

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

July 31, 2001

Dear Mr. Secretary:

Since the Committee's last meeting in May, economic growth has slowed further, the Fed has reduced the federal funds rate by an additional seventy-five basis points, and the President has signed into law a tax cut that includes a rebate to be distributed over the next several weeks.

Real GDP growth slowed to 0.7% in Q2, versus 1.3% in Q1, according to the advance estimate released last Friday. Real final sales growth slowed more abruptly, from 4% in Q1 to 0.7% in Q2. The resilience of household spending on autos and residences appears to have shielded the economy from an outright decline. Employment fell in the second quarter by 271 thousand according to the latest government figures. Major economic uncertainties for the future revolve around the question of whether the stimulus from the tax cuts and monetary easing will offset the contractionary effects of weakened labor markets.

Interest rates on Treasuries have fallen by 20 to 30 basis points throughout the yield curve since May. A lower federal funds rate, continued weakness in the employment and business outlook, and a reduction in inflation expectations all contributed to the decline in rates.

The near term fiscal outlook has changed somewhat since our last meeting. The tax bill signed by the President on June 7th contained a tax rebate of approximately \$40 billion that was not anticipated in April. In addition, corporate profits tax payments in June fell by 24.7% on a year-over-year basis.

Against this backdrop, the Committee considered the composition of financing to refund \$12 billion of privately held notes and to raise approximately \$15 billion in new funds.

Prior to the Committee's consideration of specific recommendations for the upcoming refunding, the Treasury asked the Committee whether recent changes in the near term financing requirements imply that any special considerations be taken into account in distributing financing needs across weekly bills, 2-year notes, and the quarterly refunding issues.

In order to properly address this question, the Committee decided first to determine the nature of the increase in financing needs. Most felt that the surge in financing needs was due primarily to the tax rebates sent during the quarter as well as the change in the corporate tax date from mid September to early October: both one-time events; and only secondarily due to changes in surplus estimates. Due to the probable temporary nature of the larger borrowing sizes, the Committee felt that increasing bill offerings then two-year notes would serve the Treasury best in

holding down borrowing costs while providing flexibility going forward should the borrowing revert to more predictable levels. Somewhat larger 2-year notes would also help fill in the sharp decline in maturing debt in the second half of 2003 after the last of the monthly 5-year notes have been redeemed. The bill market, having cheapened somewhat recently to general collateral, could easily handle increased offering sizes.

Additionally, focusing the new issuance on the short end would allow Treasury to marginally shorten the average life of their debt while remaining within the previously stated target of 5-6 years. Most felt that the shape of the yield curve supported this approach as most inexpensive for Treasury and that it left little doubt in the minds of investors as to the technical nature of the budget shortfall. Treasury would have ample flexibility to change borrowing if needed after the upcoming release of long-term budget projections by OMB and CBO.

The committee unanimously recommends a total financing of \$27 billion consisting of the following offerings:

- \$11 billion reopening of the 5-year notes due May 15, 2006.
- \$11 billion of 10 year notes due August 15, 2011.
- \$5 billion reopening of the 30-year bonds due February 15, 2031.

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

- A 2-year note of \$13 billion in August.
- Weekly issuance of 3- and 6- month bills, as well as issuance of the new 4-week bills. It is anticipated that the 4-week bills can be scaled up or down sufficiently to eliminate the need for a cash management bill this quarter. It is further anticipated that the 4-week bills will make it possible to reduce somewhat the size of the 3- and 6- month bills late in the quarter.
- Buybacks totaling \$9.5 billion.

For the October-December quarter, the Treasury estimates a net paydown of \$36 billion with a cash balance target of \$30 billion on December 31st. To accomplish this requirement the Committee preliminarily recommends the financing schedule in the attached table.

In February 2000, the Treasury announced and subsequently implemented a policy of regular reopenings of its refunding issues—5-year and 10-year notes and 30-year bonds. The practice has been for the initial issuance amount to be slightly larger than the reopening, like an initial issuance of \$10 billion and a reopening of \$8 billion. At the request of the Treasury, the Committee discussed a change in approach such as a larger initial issuance amount and a smaller reopening.

Committee members were of the opinion that while a larger initial offering of refunding issues would add some liquidity, it is unlikely that the change would significantly affect trading patterns in the financing markets. Members believe that the prospect of the reopening has kept

the financing markets in relative balance since the new policy was announced. Members were not opposed to small changes in the initial offering sizes but also expressed the view that the size of reopenings of 5-year and 10-year notes not fall below threshold levels of about \$8 billion to \$10 billion in order to maintain active participation in the auctions of reopened issues.

Recently, the Treasury released for comment in the *Federal Register* an Advanced Notice of Proposed Rulemaking (ANPR) regarding the so-called 35 percent rule and net long reporting requirements. In the notice, the Treasury identified a set of five alternatives to the current procedure. (The current procedure states that the sum of a bidder's net long position (NLP) in a security and its auction award must not exceed 35 percent of the total being auctioned. For a reopening, the NLP calculation includes when-issued holdings of the reopened security plus all holdings of the outstanding security.) At the Treasury's request, the Committee reconsidered its prior recommendations on this matter.

The Committee continues to believe that the preferred alternative is that the 35 percent rule be altered so that the NLP refer only to the bidder's position in the when-issued security. Also, members suggest an explicit statement that the rule apply to positions at the time of auction (usually 1:00 p.m. EST) even if reports are filed prior to the auction.

Finally, at this point the Committee is of the opinion that the recent shortfall in the budget surplus has been caused primarily by one-time events, like the tax rebate and the change in the corporate tax date, and by short-term cyclical fluctuations in the economy. The structural trend toward paying off the federal debt at some point in the middle of the decade does not appear to have been reversed unless long-run projections of productivity are lowered significantly or major new policy initiatives are enacted. As a result, members expect that the Treasury and, by extension, the Committee will again be faced with the question of what auction issues to eliminate or downsize over the coming years. In that regard, members believe that the Treasury's views on longer-term debt issues will be important in formulating future financing plans. For example, some members ask whether the Treasury believes that maintaining a complete yield curve out to 30 years with newly auctioned securities represents a public good that outweighs the financial considerations of issuing debt that might have to be bought back within a few years. Other members questioned whether the Treasury believes that major policy uncertainties such as privatization proposals for Social Security affect the Treasury's views on the desirability of maintaining longer term issues. In any event, the Committee encourages the Treasury to proceed with a formulation of its views on longer term debt issues and to communicate them to market participants as soon as possible.

Respectfully submitted,

James R. Capra, Chairman

Timothy W. Jay, Vice Chairman