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

August 3, 1999

Dear Mr. Secretary:

Since the Committee's last meeting on May 4, 1999, economic activity in the U.S. has continued to expand at a relatively brisk pace. Indeed, even though the Commerce Department recently reported that GDP growth moderated in the second quarter, much of the downshift was attributable to a reduced pace of inventory growth and a surprising decline in government spending. There are few signs of slowing in the underlying pace of growth in the economy. Strength in consumer demand and ongoing momentum in business capital spending continue to drive the economy, with some offset from the trade sector.

Shortly after our last meeting, the Federal Reserve announced a shift to a tightening policy bias, and subsequently the Fed hiked the target federal funds rate by 25 bp to 5%. Treasury market yields have moved sharply higher since early May, reflecting the current economic environment and the outlook for monetary policy, as the markets anticipate additional tightening moves by the Fed over the next few months.

In this environment, credit market spreads have widened significantly, and secondary market liquidity conditions have deteriorated as corporate and agency debt issuance have increased dramatically, driven by extraordinary merger activity, and at least in part, by a desire to complete funding activities in advance of any potential disruptions surrounding the millennium change.

Within this context, the Committee considered the composition of a financing to refund approximately $29.0 billion of privately held notes maturing on August 15, and to raise approximately $8.0 billion. The Committee unanimously recommends a total financing size of $37.0 billion consisting of the following offerings:

- $15.0 billion 5-year notes due August 15, 2004
- $12.0 billion 10-year notes due August 15, 2009
- $10.0 billion 30-year bonds due August 15, 2029

The Committee did not feel that reopenings of current 5-year, 10-year, or 30-year securities were warranted by current market conditions, given current original issue discount (OID) restrictions.

In regard to the composition of Treasury market 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 $16.0 billion of 3- and 6-month bills through the remainder of the quarter, and
- Two cash management bills totaling $40.0 billion to mature within the quarter.

At the Treasury's request, the Committee addressed the question of the optimal financing plan in the fourth quarter, given the Treasury's desire to maintain a higher than normal cash balance related to Year 2000 planning. The Committee recommends that the Treasury use a combination of an increase in the weekly bill offerings and cash management bills to finance the higher year-end cash balance. The Committee noted the likelihood of increased investor demand for Treasury bills in the fourth quarter, and felt that the Treasury could lower its borrowing costs by meeting some of this demand in a more predictable manner through an increase in the weekly bill offerings. The additional fourth quarter funding requirements can be met with cash management bills.

At the Treasury's request, the Committee revisited and refined somewhat its views on potential changes in debt management practices and debt issuance in light of the continued improved fiscal situation. It has been the Committee's view for some time that, with the exception of inflation indexed securities, individual issues are now near a minimum size that would allow sufficient liquidity to maintain benchmark status. In fact, some members expressed the belief that the benchmark status of Treasuries is already threatened by the increasing size of issuance by agencies and corporations. Most members continue to believe that over the long run the concentration of Treasury offerings in large, benchmark issues would minimize the cost of debt issuance for the Treasury by enhancing market liquidity and the efficiency of the debt markets.

Changes in debt management practices continue to be the Committee's first preference as a means of addressing the current fiscal situation, and for enhancing the liquidity and benchmark status of Treasury issues. Primary among the changes currently recommended by the Committee is the institution of a debt buyback program. A buyback program is appropriate at this time with current Treasury new issue sizes close to their perceived minimum level. More importantly, a buyback program can be used to enhance the benchmark status of new Treasury offerings by allowing for the possibility of increased issuance. Also, debt buybacks can be used as a short-term cost saving measure when significant price anomalies develop.

The Committee refined its views on another potential change to debt management practices. Previously, the Committee recommended changes to original issue discount (OID) rules that would give the Treasury more flexibility to reopen issues. The Committee now unanimously believes that the Treasury should seek a permanent change in, or waiver of the OID rules, that would allow for a regular schedule of reopenings for coupon offerings.

The Committee strongly believes that it is in the long-run best interest of the Treasury to enhance market liquidity through an emphasis on large benchmark offerings and that this consideration generally will offset potential short-run cost savings from issuing new securities. The Treasury

should still maintain the flexibility to vary from a regular schedule if circumstances, or market conditions, warranted such a decision.

Specifically, the Committee would prioritize two new issues of 5-year and 10-year securities per year, would suggest one new 2-year security each quarter, and recommend the adoption of a standardized pattern of reopenings for 30-year bonds. The Treasury needs to consider in its planning the possibility of alternating the reopenings of 5-year and 10-year securities in the quarterly refundings in order to avoid a concentration of maturities in future years.

On the subject of potential additional changes to the debt issuance schedule, the Committee discussed possible adjustments in the frequency of 1-year bill and 2-year note offerings.

Members unanimously agreed that the next significant change in the issuance calendar should be the reduction in the frequency of 1-year bill offerings, with some sentiment expressed in favor of the eventual elimination of the issue. As suggested in the Committee's May report, the reduction in the frequency of 1-year bill offerings could be used to accommodate the improving fiscal situation as well as to increase the issue sizes for weekly bills and Treasury coupons.

The Committee recognizes that the reduction or elimination of the 1-year bill would cause the current buyers of that instrument to seek alternative investments, but members believe that the market for short dated coupons has sufficient liquidity to accommodate investor needs. In addition, members believe that the reduction of the 1-year bill, from the perspectives of Treasury monthly cash flows and market liquidity, is preferable to the alternative of reducing or eliminating 2-year note issues.

In considering the potential elimination of the 1-year bill offering, some members suggested that the effect on other markets, such as that for adjustable rate mortgages, should be examined. Members generally believe that the impact would likely be limited, with most indexing now being based on Libor or constant maturity Treasury benchmarks.

Finally, in addressing the potential for further reduction of Treasury offerings, the Committee noted that in its view there remained additional scope for reductions in inflation indexed securities, particularly given their size relative to the traditional fixed rate issues. The Committee unanimously recommended a reduction from $7 billion to $5 billion for these offerings.

Respectfully submitted,

Kenneth M. deRegt