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

July 31, 1991

Dear Mr. Secretary:

Changing assessments of U.S. economic growth prospects have been the primary factor influencing Treasury issue yields since our last report in early May. Shortly after the last quarterly refunding auctions were held, both private and official statistics began to display a notably firmer trajectory for both sales and production, as well as an accelerated rate of inventory liquidation. Taken together, this information suggested that a recovery in business activity had begun following a relatively brief and shallow recession. Fearing a clash between rising private credit demands and record-high Federal borrowing needs, financial market participants adopted a more defensive posture toward long-duration fixed income instruments, and thus the Treasury yield curve steepened somewhat further. In recent days, however, Treasury yields have declined modestly across all maturities, as sluggish monetary growth and some soft economic data have revived concerns about the possibility that the rebound will prove to be unusually weak or short-lived. Notwithstanding these oscillations in attitudes, the fluctuations in market yields over the past few months have been fairly mild, and the net change has been quite small. A key reason for this stability has been the continued widespread optimism among investors about the inflation outlook, which is apparently shared by most Federal Reserve officials. Since early May, discount yields on 91-day Treasury bills and 3-year note yields have essentially held steady, at 5.60 percent and 7.30 percent, respectively. Over the same period, 30-year bond issue yields have risen slightly, from 8.25 percent to 8.40 percent. With this perspective as background:

The Committee unanimously recommends that the following securities be sold at yield auctions to refund \$21.6 billion maturing securities and raise \$16.4 billion of new cash:

-- \$14.0 billion 3-year notes due 8/15/94;

-- \$12.0 billion 10-year notes due 8/15/01;

-- \$12.0 billion 29 3/4-year bonds due 5/15/21.

For the remainder of the current quarter, the Committee recommends:

-- Sell \$12.75 and \$13 billion 2-year notes at two auctions, raising \$4.75 billion of new cash;

-- Sell \$9.5 and \$9.75 billion 5-year notes at two auctions, raising \$11.65 billion of new cash;

-- Sell \$13.5 and \$14.5 billion 52-week bills at two auctions, raising \$6.75 billion new cash;

-- Increase immediately the weekly 3- and 6-month bill auction size to \$21 billion through September, raising \$14.7 billion of new cash.

-- Sell in early September \$4 billion cash management bills, with an April 23 maturity.

Summary of New Cash for Quarter

Refunding	$16.40 billion
3- and 6-month bills	14.70
52-week bills	6.75
2-year notes	4.75
5-year notes	11.65
April cash management	4.00
Total	$58.30
Already raised	46.50
Estimated Foreign Add-ons	2.95
Net Market Borrowing	$107.70 billion

The Committee recommends a cash balance of $30 billion on September 30. Given the uncertainty and general sluggishness of cash demands related to projections by the RTC, the Committee believes there is reasonable likelihood that the proposed schedule will result in a higher end-of-quarter balance. Adjusting the regular coupon cycle and bill offerings will give Treasury the flexibility to handle such a contingency.

The Committee's schedule adds an additional element of flexibility -- for either higher or lower market borrowings -- by suggesting an April cash management bill. This suggestion accomplishes two ends. First, it could be positioned to meet a seasonal low point in the September cash balance. Second, this option can be used to smooth quarter-to-quarter market borrowing requirements by shifting current long-term needs into the relatively slow funding period of the second calendar quarter. Furthermore, the Committee's schedule clearly emphasizes an increased focus on the 1-year bill offering. The Committee has believed for some time that this is an underutilized auction slot where substantial institutional and speculative participants are consistently available. Currently, this market is even more attractive as individual investors stretch out the yield curve and shift credit preferences. We thus recommend moving year bill auction sizes into the $14-15 billion plus range over the next several months.

As for the refunding, the Committee supports the continued gradual increase in the size of the various quarterly maturities. As noted with reference to year bills, there is great interest among many types of investors to shift out of the relatively short spectrum of the yield curve, and the Treasury should position itself at the margin to capture that demand. In that regard, a $500 million increase in the 3-year note appears desireable. Additionally, the Committee voted 12-6 in favor of a reopening of the 8-1/8 percent bond of 5-15-2021. The group generally feels that reopenings over time promote the liquidity of secondary markets and minimize the unnecessary proliferation of issues.

The Committee also recommends that the Treasury include in the quarterly announcement its intention to assign a coupon other than 8 percent to the new 10-year note. The August 2001 slot is presently occupied by an 8 percent 2001 callable bond and the group feels the potential for market errors and possible sales abuses are significant enough to warrant an 1/8 percent shift to either side of 8 percent to avoid a coupon match. Eleven members voted in favor of this suggestion while five members simply believed the May 2001 10-year note should be reopened. Two members believed the Treasury should assign a coupon and bid by yield accordingly.

For the October/December quarter, the Committee suggests that further increases be made in the weekly bill, year bill, and coupon and refunding cycles from the levels proposed for the current quarter. We anticipate that additional cash management bills, probably with a June maturity, are likely to be needed by mid-November. Suffice it to say, we believe the current Treasury schedule can comfortably accommodate the substantial market borrowing requirements. The Committee believes the appropriate cash balance for December 31 is $30 billion.

Moving to the other topic of the charge, the Committee spent a good deal of time discussing the members' views on: (a) the efficacy of the auction process; and (b) secondary market concerns and potential corrective steps regarding the purported Treasury issue squeeze.

To begin, the Committee was able to derive several acknowledgeably general themes on these two questions.

(1) The Committee believes unanimously in the overall efficacy of the Treasury auction process. That process serves Treasury finance well. Many members are, however, uneasy with the uncertain legal and market practice framework in which that process takes place.

(2) The Federal Reserve, in its role as the supervisor of the primary dealers, should develop a private disclosure system which allows the Fed's good offices to be adequately informed of secondary market concentrations in cash and financing markets for primary dealers and their clients.

(3) It is important for the Fed and the Treasury to proactively use existent legal and moral authority to promote fair and competitive market behavior.

(4) The Committee acknowledges the difficulty (if not the impossibility) of writing generalized legal rules or regulations which could define for all seasons what constitutes concerted, collaborative, or collusive behavior. Each situation requires judgment, as well as a strict legalistic response.

In addition to these thematic views, the Committee discussed and considered specific options designed to address these limited problems. Each option was discussed in the context of its potential impact on Treasury funding cost, the practical ability to execute the option, and the efficacy of the option in meeting a perceived problem.

First, there was nearly unanimous support for the view that no changes to the auction rules were necessary. This view encompasses ideas such as an adjustment to the 35 percent rule. More adamantly, the group strongly rejected any requirement that customers bid directly to the Fed. This latter suggestion was felt to: (a) reduce further the value of a primary dealer franchise; (b) reduce the ability of primary dealers to receive important customer/market information; (c) create numerous logistical problems; and (d) potentially undermine the breadth of auction participation. The Committee voted 17-1 against reducing the "35 percent rule" and 18-0 against required direct customer bidding.

Second, there was much discussion of the concept of opportunistic "reopenings" or creating a viable option of "tapping" an outstanding issue which was posing a secondary market problem and/or was subject to a squeeze. Supporters believe that the potential for such an auction or an occasional usage by the Treasury of this option would convince market participants that "market squeezes" would fail if not be financially disastrous. Those opposed to the idea are concerned about Treasury's ability to define a "market problem" objectively and the potential for uneven application of the action for the detriment or betterment of individual market participants. The vote on this proposition was 10-8 in favor of establishing this contingent response by Treasury. Almost all Committee members felt that regularly scheduled auctions should be reopened where practical to add depth, breadth, and liquidity to outstanding issues. This reopening procedure might be extended to include even a short-maturity note such as a previous month's 2-year note.

Third, many members were supportive of a general view that tender language should be adjusted so as to reemphasize the Treasury's authority to reject any and all bids at its discretion. Precision with reference to the appropriate language was difficult for the Committee to derive. The Committee stands prepared to work with the Fed and/or Treasury to develop the acceptable language. The Committee did take a poll of members on tentative language options relative to changing the tender language. Option A -- do nothing with the tender wording -- received 5 votes. Option B was focused on a view that bidders would attest by their signature on the tender that their actions in the auction process were "not inimical to a competitive bidding process." Option B or a close derivative proposal received 13 votes supporting its further exploration and development.

Seeking to clarify and understand what "inimical" or "acceptable" behavior is, the Committee felt that it might be productive for a Treasury and/or Federal Reserve study group in conjunction with the Primary Dealers' Trading Practices Committee to explore the potential for creating guidelines for acceptable market practices in the auction process. If tangible results or specific guidelines could be developed, then education seminars could be held among the primary dealers. This proposal was supported by a 10-8 vote.

Finally, let us return to one of the general points which lends itself to practical action. Reporting and disclosure to the Fed on concentrated positions could be a relatively harmless adjunct to weekly dealer and aspiring dealer reports. Concentrated positions should include cash, forward-settled, and financing positions. Using that information in conjunction with a proactive moral suasion posture with senior dealer management, the Treasury and/or the Fed should be able to encourage the early correction of any identifiable market problem.

Allow me to close my report on this complicated subject by reasserting the Committee's view that the market generally and the auction process specifically work exceedingly well. Some tinkering at the margin may be useful in priming a self-correcting process. However, legalistic rules and regulations may have unknown consequences which could be detrimental to the long run health of the market and could in turn lead to a meaningful increase in the cost of Treasury finance.

Mr. Secretary, that concludes our report, and we welcome questions and discussion, whether now or at a later date.

Jon S. Corzine
Chairman