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

July 30, 1997

Dear Mr. Secretary:

Since the Committee's last meeting on April 30, 1997, the pace of economic activity has slowed significantly. Consolidation in the consumer sector after a vigorous first quarter led the downshift in domestic demand. Positive income and employment underpinnings, however, suggest that this period may prove to be a pause, rather than the beginning of a sustained slowdown. In the meantime, strength continued to be exhibited in other sources of private-sector demand. Manufacturing output has generally outpaced demand, with producers continuing a healthy pace of inventory accumulation in response to lean stock-to-sales ratios. All the while, the inflation outlook has remained becalmed, with contained labor cost growth and slight softness in wholesale prices contributing to a stable rate of consumer price inflation.

During this period, interest rates on Treasury securities declined sharply, fully reversing the rise in rates earlier in the year. Intermediate and long-term rates fell 55-65 basis points as economic activity slowed and inflation remained remarkably well contained. The Treasury securities market further benefited from a significantly greater than expected decline in the Federal budget deficit as well as a strong dollar. Fears of a near-term credit tightening have subsided,

while market participants reassess the prospects for a re-emergence of unsustainable demand pressures in the second half.

Within this context, to refund the $26.8 billion of privately-held notes maturing on August 15, 1997 and to raise $11.2 billion of cash, the Committee unanimously recommends that the Treasury auction $38.0 billion of the following securities:

- $16.0 billion 3-year notes due August 15, 2000;
- $12.0 billion 10-year notes due August 15, 2007;
- $10.0 billion 30-year bonds due August 15, 2027.

The Committee unanimously supported a further reduction in the size of the 3-year note to $16.0 billion from the $17.0 billion level in the prior refunding. This recommendation is consistent with the Treasury's recent practice of reducing offering amounts of short and intermediate-term issues, reflecting the continued trend of lower budget deficits and related financing needs.

In terms of its recommendation on the 10-year note, the Committee felt that it would not be desirable to reduce the size of the offering from the previous quarter's level. In this regard, the Committee took into account the Treasury's recent decision to eliminate the issuance of 10-year notes in mid-July and mid-October, thus reducing from 6 offerings to 4 offerings per year of nominal 10-year securities. Also, the relative flatness of the yield curve supports the issuance of longer dated securities.

The Committee unanimously recommends a new 10-year note rather than re-opening the 6 5/8 percent notes due May 15, 2007. The outstanding 6 5/8 percent notes currently trade at a substantial premium which, on the margin, may be an impediment for some investors. Also, there is no indication of unusual tightness of the 6 5/8 percent notes in the repurchase agreement markets.

In terms of the bond in its refunding recommendation, the Committee unanimously supported $10.0 billion as the appropriate size. This is consistent with the Committee's view as stated in its report dated May 1, 1996 that minimum sizes for 30-year bonds should not be smaller than $10.0 billion.

With the aim of achieving a cash balance of $40.0 billion on September 30, 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 $11.5 billion each, to raise $1.0 billion of new cash;
- Two 2-year notes totaling $15.5 billion each, to pay down $5.8 billion of cash;
- Two 1-year bills totaling $13.0 billion each, to pay down $4.1 billion of cash; and

- Weekly issuance of 3- and 6-month bills through the remainder of the quarter, to raise $3.3 billion of new cash.

Including the $11.2 billion raised in the mid-quarter refunding as well as anticipated foreign add-ons of $4.7 billion, the proposed financing schedule will raise a net amount of $10.3 billion. This amount, after subtracting the net paydown of $0.3 billion to date in the quarter, will accomplish the total net market borrowing requirement of $10.0 billion.

In addition, intra-quarter cash management bills totaling approximately $25.0 billion will be needed to cover the cash low point in early September.

For the October-December quarter, the Treasury estimates a net market borrowing requirement of $45-50 billion with a cash balance of $30.0 billion at the end of December. To accomplish this requirement, the Committee unanimously recommends the provisional financing schedule attached in Table 1.

At the Treasury's request, the Committee considered whether, in light of smaller forecasted deficits, further adjustments should be made in the Treasury's financing program. In this regard, the Committee noted that, relative to peak offering sizes over the past twelve months, very substantial adjustments have already been made, in response to improved fiscal performance. Indeed, as noted in Table 2, at recent or recommended current offering amounts the existing

annual nominal note and bond financing calendar implies gross issuance of about $466.0 billion, which represents a reduction of about $79.0 billion (14.5 percent) from annual peak issuance.

Looking ahead, and for illustrative purposes only, the Committee noted that if existing note and bond offerings were assumed to be frozen at current sizes, and including existing and assumed issuance of inflation-indexed securities, the Treasury would raise less than $2.0 billion in net new cash from public note and bond financings over the next twelve month period (See Table 3).

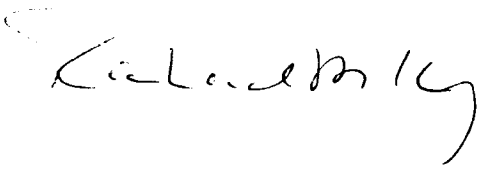
In light of the size of adjustments which the Treasury has successfully made to date, and given inevitable uncertainty over the size of future financing needs, the Committee was unanimous in the view that future adjustments in the financing program were best approached by means of modest further adjustments in the size of existing offerings. Specifically, the Committee members felt that existing note offerings, particularly out to five years, as well as existing bill offerings could be adjusted as needed in response to changing estimates of financing needs. In this regard, the Committee did note the point, raised in its April 30, 1997 report, that there were practical limitations to the size reductions which could be made in the regular weekly bill offerings without adversely impacting liquidity in that market. With the recent increases in the sizes of those offerings, this was not seen as a current concern.

In reaching these overall conclusions, the Committee reaffirmed its long held view as to the desirability of maintaining predictability in the pattern of Treasury offerings and of taking regular advantage of opportunities to conduct financing activities across the entire yield curve.

Separately, the Committee considered the Treasury's request for its views on the advisability and usefulness of extending stripping eligibility to all fixed rate note offerings. This follows the Treasury's recent decision to make the 5-year inflation-indexed notes strippable. In the discussion, it was noted that it would be operationally easy and inexpensive for the Treasury to make this policy modification. It was also noted that such a change would, at least at the margin, add some liquidity and flexibility to the short end of the zero coupon curve. Finally, while demand for short dated zero coupons was currently quite limited, the self disciplining nature of market demand and supply forces would work to capture any available benefits for, nd limit any costs to, the Treasury. Thus, the Committee concluded that it would be advisable for the Treasury to make this modest policy change and extend stripping to all fixed rate note offerings.

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

Respectfully submitted,



Richard M. Kelly
Chairman