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

February 3, 1999

Dear Mr. Secretary:

Since the Committee's last meeting on October 28, 1998, the US economy has performed strongly. The Commerce Department recently reported that GDP expanded at an impressive 5.6% pace in the fourth quarter of 1998. The growth rate for the year as a whole was about 4% — matching the performance seen in 1997. To this point, consumer-led demand strength, gains in construction activity and continued forward momentum in business capital spending have more than offset any headwinds in the trade sector arising from a slowdown in the global economy.

On the inflation front, the news remains very favorable. Despite extremely tight labor markets, wage pressures actually show signs of some moderation. The Labor Department recently indicated that the employment cost index advanced at just a 0.7% pace in the fourth quarter – with the year/year rate ticking down to 3.3%. Moreover, quotes for energy items and other industrial commodities remain quite soft. Finally, outside of recent spikes in tobacco prices, CPI and PPI readings have continued to be benign.

The Treasury yield curve is considerably flatter than at the time of the Committee's last meeting. While the yield on 2-year notes has risen about 50 basis points during this interval, there has been little change in yields at the long end of the curve. The back-up in short term rates reflects a diminished expectation of near term easing by the Federal Reserve, in the wake of the cumulative 75 basis points of rate cuts that occurred between September 29 and November 17. While an intensification of the Brazilian crisis reignited some flight-to-quality buying of US Treasuries in mid-January, in general these flows have slackened while domestic financial market conditions have improved significantly in recent months.

At the Treasury's request, the Committee discussed the longer term implications for Treasury debt management of current Administration and CBO forecasts of extended, growing budget surpluses. The discussion was in the context of explicit recognition of the inherent uncertainty of the key assumptions which underlie

those forecasts—not only as they relate to economic developments, but also future fiscal policy actions, as well as the increased importance of financial asset market performance as a source of tax revenue growth. Those sources of uncertainty strongly suggest the importance of preserving flexibility to adapt debt management practices, in the event of significant changes in the fiscal outlook.

As a starting point for its discussion, the Committee considered, and generally reaffirmed, its views on the appropriate debt management objectives in an environment of extended fiscal surpluses. Specifically, those objectives should be: (1) to seek the lowest long-run expected interest cost consistent with low risk relative to that expectation; (2) to maintain flexibility to respond to changes arising from fiscal policy actions and uncertain economic developments; (3) to preserve, to the extent practical, the liquidity of key segments of the Treasury bill and coupon markets; and (4) to provide transparency and predictability, so as to limit the direct and indirect costs of disruptive shifts in Treasury financing plans.

In the context of these general objectives, the Committee discussed at some length the various debt management tools available to the Treasury and their relative advantages and disadvantages in meeting these objectives. These tools include modifications to the frequency of regular bill and coupon offerings; changes in the size of such offerings; issuance of specialized forms of Treasury securities, and secondary market debt repurchase mechanisms. Thus far, the Treasury has focused its actions on reducing the number and frequency of benchmark coupon offerings, while seeking to maintain relatively large benchmark issues. Looking ahead, and if the proposed surpluses were to materialize in the size forecasted, it is likely that the Treasury would wish to make use of all available tools, in order to distribute the impact of its debt retirement activity in a way which preserves as much of the cost efficiency and liquidity of the Treasury securities market as is practical.

As regards the frequency and size of regular coupon offerings, to the extent further changes in the issuance cycle might be needed in the years ahead, the Committee reaffirmed its view, as set out in its report of August 4, 1998, that a reduction in the frequency of 2-year note offerings, as well as a reduction of one 30-year bond offering, were preferable to significant reductions in the size of the benchmark quarterly refunding issues. There was also some discussion of the trade-off between preserving liquidity in the benchmark coupon offerings relative to the impact of reduced issuance on liquidity of the Treasury bill market. While Committee members generally stressed the importance of the liquidity of coupon issues, this should not be at the expense of foregoing access to the bill market, where restrictions on certain investor holdings make Treasury bills especially attractive.

In terms of primary market activity, the Committee also discussed two additional possible changes in debt management practices which might enhance the Treasury's ability to meet its objectives. First, the Committee discussed the possibility of shifting some portion of longer term issuance into callable structures, such as

a 30-year, non-call 5-year structure. Given the uncertainty surrounding the size of the longer term surpluses, as well as the potential financing needs once social security surpluses are depleted, it could well be that the extra costs to the Treasury of call features in its long term debt is a reasonable price to pay for the flexibility it would provide. The Committee felt further evaluation of this type of tool would be in order.

Second, the Committee again discussed the relative size of the annual issuance of inflation-indexed securities. As noted in its last report, the Committee views the current size of these offerings as disproportionately large relative to the size of regular financing activity in the nominal coupon markets. As part of a longer term strategy of overall debt reduction, the Committee felt that the Treasury should consider reducing the size of these offerings. There was also a suggestion, generally endorsed by the Committee, that the Treasury evaluate a change to a continuously offered format for TIPS offerings, instead of the existing approach of large quarterly auctions. It was felt that the current auction sizes and method is resulting in the Treasury absorbing a significant risk premium for this specialized debt instrument.

In a forecasted environment of sizable shrinkage in the size of outstanding Treasury debt, the Committee reconsidered the possible use of secondary market debt buyback mechanisms. These mechanisms were viewed as especially useful to the Treasury in terms of managing the impact of debt reduction on various maturity sectors of the market; in terms of balancing the possible impact of less frequent 2-year note offerings on the average maturity of the outstanding debt; and in terms of preserving flexibility to adapt to the impact of a less favorable economic environment or different fiscal policy outcomes. The Committee again took note of the current budget accounting requirements which would expense any premium paid to retire current debt in the year of repurchase while lowering future year interest expenses. While the Committee suggested that consideration be given to seeking changes in these requirements to better align accounting with the real economics, the Committee felt that the Treasury should evaluate the use of this tool primarily on the basis of the underlying market economics, as well as the advantages it would provide in terms of greater debt management flexibility.

In summary, the Committee would stress three points when considering how to adapt debt management practices to an environment of projected sizable, sustained fiscal surpluses. First, there is a high degree of uncertainty inherent in all long term fiscal forecasts, so care should be taken not to impair currently valuable financing tools. Second, the scale of projected debt retirement, should it materialize, will have profound effects on the structure and liquidity of the Treasury debt markets. As such, it is in the Treasury's interest to make use of the full range of tools available to it, in order to manage carefully the impact of these changes. Third, once the Treasury has made decisions on any changes it may wish to make in terms of the frequency, timing or structure of its offerings, it is in both the Treasury

and the market's interest to announce those changes in advance, so as to limit any disruptive impact.

Against this backdrop of longer-term considerations, the Committee addressed the composition of the Treasury's February refunding.

The Committee unanimously recommended a total refunding size of $36 billion, to refund approximately $27 billion of privately held notes and bonds maturing on February 15, and to raise approximately $9 billion of new cash.

The Committee's discussion regarding the composition of the refunding focused on the 30 year bond, specifically, the benefit to the Treasury of a lower interest cost associated with a new bond offering, contrasted with the presumed long-run benefit associated with the increased liquidity afforded by a reopening of the existing bond. Members were evenly divided on this issue, with 9 members favoring a new bond offering, while 9 members preferred a reopening of the existing bond. This preference was the key determinant of the composition recommendation, as the members who preferred a new bond favored a $10 billion size for the offering, while those who favored a reopening felt that the size should be $8 billion.

The preferred size of the 10-year offering recommendation was $12 billion for those nine members who proposed an $8 billion re-opening of the long bond, while the other nine members preferred a $10 billion 10-year offering. A majority of 15 members of the Committee favored a reopening of the existing 10-year note, based on the potential benefits of increased liquidity in this key sector and the likelihood that there would be little, if any, premium for the Treasury if it were to issue a new security. Should the Treasury decide to proceed with a reopening, it should clarify for the market that this would be contingent on meeting original issue discount regulations.

The Committee unanimously supported a $16 billion size for the 5-year note offering.

In response to the Treasury's request, members also considered how they would potentially reduce the size of the refunding further. The 9 members who favored an $8 billion reopening of the current bond would support, in those circumstances, a smaller reopened ten year note offering of $10 billion. Of the 9 members who supported a new bond offering of $10 billion, a majority of 7 members would reduce the five year note offering from the proposed size of $16 billion. The minority view was that a cut in the size of a new bond offering below $10 billion was preferable to a reduction in the size of the five year note offerings.

In the context of the discussion concerning reopenings, one member raised a concern regarding the application of Treasury regulations on the auction process

for a reopened security. Currently, holdings in an outstanding issue are considered against the bidding restriction of 35% for a new security auction. As the size of new Treasury offerings shrink, while the size of dealer firms grow with industry consolidation, there is increased likelihood that this rule, as currently applied, will limit potential participation in the when issued market and the auctions for reopened securities. Recognizing that the intent of the rule was to promote distribution of new issued securities, it was felt by the Committee that only positions in the when-issued security should be relevant as it relates to the auction restriction, thus allowing an entity to purchase up to 35% (including WI holdings) of a reopened security, regardless of holdings in the outstanding issue. The Committee suggested that the Treasury reconsider this aspect of the rule.

In regard to the composition of Treasury marketable financing for the remainder of the current quarter, the Committee recommends that the Treasury meet its borrowing requirement in the following manner:

- Two 2-year notes of $15.0 billion each,
- Two 1-year bills of $10.0 billion each,
- Weekly issuance of $15.0 billion of 3- and 6-month bills through the remainder of the quarter, and
- Two cash management bills — $20.0 billion to be issued February 16 to mature April 15, 1999, and $35.0 billion to be issued March 1 to mature April 19, 1999.

For the second quarter of 1999, the Treasury estimates a net market paydown in the range of $105-110 billion. To accomplish this requirement, the Committee recommends the provisional financing schedule in the attached table.

Respectfully submitted,

Stephen G. Thieke
Chairman

U.S. TREASURY FINANCING SCHEDULE FOR 2ND QUARTER 1999 (PRELIMINARY)
BILLIONS OF DOLLARS

Issue	Announcement Date	Auction Date	Settlement Date	Offered Amount	Maturing Amount	New Money	Foreign Add-Ons
3&6 MONTH BILLS	03/25	03/29	04/01	15.00	15.8	-0.77	
	04/01	04/05	04/08	15.00	15.5	-0.53	
	04/08	04/12	04/15	14.00	15.6	-1.61	
	04/15	04/19	04/22	14.00	15.5	-1.51	
	04/22	04/26	04/29	14.00	15.5	-1.55	
	04/29	05/03	05/06	14.00	15.9	-1.88	
	05/06	05/10	05/13	14.00	15.5	-1.51	
	05/13	05/17	05/20	14.00	15.5	-1.51	
	05/20	05/24	05/27	14.00	15.5	-1.50	
	05/27	05/31	06/03	14.00	15.5	-1.551	
	06/03	06/07	06/10	14.00	16.2	-2.20	
	06/10	06/14	06/17	14.00	15.8	-1.84	
	06/17	06/21	06/24	14.00	15.0	-1.04	
			=========	=========	=========	======	
				170.00	187.92	-18.96	
1-Year Bills							
	03/25	03/30	04/01	10.000	11.2	-1.23	
	04/22	04/27	04/29	10.00	10.1	-0.11	
	05/20	05/25	05/27	10.00	10.0	-0.03	
	06/17	06/22	06/24	10.00	10.2	-0.16	
			=========	=========	=========	======	
				30.00	31.37	-1.53	
Cash Management Bills							
58-Day Bill	02/10	02/13	02/16	0.00	20.00	-20.00	
	Matures 4/15/99						
49-Day Bill	02/23	02/25	03/01	0.00	35.00	-35.00	
	Matures 4/19/99						
21-Day Bill	03/29	03/31	04/01	25.00	25.00	00.00	
	Matures 4/22/99						
14-Day Bill	05/25	05/27	06/01	25.00	25.00	00.00	
	Matures 6/15/99						
COUPONS							
INFLATION-INDEXED SECURITY	04/07	04/14	04/15	8.00	9.1*	-1.1	
2-YEAR NOTE	04/21	04/28	04/30	15.00	18.1	-3.1	
					11.1	-11.1	
5-YEAR NOTE	05/05	05/11	05/15	16.00			
10-YEAR-NOTE	05/05	05/12	05/15	26.00 10.00	28.6	-2.6	
2-YEAR NOTE	05/19	95/26	05/31	15.00	17.6	-2.6	
				11.5	-11.5		
2-YEAR NOTE	06/16	06/23	06/30	15.00	17.0	-2.0	
					11.4	-11.4	
				=========	=========	=========	=========
				82.00	124.4	-45.4	11.0

net cash raised this quarter	Treasury	-120.92	Assumes $11
foreign add-ons/misc. purchases	announced Q1	11.00	Billion Foregn
total new money raised this quarter	borrowing	-109.92	add-ons for the
			quarter

* Maturing 7-Year Note
A = Announced