee recommends, by an 18-1 majority, a reopening of the 6 1/8% bond of November 15, 2027. The Committee felt that a reopening would enhance the benchmark status of the bond by creating a larger, more liquid issue. This could be especially useful with a six month interval before the next expected bond offering. There has also been increased investor activity in the bond sector, and some accompanying increase in financing market pressures. All members felt that the size of the long bond offering should remain at $10 billion in this refunding.

In its refunding recommendation, a sizable majority of 13 Committee members felt that the Treasury should reinforce the benchmark status of the 10-year note by offering $12 billion. This majority believed that the 2 and 3 year maturity areas offer the best alternatives for future reductions in coupon sizes, and recommends a $13 billion 3-year security in this refunding. Three members felt that the most recent auction sizes of $14 billion 3-years and $11 billion 10-years would be preferable, believing that stability would be desirable in the near term, with the uncertainty over potential future surpluses and financing requirements. Finally, 3 members supported a smaller refunding offering of $34 billion, with a reduction in the 3-year offering to $13 billion.

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With the aim of achieving a cash balance of $20 billion on March 31, 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 $11.0 billion each;
- Two 2-year notes totaling $15.0 billion each, with these four auctions paying down a net $9.1 billion of cash;
- A 1-year bill totaling $12.0 billion, to pay down $3.7 billion of cash;
- Weekly issuance of 3- and 6-month bills through the remainder of the quarter, to pay down $7.2 billion of cash; and
- Two cash management bills totaling $47 billion.

Including the $9.1 billion raised in the mid-quarter refunding, as well as anticipated foreign add-ons of $5.0 billion, the proposed financing schedule will raise a net amount of $41 billion. This amount, when added to the $31 billion paydown for issues that have already been auctioned (or announced) in the quarter, will accomplish the total net market borrowing requirement of $10 billion.

For the April - June 1998 quarter, the Treasury estimates a net pay down of $75 - 80 billion, with a cash balance of $35 billion at the end of June. To accomplish this requirement, the Committee recommends the provisional financing schedule attached in Table 1.

At the Treasury's request, the Committee discussed the alternatives for changes in Treasury market financing, if there is further improvement in the Federal budget. In this regard, the Committee recognized the uncertainty regarding both the size and duration of potential budget surpluses. That uncertainty, which arises both from future economic developments as well as future fiscal policy decisions, needs to be taken into consideration by the Treasury in evaluating techniques for modifying existing debt management arrangements in the face of improved fiscal performance.

One such technique would be to introduce arrangements for the repurchase of outstanding Treasury obligations. In the view of most members of the Committee, this debt management technique would be most useful to the Treasury in circumstances where uncertainty regarding the duration of a fiscal surplus make it premature to consider changes in the number or frequency of regular coupon offerings, and where there was only limited scope for further reduction in existing issue sizes, without putting at risk the attractive liquidity features of benchmark issues. In such circumstances, the Treasury could target the repurchase of existing off-the-run issues, with the choices as to particular issues or sectors reflecting then prevailing market supply-demand conditions.

The Committee further discussed whether any such repurchase initiative should be limited to formal "reverse auction" style debt exchanges or also include the ability to employ discretionary secondary market purchases, most likely using the Federal Reserve Bank as the Treasury's fiscal agent. A minority of the members of the Committee felt that any such initiative should be limited to formal auction style debt exchanges, so as to ensure a high degree of transparency and regularity. A majority of the Committee felt that the Treasury need not limit itself to formal debt exchange offerings, since there could be advantages to be gained by smaller, more targeted secondary market repurchases, with execution at competitive secondary market prices. All members of the Committee recognized that there were government accounting policy issues that needed to be addressed.

The Committee then discussed the question of the scope for further reduction in sizes of existing Treasury coupon offerings. Recognizing the size of reductions made to date, the Committee felt there was little, if any, room for further cutbacks in the size of 10 and 30-year offerings. Indeed, many members of the Committee would favor modest increases in the size of these benchmark offerings, especially the 10-year note. In the Committee's view, there is still some scope for reduction in issue sizes of the 2-year, 3-year and, to a lesser extent, 5-year note offerings, before raising concerns about the liquidity of those benchmark offerings.

In the short term, limited further issue size reductions in the 2 and 3-year notes, together with flexible utilization of a debt repurchase arrangement, should provide sufficient tools to respond to further improvements in the budget picture. Size reductions would be more feasible if there were greater use of re-openings of existing issues, as market circumstances permit.

Longer term, it may be necessary to re-evaluate the number and frequency of regular coupon offerings, with a view to preserving the liquidity features of large benchmark issues. Indeed, with the prospect of a large Euro-denominated government bond market in the years ahead, maintaining large liquid Treasury benchmark issues was felt to be an even more important policy consideration for the U.S. Treasury. With this in mind, and to the extent Treasury coupon cycle changes were to be needed, the Committee felt they would best be made in the 2 or 3-year sectors of the curve, with some members inclined toward less frequent offerings of 2-year notes and others partial to elimination of the 3-year note. In either case, the objective would be to focus Treasury issuance on large, liquid offerings of benchmark securities.

Finally, in forming its recommendation on the auction schedule for a 30-year inflation-indexed bond, it was the view of the Committee that enhancing participation in this market should receive greater weight than other factors, including the short-term management of the Treasury's cash position. All members of the Committee agreed that the next offering of an inflation-indexed security should be a 30-year bond. This will provide the Treasury with important market feedback on the nature and level of investor interest in long-term inflation protection. That feedback will be useful to the Treasury in shaping its plans for future inflation-indexed security issuance.

A majority of 13 members believed that maintaining a regular January, April, July, October cycle for inflation-indexed securities provided the best platform for investor focus on these instruments as a distinct asset class. This majority recommends that the Treasury announce a 30-year inflation-indexed bond of $8 billion on April 1 for auction on April 8. The other six members believed that investor interest was more likely to be increased if the instrument was auctioned as part of the May refunding, believing that this time of generally increased investor focus on Treasury securities was more likely to increase investor interest in the new security.

Respectfully submitted,

Stephen G. Thieke
Chairman