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

February 5, 1997

Dear Mr. Secretary:

Since the Committee's last meeting on October 30, 1996, the pace of economic activity has been brisk. The mid-year slowdown in consumer spending proved temporary, as robust gains in employment and income led to renewed vigor. Significant improvement in net exports, although somewhat exaggerated, also contributed to the fourth quarter rebound. Despite above-trend growth, and aside from energy prices, inflation has remained remarkably well behaved. On a more cautious note, wage and salary gains are trending higher and may well rise further amid persistent labor market tightness.

Interest rates on Treasury securities are currently little changed from the levels which prevailed at our last meeting. Monetary policy has remained unchanged since January of last year, while market expectations presently seem tilted in the direction of somewhat tighter credit in the coming months. Foreign demand for Treasury securities continues to be supportive of the market, reflecting strength in the dollar as well as relatively attractive U.S. yield levels.

Within this context, to refund the $18.0 billion of privately-held notes maturing on February 15, 1997 and to raise $21.75 billion of cash, the Committee recommends that the Treasury auction $39.75 billion of the following securities:

- $17.75 billion 3-year notes due February 15, 2000;
- $12.0 billion 10-year notes due February 15, 2007;
- $10.0 billion re-opened 6 1/2 percent bonds due November 15, 2026.

The Committee unanimously supported a modest reduction in the size of the 3-year note to $17.75 billion from the $18.5 billion level in the prior refunding. This recommendation is consistent with the Treasury's recent tendency to modestly reduce offering amounts of shorter-term coupon issues, in connection with more frequent offerings of longer-term securities. The Committee also took into account the new cash raised through the Treasury's initial offering of inflation-indexed securities. In that context, this recommendation further contributes to recent efforts to reduce reliance on short-term financing.

Eleven of the thirteen members present voted to recommend that the Treasury issue $12.0 billion 10-year notes, up from the $10.0 billion level in the prior refunding. Two of the members

favored a size of $14.0 billion, consistent with 10-year issue sizes before the shift to more frequent offerings. In formulating this recommendation, the Committee was mindful of the need for large, liquid issues in this important benchmark maturity. The Committee also considered the interval between this auction and the next 10-year note auction in the May refunding. It was felt that the larger sized offering would reduce the potential for an undue scarcity to develop in the repurchase agreement market. It is also consistent with the Committee's recommendation in its report of May 1, 1996 that it would be preferable to target a minimum size of $12.0 billion for the 10-year note auctions in February and May.

Another factor in the Committee's consideration of the size of the 10-year note was its unanimous vote not to re-open the 61/2 percent notes due October 15, 2006. This security, first issued on October 15, 1996, was re-opened in last year's November refunding. An additional re-opening would result in a particularly large issue which, on the margin, would be somewhat more difficult for the Treasury to efficiently refund upon maturity. Also, there was no evidence of a shortage of this issue in the repurchase agreement market, and it was felt that the market was likely to place a premium on a new large 10-year benchmark issue.

In terms of the bond in its refunding recommendation, the Committee unanimously supported $10.0 billion as the appropriate size. The Committee also voted by 11-2 to recommend a re-opening of the 6 1/2 percent bonds due November 15, 2026. The majority felt that a further increase in the strippable product with May 15 and November 15 maturities was desirable. It was also noted that a large issue would reduce the potential for a shortage to develop in the repurchase agreement market during the six-month period before the issuance of the next 30-year bond.

With the aim of achieving a cash balance of $20 billion on March 31, the Committee unanimously recommends that, for the remainder of the quarter, the Treasury meet its borrowing requirement in the following manner:

- Two 5-year notes totaling $12.5 billion each, to raise $4.7 billion of new cash;
- Two 2-year notes totaling $17.5 billion each, to pay down $1.5 billion of cash;
- One 1-year bill totaling $19.25 billion, to raise $0.5 billion of new cash;
- Weekly issuance of 3- and 6-month bills through the remainder of the quarter, to raise $9.1 billion of new cash; and
- A cash management bill totaling $20.0 billion to mature on April 24 to meet the seasonal cash need in early March.

Including the $21.75 billion raised in the mid-quarter refunding, as well as anticipated foreign add-ons of $7.0 billion, the proposed financing schedule will raise a net amount of $61.6 billion. This amount, after subtracting the net paydown of $11.6 billion to date in the quarter, will accomplish the total net market borrowing requirement of $50.0 billion.

For the April-June quarter, the Treasury estimates a net paydown in the range of $10-15 billion with a cash balance of $35 billion at the end of June. To accomplish the anticipated net paydown, the Committee recommends the provisional financing schedule attached to this report.

In its deliberations concerning this financing schedule, the Committee assumed that the next offering of inflation-indexed securities in April would be maintained at $7.0 billion. Given this assumption, and in view of the size of the planned net paydown, the Committee recognizes the Treasury's need for flexibility in terms of possible modest reductions in the size of coupon auctions.

In response to the Treasury's request for its views, the Committee considered the question of whether to introduce half-decimal bidding for 13-, 26- and 52-week bill auctions. As noted by Treasury staff, half-decimal bidding would provide unique prices for bills with maturities of more than 72 days. The Committee's view on half-decimal bidding was unanimous in favor of this change.

As noted in its report of August 3, 1994, when the committee considered the question of 3-decimal yield bidding for note and bond auctions, the Committee feels that smaller bidding increments would, on the margin, induce some market participants to bid somewhat more aggressively, with potential for modest savings to the Treasury. The Committee also feels that such a change would be relatively easy to introduce, as it is consistent with existing secondary market practices and generally in line with the changes introduced by the Treasury in February 1995 for note and bond auction bidding.

The Committee also considered possible complications which might arise, in terms of monitoring Treasury's auction bidding rules, as a result of reductions in the amount of certain bill offerings available for purchase by the public. In particular, it was noted that, after taking account of auction allotments to central banks and other official institutions, the remaining size of some bill offerings was such that a potential maximum 35 percent award could be smaller than the Treasury's current $2 billion net long position auction reporting threshold. Such reporting requirement is used to facilitate enforcement of the Treasury's policy concerning maximum amounts of securities awarded to any one bidder in all auctions of Treasury securities.

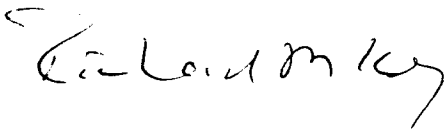
In order to help avoid inadvertent violations of that policy in cases involving auctions of small sizes of Treasury bills, the Committee considered a number of possible reporting practice changes. This included adjusting the size of the reporting threshold on an auction-by-auction basis, when Treasury is aware that the available size of a bill offering would entail a maximum potential single bidder award below $2 billion. Alternatively, the Committee considered a reduction in the reporting threshold for auctions of Treasury bills to $1 billion -- an amount judged sufficient to ensure proper monitoring of the single bidder award policy.

With one abstention, the Committee members strongly preferred lowering the current net long position reporting threshold for Treasury bill auctions to $1 billion, while retaining the current $2

billion threshold for note and bond auctions. The Committee felt this approach would lessen the risks of unintended errors which might arise from frequent auction-to-auction changes in reporting thresholds. It would also limit the additional complexities, and related compliance costs, associated with adhering to the Treasury's rules and procedures for auction bidding. In this regard, it was noted that those complexities inevitably add costs to participants in the process, and particularly for those investors who are only occasional direct participants in Treasury auctions.

Mr. Secretary, that concludes the Committee's report. We welcome any comments or questions.

Respectfully submitted,



Richard M. Kelly
Chairman