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

May 2, 1990

Dear Mr. Secretary:

Yields on U.S. Treasury securities have continued to rise over the period since our meeting last February, as market participants have recently become more concerned about the possibility of some pickup in the underlying inflation rate against a background of somewhat firmer economic data. Compounding this pressure on market yields has been speculation that foreign investment in U.S. Government issues, particularly by Japanese institutions, would be curtailed due to the dollar exchange rate's relatively high level and the more attractive yields being offered in non-dollar markets. Among coupon issues, over the past few months three-year note yields have increased from 8.56 percent to 9.10 percent, and 30-year bond yields have gone from 8.40 percent to 9.10 percent, and 30-year bond yields have gone from 8.60 percent to 9.50 percent. In addition, heavy new cash financing demands from the Resolution Trust Corporation's working capital program have put Treasury bill rates under upward pressure. Since early February, discount yields on six-month bills have risen from 7.75 percent to 8.05 percent.

Looking ahead, both domestic and international factors present a risk that U.S. interest rates will be forced even higher. In view of the recently more disturbing inflation evidence, particularly the apparent acceleration of non-energy service price increases over the last half-year, there is now little room for Federal Reserve officials to consider any easing of monetary policy in the near term. Indeed, additional signs of heightened price pressures combined with further news suggesting a pickup in economic activity over coming weeks could even lead the Fed to undertake some tightening of its credit stances for the first time in over a year. Meanwhile, increased demands for capital to rebuild Eastern European economies may tend to divert foreign investment from U.S. markets. These potentially negative factors for the U.S. financial markets underscore the desirability of an early, credible agreement between Congress and the Administration to substantially reduce the stubbornly large Federal budget deficit. Because such a plan would provide for greater fiscal policy restraint to reduce inflationary dangers while also reducing government financing needs, it would help to counter some of the forces that are currently pressuring U.S. interest rates. It is against this background that we have produced our recommendations for the May refunding.

The Committee recommends that the following securities be sold at yield auctions to refund $18.1 billion of maturing securities and raise $12.4 billion of new cash:

- -- $10.5 billion 3-year notes due 5/15/93;
- -- $10.0 billion 10-year notes due 5/15/2000;
- -- $10.0 billion 30-year bonds due 5/15/2020.

For the remainder of the quarter, the Committee recommends:

- -- Sell $10.5 billion 2-year notes raising $1.6 billion new cash;
- -- Sell $8.25 billion 5-year notes raising all new cash;
- -- Sell $10.25 billion 52-week bills at two remaining auctions, raising $2.85 billion new cash;
- -- Keep weekly 3- and 6-month bill auction sizes at $16.8 billion through the balance of the quarter raising a total of $7.35 billion.

Summary of New Cash for Quarter

Refunding	$12.4 billion
3- and 6-month bill	7.35
52-week bills	2.85
2-year notes	1.60
5-year notes	8.25
Total additional market borrowing	$32.45
Already raised	(11.25)
Estimated Foreign Add-ons	1.30
Net Market Borrowing	$22.50

With regard to the June 30 cash balance, the Committee unanimously recommends a total of $40 billion. In a period of substantial uncertainty concerning the RTC's cash needs and an authorized RTC funding plan for this quarter of up to $45.3 billion from the Federal Financing bank, the Committee believes it is prudent for Treasury to raise cash in a regularized pattern and early rather than reacting to drawdown demands from RTC. In addition, many on the Committee also believe that, in light of recent receipt and expenditure patterns, the budget deficit ex-RTC is well above current projections. With these possibilities in mind, the Treasury should bias its market borrowing higher and therefore err toward a larger cash balance than might otherwise be recommended.

For the July/September quarter, the Committee again recognizes the uncertainty associated with assuming RTC cash requirements and the pattern of its need. However, for purposes of making an indicative recommendation, the Committee is assuming net RTC cash requirements of at least $15 billion, giving a total cash requirement of $45-50 billion using Treasury's estimates ex-RTC for the period. Using that assumption, the Committee unanimously recommends a $40 billion end-of-quarter cash balance. The reasoning for the high balance is again primarily the uncertainties noted for the April/June quarter. The Committee continues to debate the merits of emphasizing only short maturity bills and notes (i.e., out to five years) as it relates to the RTC's working capital needs. By an 8 to 6 vote, the Committee recommends continued emphasis on bill financing and additions to short coupons as the basic approach to funding "working capital" needs. The minority believes that Treasury funding is basically fungible and that the maturity distinction is not economically relevant. Several members believe that concentrated financing in shorter dated maturities could be detrimental to markets generally and the overall level of rates as financing rates spill over into longer-term rates.

The majority recommendation, however, would imply an increase in the five-year and shorter notes in the July/September quarter by $250-500 per auction while the weekly bills would be increased to $17.2 billion. The year bill should be increased from $10.5 billion to $11.0 billion and long-dated cash management bills should make up the residual requirement depending on evolving needs.

With regard to the Committee's views on permitting syndicate bidding and removing the 35 percent ceiling on awards, the Committee unanimously thinks it would not be a positive enhancement to REFCORP bond auctions. The Committee believes that anything that makes REFCORP look less Treasury-like is a negative for its acceptance. Further, permitting more than 35 percent to be bought by one bidder would potentially exacerbates the uncertainty for all potential participants in an auction and would marginally diminish when-issued trading. Moreover, potential bidders would be more fearful of establishing short positions when one bidder (or a syndicate) in the auction could buy all available securities.

The Committee feels strongly that REFCORP financing and the 40-year concept specifically have been much better received than the press reports would lead participants to believe. Stripping and final distribution post-auction have been extensive. Marginal savings have occurred as a result of the 40-year maturity relative to 30 years. This is particularly true since the Committee believes the recent four to five months have been a difficult market in which to effectively establish a new credit, as well as a new financing technique.

The Committee believes the primary issue concerning the REFCORP auctions is the breadth of participation. In this regard, the Committee believes the primary dealers should be officially reminded of their responsibility to underwrite and support the market for Treasury and related debt. More importantly, the Committee believes the marketplace is uninformed and confused about issues surrounding the size of the REFCORP financing need and its credit structure. Further marketing and education efforts should be undertaken by Treasury to promote this credit both domestically and offshore. These efforts must be done somewhat repetitively .

Finally, the Committee would like to strongly endorse the initiative sponsored by PSA and the primary dealers to automate the auctions of Treasury debt. Intuitively, we believe that such a change would offer significant savings for the Treasury. The Committee is prepared to work with Treasury to investigate and develop a fair and secure system which achieves the perceived benefits.

Thank you Mr. Secretary, that concludes our report and we welcome questions and discussion.

Respectfully submitted,

Jon S. Corzine
Chairman