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

November 1, 1995

Dear Mr. Secretary:

Since the Committee's last meeting with the Treasury in August 1995, the economy continued to expand at a moderate pace, inflationary pressures remained modest, and there was no change in monetary policy.

Yields on Treasury securities extended the decline begun earlier this year. The drop was greatest for longer maturities, with the yield on 10-year and 30-year securities falling by approximately 40 basis points. Treasury bill rates, in contrast, fell only a few basis points. As a consequence, the yield curve is substantially flatter, indicating that market participants foresee only a limited likelihood that interest rates will rise in the coming months.

Within this context, to refund the $32.8 billion of privately-held notes and bonds maturing on November 15, 1995 and to raise $24.2 billion of cash, the Committee recommends that the Treasury auction $57.0 billion of the following securities:

- $18.5 billion 3-year notes due November 15, 1998;
- $13.5 billion 10-year notes due November 15, 2005;
- $16.0 billion cash management bills due December 21, 1995; and,
- $9.0 billion cash management bills due January 25, 1996.

The 16 Committee members present for the meeting were unanimous in their support of this refunding recommendation. The recommendation does not take into account possible constraints associated with the debt ceiling. The Treasury may wish to postpone the cash management portion until an increase in the debt limit is assured.

With the aim of achieving a cash balance of $20 billion on December 31, the Committee unanimously recommends that for the remainder of the quarter, the Treasury meet its borrowing requirement in the following manner:

- One 5-year note totaling $12.0 billion, to raise $12.0 billion of new cash;
- One 2-year note totaling $18.25 billion, to raise $400 million of new cash;

- Two 1-year bills totaling $18.75 billion each, to raise $2.9 billion of new cash;

- Weekly issuance of 3- and 6-month bills through the remainder of the quarter, to raise $11.6 billion of new cash; and,

- A cash management bill totaling $10.0 billion to mature on January 25, 1996 to meet the seasonal cash need in early November.

Including the new cash raised in the mid-quarter refunding as well as anticipated foreign add-ons of $1.7 billion, the proposed financing schedule will raise a total of $46.8 billion (exclusive of intra-quarter cash management bills). This amount, when added to the $14.7 billion already raised or announced in the quarter, will accomplish the total net borrowing requirement of $61.5 billion. In addition, intra-quarter cash management bills totaling approximately $16.0 billion and maturing on December 21, 1995 will be needed to cover the cash low point in early December.

For the January-March quarter, the Treasury estimates a net borrowing requirement in the range of $70 to $75 billion with a cash balance of $20 billion at the end of March. To accomplish the anticipated net borrowing requirement, the Committee recommends the following provisional financing schedule:

Auctions		Size ($billions)	Raising ($billions)
Refunding:	3-year note	19.0	
	10-year note	14.0	
	30-year bond	12.0	
	Subtotal	45.0	13.7
Other:	5-year notes	1 x 12.0	
		2 x 12.5	20.4
	2-year notes	1 x 18.25	
		2 x 18.75	1.7
	1-year bills	3 x 19.25	5.4
	3- and 6-month bills	13 x 28.8	35.7
	Cash management bill (April maturity)	19.0	19.0
	Estimated foreign add-ons	3.3	3.3
	Subtotal		99.2
Less:	Redemption of January cash management bills		-19.0
	Redemption of 7-year notes		-7.4
	Total Net Market Borrowing		72.8

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 response to the request for its views, the Committee discussed the minimum amount of time the market would need to set up for the 3-year and 10-year note auctions following Congressional passage an increase in the debt limit. While not costless, the rescheduling of coupon auctions in the past seems to have resulted in an acceleration of the normal distribution process. Based on observations of these previous episodes, Committee members felt that the period from announcement to auction could be as short as one day with, in all likelihood, only minor impact on the Treasury's cost of borrowing. Accordingly, if the increase in the debt limit were to occur as late as Friday, November 10, it would be possible to auction the 3-year note on Monday, November 13, and the 10-year on Tuesday, November 14, both for payment on the scheduled settlement date, Wednesday, November 15.

In addressing the timing of increases in the size or the frequency or both of regularly offered Treasury securities to meet prospective borrowing requirements, assuming resolution of the debt limit issue before yearend, the Committee referred to the recommendations made in its last report. Looking to 1996 and beyond, the Committee noted that the cash raising potential of the 5-year note would be substantially diminished. The size of all offerings cycles will need therefore to be increased. The Committee recommends that the Treasury continue gradual and modest increases, perhaps quarterly, of all coupon offerings throughout 1996.

In developing its recommendation regarding increases in the frequency of specific cycles, the Committee reaffirmed the goals of slowing or arresting the pace of the decline in the average length of the debt and of ensuring that the proportion of the total debt maturing within two years does not increase materially beyond the current level of approximately 50%. With these objectives in mind, the Committee considered either increasing the frequency of issuing 30-year bonds to four times a year or alternatively increasing the frequency of issuing 10-year notes to eight times a year. By a vote of 10 to 6, Committee members favored quarterly auctions of 30-year bonds with a minimum size of $10 billion per auction. A number of those favoring this recommendation noted, however, that they could support the alternative of increasing the issuance of 10-year notes to eight times a year.

If the Treasury chooses more frequent issuance of 10-year notes, the Committee recommends issuance during the first month of each calendar quarter. In January, July, and October, the Treasury typically has a large borrowing requirement. Also, the payment date for the new 10-year notes should be on the fifteenth of the month, which in effect would refund maturing 7-year notes issued in prior years. The Committee believes that if 10-year notes are issued eight times a year, the minimum issue size should be $10 billion.

The Committee also noted that between the alternatives of an irregular introduction of a new coupon cycle--for example, five or six offerings of 10-year notes per year--and increases in the size of existing coupon cycles, it has a strong preference for the latter choice.

The Committee then addressed the question concerning the market impact to date and the potential impact in the future of inaction on the debt limit. The focus of the discussion was the prospect of default. All Committee members concurred with the assessment that, so far, there was no discernible fear of default evident in the prices of Treasury securities of any maturity. Many members noted that there is even a sense of complacency, based presumably on past instances when inaction on the debt limit caused temporary and undoubtedly costly disruptions to the Treasury's financing efforts but which never threatened actual default. More likely, however, market participants see the potential consequences as imponderable and unsettling, and believe that government officials see the consequences similarly; therefore, they believe default simply will not be allowed to occur.

A tiny minority of market participants have argued that if default forced a political compromise that resulted in a major, enduring reduction in the prospective deficit, any short-term increase to the Treasury's borrowing costs would be offset by savings over the long-term. Irrespective of one's own views on the current budget debate, this line of argument, in the judgment of all Committee members, overlooks the critical point that once successfully employed to force comprise, the threat of default could be employed again at any time in the future in the furtherance of a particular political agenda. Once this point were widely appreciated, the markets would begin to recognize that the first default would not necessarily, indeed not likely, be the last. The persistence of the threat of subsequent defaults would, as a practical matter, permanently raise the cost of borrowing to the Treasury.

The technical repercussions of a default, it should be noted, would be substantial and intricate. Because Treasury obligations have enjoyed unquestioned credit standing, they are used to secure a whole range of payments throughout the domestic and international financial system. Were these payments to be disrupted by a default, there could well be a series of payment failures that could lead to gridlock in the payments system and in the financial markets. For example, the repurchase agreement market and securities clearing systems, which are both integral to the functioning of the financial system, rely on Treasury securities as "riskless" collateral to secure payments. Complex questions would arise concerning the acceptability of matured but unpaid debt and the treatment of past due interest. Given the size on the issues which would be immediately affected, the amounts involved would be large. Leveraged market participants would likely be the most exposed to major difficulty. Because a Treasury default has not be contemplated, neither private market participants nor policymakers have contingency plans to deal with the event.

If default occurs, the impact on financial markets, all Committee members agreed, would be significant and likely enduring. Confidence in the country's governance--particularly the ability to mange its fiscal affairs responsibly--would suffer serious deterioration and lead to distress in all major financial markets, including notably the market for US Treasury securities and the US dollar.

The full consequences of default are speculative. No one knows for sure what they will be. What is known is that the "full faith and credit of the US Government" has proven an extremely valuable asset, central to the nation's economic power and position in the world. It is the height of recklessness to toy with this asset. In its most forceful terms, the Committee urges all government officials to forswear default and act immediately to secure and protect the county's credit standing.

Respectfully submitted,

Stephen C Francis
Chairman