Dear Mr. Secretary:

During most of the period since our last meeting, the U.S. Treasury market has had to contend with the perception that the domestic economy was continuing to grow at a higher rate than that with which the Federal Reserve would be comfortable. Moreover, this growth was occurring despite an apparent end to the export boom, as a revival in consumer spending was replacing at least some of the stimulus that had been provided by the trade sector. Not surprisingly, then, this was also a period in which the dollar was generally under downward pressure, beginning with a sharp selloff almost immediately after the elections. The combination of continued above-trend economic growth and a falling dollar revived concerns over inflation. These were further reinforced by the very sharp runup in oil prices following the OPEC accord. Actual inflation numbers, however, continued to run at about the same rate at which they had for most of 1987 and 1988, and the sluggish behavior of precious metals prices suggested that the true extent of inflation concerns was much more limited than sometimes indicated by the commentaries of bond market participants.

Nonetheless, the Fed responded to the potential inflationary consequences of continued strong employment growth by raising the federal funds rate from around 8\(\frac{1}{4}\)% to 8\(\frac{3}{8}\)% at the time of our last meeting to around 9\% to 9\(\frac{1}{8}\)% by early January. Partly as a result, the dollar turned around rapidly, and has since shown impressive strength in the face of concerted intervention, interest rate increases in Europe, and another disappointing trade report. At the same time, perceptions regarding the economy have begun to shift as it now finally appears that the long-awaited deceleration in real growth is starting to occur.

The net result of all of these forces has been an increase from November 1 to today of about 75-to-80 basis points in yields on Treasury debt out to around 2-year maturities. Thus, 3-month bills have gone from 7.34\%-to-8.37\%, while 2-year notes have moved from 8.25\%-to-9.07\%. But yields on the longer maturities have increased by much less and actually decreased in the case of the 30-year bond, leading to an inversion of the curve from 2-years on out. (The yield on the long-bond is currently only up by about 1/2\% from the lows of last year, despite the roughly 250 basis point rise in the funds rate.)
It is possible to cite several technical factors which have helped to stabilize the long-end. One is the shift out of longer corporate paper due to heightened fears of event risk. Another is the alteration in investment policy on the part of some pension managers to more closely match the durations of their assets and liabilities. But perhaps more fundamentally there is a sense that real interest rates are fairly high around recent levels and that the risks of them increasing further do not seem very great.

Looking ahead, there is a broad consensus that the economy will grow at a lower rate in 1989 than in 1988. As noted above, the key to this deceleration is likely to be the sharply reduced stimulus from exports. And while consumption might continue fairly strong for a few more months in response to recent employment growth, it is not expected to be able to make up for the reduced rate of export gains, given the debt-burden on the average household. Furthermore, survey data indicate that plant and equipment spending should grow by only about one-half the rate in 1989 that it did in 1988. And with housing levels under pressure to retrench, it is hard to find any sector that looks exceptionally strong. But even if real growth does slow to 2% to 2 1/2% this year, low unemployment and high capacity utilization should lead to some further acceleration in the inflation rate. And at least at the moment, it is still far from clear what progress will be made on the federal deficit. It is against that background that we have produced our recommendations for the refunding.

The Committee recommends that the following securities be sold at yield auctions to refund $15.1 billion maturing securities and raise $14.9 billion of new cash:

-- $9 1/2 billion 3-year notes due 2/15/92;
-- $9 1/2 billion 10-year notes due 2/15/99; and
-- $11 billion 30-year bonds due 2/15/2019.

After a lengthy discussion, the Committee voted for the above plan by 15-to-3 with 2 abstentions. Our discussions focused importantly on the size of the bond. All of the Committee felt that a significant increase in the long bond offering was warranted due to the strong retail demand in that area of the market. It was noted that there is an especially strong demand for longer term STRIPS from foreigners, individual savers and pension funds and that this demand is likely to continue.
In arriving at the $11 billion number we noted that a $2 billion increase from the previous auction is not unprecedented, (it had been done before in 1986) and it was natural to favor the 30-year bond over the 10-year because the yield curve is inverted. Therefore it is cheaper for the Treasury to borrow in the long end. The minority felt that $1/4-to-$1/2 billion less of bonds might be more in keeping with tradition and perhaps the Treasury.

For the remainder of the quarter the Committee recommends:

-- Sell $9.5 billion 2-year notes at 2 remaining auctions paying down $2.2 billion.

-- Sell $7.5 billion 5-year notes raising all new cash.

-- Sell $7.5 billion 4-year notes raising $1.5 billion.

-- Sell $9.25 billion 52-week bills at 2 remaining auctions paying down $.6 billion.

-- Sell $15.1 billion at each of the remaining 3- and 6-month Treasury bill auctions raising $3.8 billion new cash.

Summary of new cash needed for the Quarter

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refunding 3- and 6-month bills</td>
<td>3.8 billion</td>
</tr>
<tr>
<td>52-week bills</td>
<td>(.6)</td>
</tr>
<tr>
<td>2-year notes</td>
<td>(.2)</td>
</tr>
<tr>
<td>4-year notes</td>
<td>1.5</td>
</tr>
<tr>
<td>5-year notes</td>
<td>7.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>24.9</strong></td>
</tr>
<tr>
<td>Already raised</td>
<td>5.8</td>
</tr>
<tr>
<td>Estimated Foreign Add-ons</td>
<td>6.0</td>
</tr>
<tr>
<td><strong>Net Market Borrowing</strong></td>
<td><strong>$36.7 billion</strong></td>
</tr>
</tbody>
</table>

The Committee recommends a cash balance of $10 billion or 3/31/89.

For the second quarter, the Committee recommends continuing the coupon offerings at current levels that is:

7-year notes at $7.0 billion
2-year notes at $9.25 billion
5-year notes at $7.5 billion
4-year notes at $7.25 billion
The refunding is projected at $29 billion one-year bills held at $9.25 billion and weekly bills phased down to the $14.4 billion level. The cash balance at June 30, 1989 would be $20 billion.

Mr. Secretary this Committee has traditionally held special meetings to consider longer term financing strategies for the Treasury. In view of the questions raised by the market demand for STRIPS and long-term securities such a meeting may well be in order. If you so desire, we would be pleased to do so in conjunction with the PSA's Spring Meeting at the Greenbrier in late April. This concludes our report and we welcome questions and discussion.

Donald B. Riefle
Chairman
REPORT TO THE SECRETARY OF THE TREASURY
FROM THE U.S. GOVERNMENT AND FEDERAL
AGENCIES SECURITIES COMMITTEE OF THE
PUBLIC SECURITIES ASSOCIATION
May 2, 1989

Dear Mr. Secretary:

In the period since our last meeting, inflation -- especially at the producer level -- has accelerated even more than market pessimists had been expecting at the start of this year. Only in recent weeks have the resulting inflationary concerns been offset by a growing conviction that the long-awaited economic slowdown is finally occurring.

The surge in oil prices has obviously been a major contributor to the pickup in inflation, but it is not the only one. Prices of raw industrial materials in general have been quite strong in the past few months. Moreover, there has been increasing speculation that wages could begin to drive inflation later this year rather than merely respond to it. So far, however, there has been no real evidence that this has started to happen, despite the new lows registered by the unemployment rate. Indeed, the March CPI increase of 0.5% suggested that the acceleration in inflation has been largely contained within the food and energy sectors.

At the same time, the economic data for February and March have shown widespread evidence of slowing in real economic growth from the strong January reports. The significance of the slowing in employment is still subject to debate, given the accompanying drop in the unemployment rate in the most recent figures. But the pattern in retail sales (particularly autos), durable goods orders, housing starts, and industrial production has clearly been one of deceleration. As a result, the Federal Reserve seems content for now to maintain the federal funds rate at around 9 7/8% and to leave the discount rate at 7%. This attitude on the part of the Fed is presumably reinforced by the dollar's continued firmness in the face of both concerted central bank intervention and the recent increase in official German interest rates.

In response to all of these developments, the yield curve in the Treasury market has become even more inverted than it was when we last met (although the inversion is currently less extreme that it was just a few weeks ago). Since January 31, 3-month bills have gone from 8.37% to 8.55%; 2-year notes, from 9.11% to 9.20%; and long-term bonds, from 8.84% to 8.97%. At no time during this period did long-term bond yields reach their peaks of last August despite the sharp jump in inflation.
Expectations for real growth during the rest of 1989 remain essentially as they were in January, i.e., around 2% to 2.5%. However, recent trends indicate that exports may run a bit stronger than expected while there are clearly downside risks in the construction area. As for inflation, the latest rise in oil prices effectively guarantees that it will be higher than projected, at least for the next few months. But with the oil market still volatile and supply disruptions in both the North Sea and Alaska presumably temporary, consumer price inflation could still be in the 5% to 6% range in the latter part of this year.

The big uncertainty regarding supply in the Treasury market for the remainder of this year relates to the funding of the thrift industry rescue package currently working its way through Congress. It is against this background that we have produced our recommendations for the May refunding.

The Committee recommends a refunding similar in composition to the February borrowing. This is importantly appropriate due to the uncertainties surrounding the REFCORP financing. The Treasury might give the wrong signal if the composition were changed. Nevertheless, we would reiterate that the market continues to have a better appetite for 30-year bonds than shorter term securities due to a continuation of stripping activity that is concentrated in long term issues.

The Committee recommends that the following securities be sold at auction to refund $17.3 billion maturing securities and raise $11.5 billion of new cash:

-- $9.75 billion 3-year notes due 5/15/92;
-- $9.5 billion 10-year notes due 5/15/99; and
-- $9.5 billion 29 3/4-year bonds due 2/15/2019

The reopening of the 8 7/8 due 2/15/2019 is appropriate because it would help liquidity by raising the size of the issue. Furthermore, its proximity to par at current market prices would make a reopening attractive to investors.

For the remainder of the quarter, the Committee recommends:

-- Sell $9.25 billion 2-year notes at each of 2 remaining auctions, paying down $2.4 billion.
-- Sell $7.75 billion 5-year notes, raising all new cash.
-- Sell $7.5 billion 4-year notes, raising $.6 billion.
Sell $9 billion of 52-week bills at each of 2 remaining auctions raising $.4 billion new cash.

Sell $13.0 billion at each of the remaining 3- and 6-month bill auctions paying down $14.7 billion.

Summary of New Cash Needed for Quarter

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refunding</td>
<td>$11.5 billion</td>
</tr>
<tr>
<td>3- and 6-month bills</td>
<td>(14.7)</td>
</tr>
<tr>
<td>52-week bills</td>
<td>.4</td>
</tr>
<tr>
<td>2-year notes</td>
<td>(2.4)</td>
</tr>
<tr>
<td>4-year notes</td>
<td>.6</td>
</tr>
<tr>
<td>5-year notes</td>
<td>7.7</td>
</tr>
<tr>
<td>Total</td>
<td>3.3</td>
</tr>
<tr>
<td>Already paid down</td>
<td>(3.3)</td>
</tr>
<tr>
<td>Estimated Foreign Add-ons</td>
<td>6.0</td>
</tr>
<tr>
<td>Net Market Borrowing</td>
<td>$6.0</td>
</tr>
</tbody>
</table>

The Committee recommends a cash balance of $34 billion on 6/30/89.

For the July/September quarter, the Committee recommends a continuation of coupon offerings at the same level as are contemplated in the April/June quarter. Regular weekly bills would be increased back to the $14 billion level, as needed. The cash balance at 9/30/89 would be targeted at $24 billion.

Our projections for both quarters assume that the cash need projections outlined in the Treasury presentation are maintained. If the higher revenues indicated by the most recent data prove to be long lasting, the Committee suggests that coupon offerings in coming months should be reduced by 1/4 to 1/2 billion dollars each and that the projected increase in Treasury bill offerings in the July/September quarter be delayed, in order to prevent cash balances from escalating to unneeded levels.

Mr. Secretary, let's turn to the REFCORP financing recommendations. The Committee feels that to get the lowest cost financing for REFCORP bond sales, the securities should be designed and merchandised to appear to be similar to Treasury bonds. To accomplish this, the following actions are recommended:

-- bonds sold at yield auctions;
-- a regularized schedule should be planned;
-- the Federal Reserve should be Fiscal Agent;
bonds should be stripable on the Fed's book entry system;

the Fed should include REFCORPS when purchasing Treasury securities for open market account or repos;

they should be acceptable for T.T.&L.;

Treasury bond brokers should be asked to include REFCORPS on "Treasury run" quotes;

the Treasury should make it clear that interest payments are guaranteed by the U.S. Treasury and the corpus is defeased with Treasury securities; and

a ruling should be obtained to allow banks to underwrite REFCORPS.

As to the timing, it is our view that, looking forward, regularization could best be achieved by scheduling four issues a year -- approximately midway between the quarterly financings. This would allow the auctions to take place in the same week as the 7-year notes; i.e., the first half of January, April, July, and October. Unfortunately, the need for $10 billion in fiscal 1989 means that some deviation from this schedule will be necessary. Therefore, we propose that the first issue be auctioned as soon as feasible in July with another issue scheduled for September assuming $10 billion is required in fiscal 1989. Since this timing may prove unsettling to the market, the Treasury should seek authorization to offer bond anticipation notes as a temporary measure in order to allow bond auctions to be regularized into their quarterly slots as soon as possible.

The Committee considered the optimal size of the issues and recommends $5 billion per auction. While there is some concern that these auctions will be too large to achieve the narrowest possible spread over Treasuries for a new security, the size is pretty well mandated by the projected need for $50 billion over a 2 1/4 year period and by the view that four auctions a year will fit neatly into the Treasury's financing schedule.

We also feel that once the REFCORP name is established in the market, the size of these offerings could probably be raised to $6 or $7 billion, as needed. The Committee agrees that the maturity of the issues should be 30 years. They should be noncallable due to clear cost considerations but the Treasury should seek authority to repurchase the bonds in the market since under certain circumstances, it might be appropriate to retire the issues before maturity.
We believe that the Treasury should do a "road show" in order to publicize and explain the new securities to potential buyers overseas. The majority feels that this is a good idea in order to gain a positive acceptance of these new securities. A minority is either unsure about this or feels that it might be counter-productive and detract from the idea that REFCORPS are just another form of Treasury obligation.

Finally, the Committee suggests that the Treasury announce their intentions as soon as possible -- especially in light of the uncertainty about how the securities should be defeased. We believe that the Treasury should issue zero coupon securities directly to REFCORP in order to defease the principal payment. However, if market strips are to be used, it is important to permit the use of only Treasury securities with no substitutions allowed.

The Committee also considered but rejected the idea of a syndicate underwriting. We concluded that while this might help to sell the security, it would make them look more like Federal Agency securities and less like Treasury issues.

Mr. Secretary, this concludes our report and we welcome questions and discussion.

Donald B. Riefler
Chairman
Dear Mr. Secretary

When we met in early May, the evidence was beginning to accumulate that the U.S. economy was truly beginning to slow down. Coupled with the surge in the dollar that was then in progress, the signs of economic weakness allowed the markets to rally as they looked beyond the still-high inflation readings that persisted through the spring. And by the time that the dollar turned around in June, the economic data had convinced the Federal Reserve that a modest easing move was in order, thus ratifying the market-led decline in interest rates that had begun in March. More recently, the shift in the terms of the economic debate has become even more pronounced, as the latest inflation numbers have supported the view that pressures on prices may have peaked, while Chairman Greenspan spoke openly of the need to avoid a recession.

Since inflation concerns had so dominated the thinking of both the markets and the Fed earlier this year, the changing perceptions in this area are of particular significance. It now seems increasingly clear that goods prices are unlikely to add to inflation in the second half of the year: the trend in the intermediate-goods component of the PPI is distinctly down, the CRB index has continued to slide -- even oil prices have begun to decline -- and the dollar has at least temporary stabilized. That leaves labor costs as the major potential source of inflationary pressures. Yet the second quarter figures for employment costs still show no signs of any acceleration. And with labor markets likely to become at least somewhat less tight, the risks of a flare-up in wages appear considerably smaller than it did just a few months ago.

As for the economic data, the most recent figures have ironically been somewhat mixed just as discussions have been shifting from whether there is a slowdown in progress to how great are the dangers of a recession. All of the sectors that have generated the most concern -- autos, housing, and capital goods -- have in fact posted modest gains or at least shown some signs of stabilizing. Auto sales have responded positively to incentives in the first two 10-day periods of July; housing starts rebounded in June while sales of existing single-family homes rose as well; and durable goods orders eked out a small increase in June. That having been said, the outlook for the remainder of 1989 is still for growth of only around 2 percent with the risks still on the downside. With tax receipts coming in higher than expected, fiscal policy is, if anything, producing
more of a drag than originally anticipated. That leaves monetary policy as the only likely source of any additional policy stimulus for the economy between now and year-end. Whether growth stays around 2 percent or slips lower will probably turn on the balance between consumer spending, which has been on a continuing downtrend, and exports, which have held up so far this year better than had generally been expected.

The combination of a peaking in inflation and below-potential, real growth is likely to elicit further Fed ease over the coming months. In any event, that is what the markets are anticipating, as is clear from the current levels of rates. Although federal funds have slipped below 9.00 percent only in the past week, 3-month Treasury bills are currently trading at around 7.75 percent down from around 8.55 percent at the time of our last meeting. The yield on 2-year notes is currently 7.53 percent (vs. about 9.30 percent at the start of May), and that on long-term bonds, 7.83 percent (vs. 8.95 percent). Additional Fed ease would in all likelihood lead to some further steepening of the yield curve, especially since the market impact of the thrift-industry legislation is likely to lead to an increase in the supply of longer term securities. It is against this background that we have produced our recommendations for the August refunding.

Assuming the financing of the RTC is off-budget, the Committee recommends that the following securities be sold at yield auctions to refund $15.9 billion maturing securities and raise $13.5 billion of new cash.

-- $10 billion 3-year notes due 8/15/92;
-- $9.75 billion 10-year notes due 8/15/99; and
-- $9.75 billion 30-year bonds due 8/15/2019

For the remainder of the quarter the Committee recommends:

-- Sell $9.75 billion 2-year notes paying down $.85 billion.
-- Sell $8.25 billion 5-year notes raising all new cash.
-- Sell $9.75 billion and then $10 billion 52-week bills at two remaining auctions raising $1.3 billion new cash.
-- Sell $14.4 billion at each of the next four and then $14.6 billion at the following three weekly bill auctions raising $2.7 billion new cash.
Summary of Cash Needs for Quarter

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refunding</td>
<td>$13.5 billion</td>
</tr>
<tr>
<td>3- and 6-month bills</td>
<td>2.7</td>
</tr>
<tr>
<td>52-week bills</td>
<td>1.3</td>
</tr>
<tr>
<td>2-year notes</td>
<td>(.9)</td>
</tr>
<tr>
<td>5-year notes</td>
<td>8.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$24.9 billion</strong></td>
</tr>
<tr>
<td>Already paid down</td>
<td>6.0</td>
</tr>
<tr>
<td><strong>Estimated Foreign Add-ons</strong></td>
<td>3.1</td>
</tr>
<tr>
<td><strong>Net Market Borrowing</strong></td>
<td><strong>$22.0 billion</strong></td>
</tr>
</tbody>
</table>

The Committee recommends a cash balance of $25 billion on September 30.

The cash balance of $25 billion assumes a $5 billion additional cash need due to RTC borrowing from the Treasury.

For the October/December quarter, the Committee recommends raising the weekly bills to $15 billion each, the 1-year bills to $10 billion each, the regular coupon issues by $1/4 to $1/2 billion each and a long dated cash management bill due around the April tax date if needed. The appropriate cash balance for December 31 is $20 billion.

If the thrift legislation provides for on-budget financing and RTC needs $15 billion this quarter, it will be necessary to raise only another $10 billion over the earlier recommendation. This is because that proposal assumed a $5 billion RTC borrowing from the Treasury in the July/September quarter. The additional $10 billion should be raised by increasing weekly bills to $15 billion for the rest of the quarter; raising another $1 billion from the two remaining 52-week bill auctions; borrow an additional $1.25 billion in the 2- and 5-year note auctions; sell $4.35 billion long dated cash management bills.

Summary of Additional Cash Raised Over Previous Proposal

<table>
<thead>
<tr>
<th>Amount Auctioned</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$15 billion weekly bills</td>
<td>$3.4 billion</td>
</tr>
<tr>
<td>$10.25 and $10.75 billion 1-year bills</td>
<td>1.0</td>
</tr>
<tr>
<td>$10.5 billion 2-year note</td>
<td>.75</td>
</tr>
<tr>
<td>$8.75 billion 5-year note</td>
<td>.5</td>
</tr>
<tr>
<td>$4.35 billion Cash Management Bill</td>
<td>$4.35</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$10.0 billion</strong></td>
</tr>
</tbody>
</table>

Mr. Secretary, the Committee felt that the uncertainties about the method and the timing of financing the thrift legislation create an awkward situation in the market. We spent a considerable amount of time discussing the issue and we have some suggestions. First, assuming off-budget financing: at our
May meeting, we recommended that the initial REFCORP financing be limited to $5 billion in order to allow the market time to adjust to the new name. We still feel those concerns and yet are faced with the implicit need for $15 billion instead of $10 billion to be raised before the end of the quarter. In order to keep the initial financing at $5 billion, we suggest that REFCORP use its $5 billion line from the Treasury as indicated earlier and in addition explore the possibility of the issuance of $5 billion Bond Anticipation Notes. To allow for a more timely integration of REFCORP securities into the regular Treasury financing schedule, the BAN maturities should be phased into a regularized schedule of REFCORP bond financing, in fiscal year 1990 allowing the size of the auctions to increase as the market becomes more familiar with the REFCORP name.

Secondly, assuming on-budget financing, our recommendation is to rely mainly on the bill market for raising the additional funds this quarter. In subsequent quarters, we suggest that more of this financing be phased into the long-term coupon market including the quarterly refundings by raising the size of scheduled auctions. The reason for relying on the bill market initially is because we believe that in order to reduce uncertainties, the composition of the current refunding should not be dependent on the off/on-budget decision. After the refunding there is no good opportunity to raise significant additional amounts of new cash in the coupon market this quarter without creating a new coupon cycle.

Finally, we believe that in the press conference, the Treasury should clarify to the extent possible the off/on-budget alternatives; announce the fact that projected RTC needs have grown from $10 billion to $15 billion for this quarter; and finally, discuss the market implications of the pending legislation regarding the debt ceiling.

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

Donald B. Riefler
Chairman
Dear Mr. Secretary:

In some respects, we have come full circle since we met at the start of August. The day of our meeting, the Treasury market was experiencing a strong rally fueled by both a growing conviction that the U.S. economy was weakening rapidly and by the related expectation that further overt ease on the part of the Federal Reserve was imminent. As it turned out, however, the highs registered by government bond prices that day were not to be approached again until October 13, when the stock market suffered its worst one-day slide since the 1987 crash. In between, yields on long-term government bonds backed up by about 50 basis points as new economic data indicated real GNP growth in the third quarter was much stronger than it had earlier appeared to be and that there was therefore little incentive for any prompt easing move from the Federal Reserve. More recently, the numbers have once again begun to turn soft and it has become clear that monetary policy has indeed been eased at least modestly. Thus, the federal funds rate, which had been trading just marginally below 9.00 percent, when we met in August, has recently been hovering around 8.75 percent or slightly lower. Three-month Treasury bills were trading at 7.63 percent then vs. 7.78 percent now; 2-year notes were 7.46 percent vs. 7.85 percent; and 30-year bonds were 7.83 percent at the close on August 1, although they had touched 7.75 percent during the day; they are currently around 7.90 percent.

The dollar is also relatively little changed since our last meeting, when it was trading at 136.7 against the yen and at 1.865 against the deutschmark, having strengthened somewhat against the yen and weakened a bit against the mark. Along the way, of course, it had surged against both those and other currencies, only to be brought back down by some of the most intensive central bank intervention ever seen. Its relative firmness is all the more impressive given the significant increases in money market rates in both Germany and the U.K. earlier this month, as well as the sharp deterioration in the latest U.S. trade statistics.

Indeed, it is the possibility that the trade adjustment process may have at least temporarily run its course that raises the greatest concerns over the economic outlook for the remainder of this year and for early 1990. If the net export sector is no longer going to provide much stimulus to the economy, then growth will have to come from the domestic sectors. Yet none of these look particularly robust. Recent figures on durable goods orders suggest that the business investment boom of the last two years
may be over, while residential investment continues to be extremely weak. And although consumer spending rebounded substantially last quarter, much of the strength appears attributable to factors such as auto incentives, which are not present so far this quarter. (The very near-term outlook is also being affected negatively by the impact of hurricane Hugo and the San Francisco earthquake. However, the rebuilding from these disasters could produce some offsetting strength early next year.) In sum, real growth is likely to continue on the decelerating trend on which it has been for well over a year, implying quarterly increases in real GNP of only around a 1.5 percent annual rate beginning with the current quarter. If those projections are borne out, then inflation is likely to stabilize around the 4.0 percent to 5.0 percent range as measured by the CPI, particularly if oil prices retreat somewhat over the next few months in the face of slower consumption growth and strong OPEC production.

The risks to the above forecast seem to be on the downside as far as real growth is concerned. Last month's employment report raises the possibility that the manufacturing sector is weakening more rapidly than anticipated. And there is the danger that the latest volatility in the stock market will have a negative effect on consumer confidence, which could also be hurt by the ongoing softness in many real estate markets. Finally, the disruptions in the high-yield bond market -- although they are unlikely to have any direct effect on economic activity -- could become a factor were they to spread in an environment in which lower-than-expected real growth began to seriously undermine the cash-flow assumptions behind more of these securities. It is against this background that we have produced our recommendations for the November refunding.

The Committee recommends that the following securities be sold at auctions to refund $20 billion maturing securities and raise $10 billion of new cash.

-- $10 billion 3-year notes due 11/15/92;
-- $10 billion 9 3/4-year notes due 8/15/99;
-- $10 billion 29 3/4-year bonds due 8/15/2019.

We felt strongly that the 9 3/4- and 29 3/4-year issues should be reopened for the following reasons:

(1) The current issues are relatively small in size, in short supply, and therefore priced high in the market.

(2) Larger issues that would be created by reopening are needed to allow hedging of large mortgage, municipal, corporate, and quasi government issues.
(3) In view of the uncertainty as to offering dates, when-issued trading, etc., reopenings would allow the market to deal more easily with potential postponements of Treasury auctions.

For the remainder of the quarter the Committee recommends:

-- Sell $10 billion 2-year notes raising $.4 billion new cash.
-- Sell $7.75 billion 5-year notes raising all new cash.
-- Sell $9.75 billion 52-week bills at two remaining auctions raising $1.3 billion new cash.
-- Sell $9 billion cash management bills for payment November 30 due April 19, 1990, raising all new cash.
-- Sell $15.6 billion at each remaining 3- and 6-month bill auction raising $13.9 billion new cash.

Summary of New Cash for Quarter

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refunding</td>
<td>$10.0</td>
</tr>
<tr>
<td>3- &amp; 6-month bills</td>
<td>13.9</td>
</tr>
<tr>
<td>52-week bills</td>
<td>1.3</td>
</tr>
<tr>
<td>April 19 Cash Management Bill</td>
<td>9.0</td>
</tr>
<tr>
<td>2-year notes</td>
<td>.4</td>
</tr>
<tr>
<td>5-year notes</td>
<td>7.8</td>
</tr>
<tr>
<td>Total</td>
<td>$42.4</td>
</tr>
<tr>
<td>Already raised</td>
<td>13.0</td>
</tr>
<tr>
<td>Estimated Foreign Add-ons</td>
<td>2.1</td>
</tr>
<tr>
<td>Net Market Borrowing</td>
<td>$57.5</td>
</tr>
</tbody>
</table>

In addition, a $10 billion cash management bill maturing December 21, 1989, auctioned for payment November 15 is recommended in order to bridge cash balance low points in mid-November and early December.

For the January/March quarter, the Committee suggests maintaining auctions for coupon securities, 1-year bills and the refunding at the same level as proposed for the October/December quarter. According to our calculations, regular 3- and 6-month bill auctions could be phased down to $15 billion as the quarter progresses.

The Committee recommends cash balances of $30 billion and $15 billion for December 31 and March 31, respectively. We raised the quarter-end cash balance targets in order to maintain a cushion in case the RTC chooses to use its $5 billion line from the Treasury.
The Committee recommends that the next REFCORP issue be sold in early January. We feel that it would be best to reopen the existing 30-year bond to create a larger, more liquid issue. The size should be $5-$7 billion. If it is not feasible to reopen because of a large move in price, we believe a 40-year issue would be appropriate. The consensus was that market demand would cause such an issue to be auctioned at a lower yield than that of the existing 30-year at the time of the auction.

The Committee examined several scenarios that might occur due to the debt ceiling problem:

Scenario No. 1
Congress raises the debt ceiling immediately.

Treasury announces financing plans as usual today, when-issued trading begins, coupon auctions are held on November 7, November 8, and November 9, with a cash management bill auctioned November 9.

This would minimize market disruption and be least expensive for the Treasury.

Scenario No. 2
Congress raises debt ceiling Friday, November 3.

Treasury announces tentative financing plan today (no WI trading) confirms schedule outline above Monday morning, November 6 when-issued trading can begin.

Treasury would lose two days of when-issued trading but disruption would be minimal.

Scenario No. 3
Congress raises debt ceiling Wednesday, November 8 dictates two possible courses:

Solution A.

Wednesday, November 1 - Treasury announces tentative financing plan (no when-issued trading).

Thursday, November 9 - Treasury announces new schedule (WI trading begins) schedule follows.

Thursday, November 9 - Sell $15.6 billion 3- and 6-month Treasury bills for same day settlement.
Friday, November 10 - Sell $10 billion 3-year notes plus $10 billion December 21 cash management bills.

Monday, November 13 - Sell $10 billion 10-year notes plus $15.6 billion 3- and 6-month bills.

Tuesday, November 14 - Sell $10 billion 30-year bonds.

Solution A severely restricts when-issued trading but maintains November 15 as a payment date so that current holders of maturing issues may roll over into new coupon securities.

Solution B.

Wednesday, November 1 - Treasury announces tentative plan. No WI trading.

Thursday, November 9 - Treasury announces new schedule (WI trading begins).

Thursday, November 9 - Sell $15.6 billion 3- and 6-month Treasury bills for same day delivery.

Friday, November 10 - Sell $30 billion cash management bills payable November 15 due November 22.

Monday, November 13 - Sell $15.6 billion 3- and 6-month Treasury Bills.

Tuesday, November 14 - Sell $10 billion 3-year notes plus $9 billion December 21 cash management bills.

Wednesday, November 15 - Sell $10 billion 10-year notes.

Thursday, November 16 - Sell $10 billion 30-year bonds plus $9.75 billion 52-week bills.

The last three coupon issues would all be payable on November 22 when $30 billion cash management bills mature.

Solution B would allow for a longer when-issued period but would not enable holders of November 15 maturities to roll over into new coupon issues.

As you can see, both solutions require an unprecedented amount of financing for such a short period of time and surely will have a negative impact on the Treasury securities market.
The Committee voted 14-4 in favor of Solution A, feeling it would be preferable to condense the when-issued trading period but enable investors to roll over November 15 maturities rather than vice versa which would be contemplated in Solution B.

Mr. Secretary, this concludes our recommendations but I want to express our strong view that the various disruptions contemplated in this report will increase the cost of financing to the Treasury. The longer the disruptions the greater the cost. We believe that the disruptions that have already occurred have been costly. There is no way of being precise about these costs but 20 basis points in yield on a regular 3- and 6-month bill auction is equivalent to $12 million. We have calculated that the addition of just five basis points to the cost of coupon financing during the month of November would be $250 million or about $50 million per basis point. This fails to take into account the effect on Treasury bills or associated federal agency financing costs which surely would also be affected. We urge you to express this view to Congress. We stand ready to answer your questions and discuss our recommendations.

Donald B. Riefler
Chairman