October 28, 1998

Dear Mr. Secretary

Since the Committee's last meeting on August 5, 1998, the domestic economy has continued to perform reasonably well although there have been some signs that a moderation in the pace of activity lies ahead. The data available at this point suggest that Q3 GDP expanded at about 2.5%, versus the 3.7% average growth rate seen in the first half of the year. While consumer spending appears to be holding up well, business capital spending and residential construction activity show signs of moderation relative to the very robust growth seen earlier in the year. Finally, a widening in the trade gap continues to be a significant drag on overall growth.

On the inflation front, the news remains generally favorable. There has been little sign of any acceleration in prices of core goods and services. Indeed quotes for energy items and other industrial commodities remain quite low by historical standards and prices of non-fuel imported goods continue to post significant declines. Meanwhile, available evidence suggests that labor markets remain tight and wage pressures continue to build. However, this process appears to be evolving very slowly.

The immediate risk to sustained growth in the US economy arises from the effects of increasing softness in foreign economies and the sharp deterioration of financial conditions here at home. To limit these risks, and in view of the benign inflation environment, the Federal Reserve recently modified its restrictive policy stance by lowering its federal funds rate target from 5.50% to 5.00% in two stages. The first move occurred at a regularly scheduled FOMC meeting on September 29. However, the financial markets remained very unsettled following this action and the Fed announced a further cut in the funds rate target and the discount rate on the afternoon of October 15. While the initial move by the Fed was widely anticipated, the timing of the latter action came as a surprise and lead to a strong market reaction.

Yields on Treasury issues are 60 to 135 basis points lower than at the time of the Committee's last meeting. The decline in yields began shortly after the refunding auctions and picked up pace toward the end of August, amid a heightened sense of global instability and a sharp drop in the US stock market. Yields on longer maturity Treasuries have backed up some over the past few weeks, and the spread between 2-year Treasury notes and 30-year bonds has widened from about 25 basis points in early August to about 100 basis points at present. The fixed income markets have also experienced a significant widening in credit spreads and erosion in liquidity. The yield differential between Moody's Aaa Industrial index and the 30-year Treasury has moved from about 60 basis points during the first half of the 1998 to about 120 basis points, currently. The spread widening experienced by lesser credits has been even more pronounced.

In the capital markets, issuance of corporate debt came to a grinding halt in early October, as investors sought to avoid credit risk at all costs. Because nearly half of all credit intermediation in the US economy involves the capital markets, this development posed a potential risk for the pace of economic growth and appeared to play a role in the Federal Reserve's decision to lower the fed funds rate on October 15. The early signs suggest that the Fed's action was somewhat successful in restoring investor confidence and corporate issuance has picked up in recent days.

Still market conditions remain fragile and the US Treasury market remains priced for a significant amount of further easing from the Fed.

Within this context, to refund approximately $27.0 billion of privately held notes and bonds maturing on November 15, 1998, and to raise $12.0 billion of new cash, the Committee recommends by a 14-5 majority that the Treasury auction $39.0 billion of the following securities:

- $17.0 billion 5-year notes due November 15, 2003
- $12.0 billion 10-year notes due November 15, 2008
- $10.0 billion of a 30-year bond

The minority of 5 members expressed a preference for a refunding that included $16 billion 5-year notes, $12 billion 10-year notes, and a larger bond offering of $11 billion.

There was considerable discussion about the potential benefits and impact of the Treasury reopening existing issues for this refunding offering. The discussion centered around the trade-off between the presumably significant price benefit to the Treasury of offering new issues, against the potential long-run benefit of increasing market liquidity by adding to existing issues. This was viewed by some as particularly relevant in the context of the dislocations and relative illiquidity in current market conditions, and the extreme scarcity of these issues evident in financing markets. Other factors discussed by the Committee were the large maturity already present in the existing 5-year sector, the fact that the existing 10-year security had already been reopened, and the existing 30-year had not previously been reopened. In considering these factors, the Committee voted by a 13-6 majority for a new 5-year security, and by a 15-4 majority for a new 10-year note offering. The Committee was evenly divided on the merits of reopening the existing 30-year bond.

The Committee recommends that for the remainder of the quarter, the Treasury meet its borrowing requirement in the following manner:

- Two 2-year notes of $16.0 billion each,
- Two 1-year bills of $12 billion each,
- Weekly issuance of $16.0 billion of 3- and 6-month bills through the remainder of the quarter, and
- Two cash management bills -- $25.0 billion of a bill to be issued November 3 to mature January 21, 1999, and $15.0 billion of a bill to be issued December 1 to mature within the quarter.

For the first quarter of 1999, the Treasury estimates a market borrowing requirement of $15-20 billion. To accomplish this requirement, the Committee recommends the provisional financing schedule in the attached table.

At the Treasury's request, the Committee discussed at some length the current conditions in the Treasury market, with a view toward whether the Treasury should respond to those conditions with modifications to its normal financing arrangements. Committee members noted the extent to which price differences had developed between on-the-run and off-the-run Treasury securities, and the extreme and persistent scarcity of on-the-run securities in the repo market. These conditions were, at least in part, due to the deleveraging pressures being experienced in the global capital markets and the disruptions in primary and secondary market activity in the US credit and mortgage backed securities markets. In turn, this was also diminishing somewhat the liquidity and efficiency of the US Treasury market, though in relative terms it remains the most liquid capital market in the world.

Against this backdrop, the Committee debated the pros and cons of the Treasury responding to these market dislocations with actions to increase the available supply of on-the-run benchmark issues, while concurrently repurchasing in the secondary market less liquid, cheaper off-the-run issues. The Committee was evenly divided on the merits of such a course of action.

Those in favor felt that the scale of dislocations was such that the Treasury could both lower its cost of funding and help improve market liquidity. Specifically, the Treasury could capture some portion of the wide disparity in yields between on-the-run and select off-the-run issues, and also help re-liquify the benchmark issues, thus diminishing somewhat the pressures in the financing market . Members recognized that, as a technical accounting matter, this would raise the level of interest expense in the current fiscal year to reflect expensing the premium paid to repurchase issues trading above par, while lowering future year interest expenses. As an economic matter, these members were confident that there would be real net savings to the Treasury, which could be clearly documented, and that the Treasury would have the flexibility to determine the extent and timing of any such initiative, to ensure that savings were in fact achieved. Members favoring this course of action also felt that the advantages of an opportunistic response to current dislocated market conditions would out weight any potential negatives, in terms of the impact on predictability and consistency of normal debt management operations.

The other half of the Committee felt that such a course of action was not advisable at this time. For one, there was some doubt as to the certainty and scale of financial advantages to the Treasury, since the announcement effect of any such initiative would tend to cause a narrowing of those spreads. Moreover, the introduction of uncertainty, both as to the size and timing of any Treasury market operation, as well as the potential for future operations, would add a higher risk premium to the prices of on-the-run Treasury issues and diminish the long-term benefits of predictability. Finally, it was felt that in the current fragile market environment, the Treasury should avoid taking actions which might surprise the market and add further volatility.

The Committee then turned to the question of whether to extend the use of uniform-price auctions to 10- and 30-year maturities, as well as to Treasury bills. The Committee took note of the findings in the Treasury staff study released just prior to the meeting and to the summary analysis presented in the public portion of the Committee's meetings at the Treasury. The Committee discussed the question of how well the uniform price auction techniques performed during 1994—the last period of sustained rising interest rates—and was advised by the staff that analysis of the 1994 subperiod did not suggest different results than for the longer period under review.

The Committee agreed that the Treasury's study showed clear benefits from the uniform price auction, in terms of broader participation in Treasury auctions. While the study also tends to support the conclusion that there was a modest price advantage to the Treasury from the use of the uniform price technique, the Committee noted that there are inherent limitations to any attempt to make precise quantification of those benefits. While the price benefits might be small and hard to quantify, there was certainly no evidence to suggest that the uniform price technique was disadvantageous to the Treasury, from a cost perspective. Finally, it was also noted that there was an additional benefit from uniform price auctions in terms of reduced post auction market volatility. Taken together, these benefits, along with the desire to see consistent auction techniques used in all Treasury offerings, lead the Committee to recommend, by a vote of 16-0 (with three abstaining), that the Treasury adopt a uniform price auction technique for all future offerings of Treasury securities.

Finally, and at the Treasury's request, the Committee discussed potential recommendations to improve the inflation-indexed securities market, now that the Treasury has announced a regular quarterly auction schedule. Committee members noted that the product continues to be impacted by a low level of secondary market activity and liquidity, which current market conditions have further exacerbated. In addition, there appears to be a need to continue with efforts to educate both the retail market and the pension consultants on the attractive features of the product. This includes both low cost protection against inflation and downside protection against deflation risk; as well as portfolio diversification features in a world where many other asset classes have become more correlated in times of market crisis. There was also a suggestion that, as the market came to better appreciate both the deflation as well as inflation protection features of the instruments, demand might improve somewhat and a preference develop for more new issues rather than periodic re-openings of outstanding securities.

Even in this context, however, it was felt that the Treasury should re-evaluate the size of current offerings, with a view to rebalancing the program in line with the reduced amount of annual issuance of nominal coupon securities. At current sizes, the relative size of the program has increased and it represents a disproportionate share of new money raised in the coupon markets. An adjustment in issue sizes to about $6 billion per offering was viewed by most members as an appropriate modification, in line with the Treasury's reduced refinancing needs, while still maintaining a long-term commitment to the product.

Respectfully submitted,

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