August 4, 2004

Minutes Of The Meeting Of The
Treasury Borrowing Advisory Committee
Of The Bond Market Association
August 3, 2004

The Committee convened in closed session at the Hay-Adams Hotel at 11:45 a.m. One member of the Committee, Keith Anderson, was not present. Acting Assistant Secretary for Financial Markets Timothy Bitsberger welcomed the Committee and gave them the charge.

The Committee first addressed the question in the Committee charge (attached) on reducing marketable issuance in the face of declining financing needs and the impact of such reductions on market liquidity.

As a preface to the Committee discussion, Mr. Bitsberger presented a series of charts (attached) showing Treasury's projected debt and issuance distribution, financing residuals, rollover, and hypothetical announced auction sizes. Two key assumptions used in the charts were the latest OMB mid-session review budget numbers and an assumption of stable bill issuance. Mr. Bitsberger explained that there is no formal target for bills as a percentage of total issuance outstanding debt, but Treasury has an interest in maintaining the robustness of the bill market because it provides great flexibility and low cost financing. The charts indicated that if lower deficits are realized, and bill issuance is maintained at current levels, that coupon issuance level will have to be reduced modestly. The charts indicated that the distribution of issuance, the distribution of outstandings, rollover amounts, as well as hypothetical auction sizes remain within historical norms.

The Committee discussed what, if any, changes were needed to the calendar or issue sizes and the liquidity effects of such changes. The Committee generally agreed that Treasury's current calendar has a great deal of flexibility and that the right tools were in place to respond to changes in financing needs. No changes to the calendar are needed at this time and lower borrowing requirements could be met with reduced issue sizes in coupons across the nominal curve. Members also felt that if deficits continued to decline changes to the calendar could be contemplated, such as eliminating the 10-year reopening. Some members pointed out that the 10-year reopening added flexibility and smoothed borrowing patterns. Others pointed out that old off-the-run 20- and 30-year issues were starting to roll down into the 10-year sector and should offer more liquidity should the Treasury decide at some future point to cut back on 10-year issuance. Another member said that Treasury's primary goal was to borrow at lowest cost and that it should not let liquidity concerns divert Treasury from this goal; the markets have adapted in the past and will adapt in the future to changes. Transparency was recognized to be important in facilitating market adaptations.

Members generally felt that that the size of issues, particularly in the 10-year note, which has in the past traded tight in financing markets and sometimes with a significant level of fails to deliver, was not the general cause of liquidity problems. They noted that the market has traded much smaller sizes in the past without liquidity problems. One member noted that the frequency of trading in other products that require the use of 10-year notes as hedges has put strain on the lending markets and has caused many of the liquidity problems. The situation is often compounded by the trading practices of some sizable foreign purchasers of Treasuries, who do not participate in the repo market because they are constrained by their own internal regulations or customs. It was suggested that Treasury could go with smaller sizes if the market's repo concerns were addressed either via a repo facility established by Treasury or a change in security lending behavior by large foreign holders. Members also noted that the past fails in the 10-year notes were exacerbated by the rate environment, and an historically rapid rise in rates.

The Committee next addressed the question in the charge dealing with the distribution of projected levels of interest rates, inflation and deficits and a range of probable outcomes. Mr. Bitsberger presented a series of charts (attached) depicting the distribution of outcomes for each of these components. This was a continuation of sensitivity analysis presented in prior meetings where Treasury presented charts showing the budget uncertainty associated with economic forecasts, legislation, and technical modeling factors. The Committee was asked whether there was anything presented within the charts that raised concerns for debt management and whether there were other factors that Treasury should consider.

The Committee generally felt that the outcomes presented in the analysis were "too stable" and did not incorporate sufficient risk; bigger shocks or stresses needed to be applied to the models or some sort of risk premium needed to be included in the models. They also suggested that the static modeling used in the analysis was too simplistic; they suggested incorporating dynamic modeling techniques such as reaction functions; for example, incorporating a function that considers the impact of changes in inflation on the level of interest rates. The Committee also suggested that attempting to disaggregate inflation and interest rate components might result in some double counting effects. One committee member felt that the modeling beyond five years was not very valuable because the uncertainty was too great. Another stated that projections beyond two years were unlikely to provide much guidance about actual outcomes. A third stated that longer-term modeling needed to be considered, even if its forecasting value was limited. It still might indicate some general trend that needs to be considered despite the uncertainty. At the close of the discussion on this issue, the Committee, upon Mr. Bitsberger's request, agreed to work with Treasury and suggest ways to improve the analysis in the future.

The Committee then discussed the third question in the charge dealing with the risks of foreign ownership of Treasury securities. Mr. Bitsberger presented a single chart showing the increase in foreign ownership of Treasury securities as a percentage of privately-held outstanding.

The Committee overwhelmingly felt that broad foreign ownership of Treasury securities was beneficial, in that it lowered domestic interest rates. They stated that in their experience foreign accounts were "buy-and-hold" investors and were much less apt to sell or lend securities in the repo market. They stated that the idea that foreign investors would rapidly "dump" bonds is not consistent with historical experience and illogical, since it would be detrimental to foreign holders' markets.

One member contended that foreign investors generally buy Treasury securities to support their foreign exchange policies and that a change in such policies from a foreign holder with a large position could be detrimental to the Treasury market. Another countered that the trend in foreign holdings was long-term and upward and that any change in foreign exchange policies would have a transient effect on the market at most. Other members noted that foreign investment in euro-denominated debt was also growing and that growth in holdings of both euro-and dollar-denominated debt was related to globalization and increases in wealth in foreign countries. These investors want the safety and stability of dollar- and euro-denominated debt. One Committee member suggested Treasury try to estimate the elasticity the demand for Treasuries, to determine what the effects of a substantial falloff in foreign participation would be on the market.

Another member raised issues about the transparency of foreign purchases of Treasury securities at Treasury auctions, arguing that some foreign participants are not subject to the same reporting requirements as domestic participants. The disparate reporting requirements makes it hard for dealers to estimate the level of foreign account participation in auctions, which in turn affects dealers' estimates of the floating supply ahead of an auction - which ultimately has price impacts at auction in the form of an uncertainty premium. This lack of transparency, it was argued, could have a negative impact on an auction if a foreign entity that has been participating heavily in auctions, unexpectedly changes its participation level because it has adopted a change in its foreign exchange policy. Members felt that greater transparency in this matter would be beneficial.

The discussion briefly turned to the Committee's final borrowing recommendations for the August refunding and the remaining financing for this quarter as well as the October-December quarter. Those charts are attached.

The meeting adjourned at 1:05 p.m.

The Committee reconvened at the Hay-Adams Hotel at 5:35 p.m. One member of the Committee, Keith Anderson, was not present. The Chairman presented the Committee report to the Under Secretary for Domestic Finance, Brian Roseboro and Acting Assistant Secretary for Financial Markets, Tim Bitsberger, and Deputy Assistant Secretary for Government Financial Policy, Roger Kodat. A brief discussion followed the Chairman's presentation but did not raise significant questions regarding the report's content.

The meeting adjourned at 5:50 p.m.

Jeff Huther
Director
Office of Debt Management
August 3, 2004

Certified by:

Mark B. Werner, Chairman
Treasury Borrowing Advisory Committee
of The Bond Market Association
August 3, 2004

Treasury Borrowing Advisory Committee Quarterly Meeting
Committee Charge – August 3, 2004

Liquidity and Reduced Financing Needs

We would like the Committee's view on reducing marketable issuance in the face of declining financing needs and the impact of such reductions on market liquidity.

Distribution of Inflation, Interest Rate, and Deficit

We will present charts to the Committee showing projected levels of interest rates, inflation and deficits and a range of probable outcomes. Does the Committee have a views on whether these are the correct variables to focus on? Is there anything presented within these charts that raises concerns? Are there any related indicators that Treasury should consider?

Foreign Ownership of Treasury Securities

Treasury is frequently asked about levels of foreign ownership. We believe that broad foreign ownership lowers Treasury borrowing costs and represents a vote of confidence by global investors. Does the Committee have any views they would like to share with us on this issue.

Financing this Quarter

We would like the Committee's advice on the following:

- The composition of Treasury notes to refund approximately $28.8 billion of privately held notes and bonds maturing or called on August 15.
- The composition of Treasury marketable financing for the remainder of the July – September quarter, including cash management bills.
- The composition of Treasury marketable financing for the October – December quarter.