Department of the TREASURY NEWS



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REMARKS BY THE HONORABLE ANTHONY M. SOLOMON
UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS
BEFORE THE
PUBLIC SECURITIES ASSOCIATION
MARCO ISLAND, FLORIDA

I am pleased to have this opportunity to talk with you about the management of the public debt. I will also comment on the Treasury's concerns with futures contracts based on Treasury securities. Then, I would like to share some thoughts with you on recent international developments.

Debt Management

It is certainly obvious to all of you that Treasury financing demands have had a major impact on the credit markets in recent years. In the fiscal years 1977 and 1978 alone the net borrowing requirement of the Treasury amounted to about $113 billion. Of that amount, the Treasury raised about $84 billion of new cash through financing in the credit markets. The bulk of this financing was conducted in a period of rising interest rates.

In managing such a large financing task, this Administration has benefitted greatly from the debt management policies which evolved in recent years, and we have tried to adhere to three basic principles in our debt management decisions:

First, to raise the money required to meet the Government's financing requirements in the most efficient manner possible.

Second, to conduct our borrowing in a way that fosters, rather than inhibits, economic stability and sustained growth of the economy.

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Third, to work toward a balanced maturity structure, in order to facilitate the orderly managing of the debt in future years.

Consistent with these principles, we have financed our requirement over the past two years primarily by regular auctions of coupon securities and a gradual shift toward longer-term financing.

The regularized offering cycles of notes and bonds have made a vital contribution to the successful efforts of the Treasury in meeting our large financing needs. These cycles provided the Treasury with regular access to the various maturity sectors of the market, and allowed investors to plan on these predictable offerings for their investment needs. We think that regularization has encouraged broader investor participation in the Government securities market and has contributed to price stability through a reduction of market uncertainty concerning our financing plans. We anticipate that the cycle offering approach will continue as an integral part of our debt management strategy.

Another marketing device that has facilitated the efficient issuance of Treasury coupon securities has been the auction technique. By allowing investors and speculators to determine the price of regular, moderately-sized issues of Treasury securities at competitive auction, we have minimized financing costs and reduced the underwriting pressures on primary dealer organizations.

Under this Administration, the Treasury has emphasized debt extension as a primary objective of debt management, a policy which we believe to be fundamentally sound. During the last two fiscal years, Treasury's market borrowing via coupon securities totaled $84.8 billion, while, at the same time, there was a slight paydown in Treasury bills. Thus, we have avoided adding to the liquidity of the economy at a time when excessive liquidity is being transmitted into increasing prices.

This policy of debt extension has also caused a significant increase in the average maturity of the debt, reversing a prolonged slide which extended over more than 10 years. In mid-1965, the average maturity of the privately-held marketable debt was 5 years, 9 months. By January 1976, it had declined to 2 years, 5 months, because huge amounts of new cash were raised in the bill market and in short-term coupon securities. Since that time, despite the continuing large needs for cash of the Federal Government, Treasury has succeeded in lengthening the debt to 3 years, 3 months currently.

Debt extension has been accomplished primarily through continued and enlarged offerings of long-term bonds in our mid-quarterly refundings. In this Administrations's first refunding, in February 1977, Treasury offered $750 million of 30-year bonds. In our most recent mid-quarterly financing, Treasury offered $1.5 billion of 30 year bonds. The market's acceptance of Treasury bonds had developed rapidly; and the importance of the longer maturity area has been recognized by Congress by providing additional bond authority, which should be sufficient until next spring.

We have also used this new bond authority in the 15-year area, beginning in June 1977 when the Treasury offered $1.5 billion of 15-year bonds. This offering was substituted for a 5-year cycle note and thus represented an interruption in the pattern of 5-year note offerings which was initiated in January 1976. From June 1977 to June of this year, we alternated between 15-year and 5-year offerings on a quarterly basis.

In September, the Treasury offered $1.5 billion of 15-year bonds at a time when market participants might have expected an offering of 5-year notes. In addition to the fundamental objective of accomplishing further debt extension, there were two immediate reasons for this decision. First, our very large cash balance rendered unnecessary the additional cash-raising potential of the 5-year note. Second, market conditions at the time of the decision were particularly favorable for a 15-year bond issue. There had been a significant decline in long-term rates in the several weeks prior to the offering announcement, which reflected strong investor demand coupled with an absence of a meaningful supply of longer-dated securities.

It perhaps would be premature to conclude that the recent 15-year bond offering necessarily indicates a shift to a quarterly cycle with this maturity. As our market borrowing needs subside, however, as we continue to move toward smaller budget deficits, the likelihood of such a quarterly cycle is greatly enhanced.

As I mentioned earlier, we are aiming at a more balanced maturity structure in order to facilitate efficient debt management in the future. In this regard, we are aware of a tendency toward some unevenness in our maturity structure for coupon issues. In 1979, for example, the total amount of privately-held coupon obligations maturing in the second quarter is $9.1 billion, as compared to $19.3 billion maturing in the fourth quarter. This imbalance has arisen partly because of the seasonality of tax receipts combined with our policy of regularized coupon offering cycles. On the one hand, tax collection dates in April and June have reduced Treasury's borrowing requirements or even permitted us to pay down marketable debt in the second quarter. Our coupon issues maturing in that quarter, therefore, have merely been rolled over. On the other hand, our borrowing requirement in other quarters has caused enlarged coupon offerings in those periods.

This situation suggests an increasing use of longer-dated cash management bills. The sale of cash management bills in the fourth and first quarters, respectively, with maturities in the second calendar quarter would remove some of the burden on coupon offerings during the earlier quarters. This temporary financing could then be replaced by permanent financing through additions to coupon offerings in the second calendar quarter. This approach, which has often been used by Treasury in the past, acknowledges the large difference in the quarterly flow of tax receipts and represents an effort to distribute the maturity structure more evenly.

Let me conclude this part of my remarks by mentioning that on November 2, 1978, the Treasury will implement the Treasury Tax and Loan Investment Program. In May, the Department issued the regulations setting forth the provisions of the Program.

With the implementation of the Program, the Treasury will return to a cash management strategy aimed at maintaining a fairly constant balance at Federal Reserve Banks. This had been our practice prior to the fall of 1974. At that time, the constant Fed balance was being targeted at approximately $2 billion, and the swings in the total cash balances were absorbed by the tax and loan balances. An average of about 20% of the Treasury's operating cash was held in Federal Reserve Banks and an average of about 80% was held in the tax and loan accounts. Since 1974, that proportion has just about reversed. During the initial stages of the new Program, we will move gradually toward reducing our balances at Federal Reserve Banks and increasing our investments in obligations of depositaries.

A significant market effect of the Program is that it will reduce the sudden large changes in Treasury balances with the Federal Reserve Banks, and there will be a corresponding reduction in the need for offsetting open market operations by the Fed.



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Futures Market

I would like to turn now to a number of concerns that the Treasury has with respect to futures markets which are based on Treasury securities.

I am sure you are all familiar with the explosive growth in these markets over the past two years.

Futures trading based on Treasury securities began in January 1976 with futures contracts for 13-week Treasury bills on the International Monetary Market (IMM) of the Chicago Mercantile Exchange. Then, trading in Treasury bond futures began in August 1977 on the Chicago Board of Trade. More recently, in September 1978, futures trading began in 1-year Treasury bills on the IMM. Also, a number of new proposals are now being considered by the Commodity Futures Trading Commission for additional futures contracts based on Treasury debt instruments.

I think it is fair to say that the volume of trading in the Treasury bill futures market and the proliferation of new futures contract proposals based on Treasury securities are much greater than anyone anticipated when Congress first authorized futures trading based on financial instruments in an amendment to the Commodity Exchange Act in 1974.

Current Congressional concern about this explosion in financial futures is expressed in Public Law 95-405, which amended the Commodity Exchange Act and was signed by President Carter on September 30, 1978. This new law requires the CFTC to submit to the Treasury Department any applications from a board of trade for designation as a contract market involving transactions for future delivery of any security issued or guaranteed by the United States or any agency thereof. The Act also requires the CFTC to consider the impact that such contract market designations might have on the "debt financing requirements of the United States Government and the continued efficiency and integrity of the underlying market for government securities."

The Treasury's concerns with futures contracts based on United States Government securities were discussed at length in connection with the Congressional hearings earlier this year on the bill just signed by the President. Today, I will just comment briefly on some of our concerns from the standpoint of Federal debt management policy.

The Treasury has not opposed the designation of contract markets involving Treasury bills. We have carefully monitored developments in the bill futures market since its establishment in 1976, and we have not seen any evidence that this market has benefitted the Treasury. However, we have not found sufficient cause to recommend suspension of trading in existing contracts or disapproval of new contract designations.

We have expressed a number of concerns, however, with respect to contract market designations involving Treasury coupon securities. Unlike Treasury bills, which are highly liquid short-term instruments and are actively traded throughout their lives, Treasury notes and bonds are longer-term securities which are typically put away in portfolio by permanent investors. Treasury relies on these investors to finance the major portion of the public debt. As these coupon securities are placed with them, there is a diminution of secondary market trading and in the availability of securities for delivery. We are concerned, therefore, that market prices on outstanding Treasury coupon securities, and thus prices on Treasury new issues, could be adversely affected by a large volume of trading in any futures contracts based on Treasury coupon securities.

Also, it is essential that the Treasury maintain the flexibility to finance the public debt at the lowest possible cost consistent with the fiscal requirements of the Government and the needs of the economy. In this regard, Treasury's flexibility could be reduced by the establishment of a futures market which is heavily dependent upon an expected new issue by the Treasury. Clearly, in establishing new markets for futures contracts in Treasury notes, it should not be assumed that the regular issuance of Treasury cycle notes will continue in its present pattern. As I mentioned earlier, just last month the Treasury substituted a 15-year bond issue for the usual 5-year cycle note. While many market participants had expected a 5-year note issue, we did not have to deal with an established futures market in 5-year notes, and we were able to accomplish this change on short notice with minimum market impact.

Treasury debt management flexibility could also be reduced by the existence of futures markets dependent upon the ready availability of outstanding Treasury coupon securities. For example, the Treasury has at times engaged in advance refundings of outstanding Treasury issues, and the Treasury also gave serious consideration recently to purchasing certain outstanding issues to relieve congestion in certain maturity areas of the market. Such debt management operations by the

Treasury could result in the unexpected withdrawal from the market of certain securities, or groups of securities, which constituted part or all of the anticipated deliverable supply in the futures market.

The Treasury would certainly welcome the establishment of futures markets in coupon securities if we felt that these markets would benefit Treasury financing. We are concerned, however, that these markets may do more harm than good from the standpoint of the efficient financing of the public debt.

I raise these concerns with the hope of encouraging your expert consideration of them. I know that many of you are active participants in the Treasury futures market and in the Treasury cash market as well. We would welcome any thoughts that you might have.

Recent International Developments

I would like now to comment on international economic and financial developments which have an important bearing on the public securities markets in the United States.

The principal developments in the international financial area in the past two years have been the very substantial reduction in the OPEC current account surplus, and the emergence of major payments imbalances among the industrial countries leading to strong exchange market pressures as the foremost problem facing the international monetary system. My expectation is that the OPEC surplus will continue to decline and that it will not be a major disruptive factor next year. I also expect that we will see signficant improvement in payments relationships among the industrial countries and increased monetary stability next year. Both of these developments would imply a reduction in foreign official purchases of U.S. Government securities in 1979.

The OPEC countries accummulated investible surpluses amounting to nearly $180 billion during 1974 - 1977, an average of $45 billion per year. This year, it is likely to be less than half the $34 billion recorded in 1977, and may decline by as much as $10 billion more next year in the absence of an oil price increase. As the OPEC surplus declines, management of OPEC's investment portfolio is becoming increasingly constrained by decisions and commitments made in earlier years, including bilateral and multilateral aid, and commitments to balance of payments financing through IMF arrangements such as the Supplementary Financing Facility which will take effect shortly. Such constraints have required a curtailment of OPEC's discretionary investments elsewhere, including the United States, which has traditionally accounted for some 20 - 30 percent of total OPEC placements. There was no significant increase in OPEC investment in the United States during the first half of 1978. In fact, there was a small decline in OPEC holdings of Treasury securities, although there were increases in other forms of U.S. assets. Preliminary evidence for the second quarter suggests no increase in OPEC's financial assets worldwide; there is no evidence of a shift by OPEC from dollar investments.

If our projections are in the right range, new OPEC discretionary investments in the United States -- or any other market -- are likely to be quite small.

The emergence in 1977 of a very large U.S. current account deficit, with attendant downward pressures on the dollar, and foreign intervention in an attempt to temper appreciation of certain currencies, has tended at times to create very large flows of foreign official capital into the U.S. Government securities market.

In the first quarter of this year, the dollar remained under heavy pressure in the foreign exchange market as the trade deficit mushroomed to an annual rate of $45 billion, and as concern mounted about our ability to achieve a better balance in the face of rising inflation, extended Congressional debate on an energy program and continued divergence of growth rates here and abroad. Foreign exchange market intervention during the quarter led to further increases in foreign holdings of Treasury securities of some $15 billion.

The situation changed sharply in the second quarter. With the trade and current deficits beginning to improve and the dollar showing signs of strength in the exchange markets, the direction of intervention was reversed and foreign holdings of Treasuries fell by some $5 billion. We do not yet have a complete picture of the third quarter, but it appears that there was no appreciable change in foreign holdings of Treasury securities.

What are the prospects for the coming year? We have just gone through an intensive round of discussions at the IMF/IBRD annual meetings. There is quite clearly a convergence of views in the official financial community that a significant improvement in the international payments situtation -- and particularly that of the United States -- is in prospect. This outlook is based in part on expectations about future policy moves here and abroad. But it is also based in substantial part on steps that have already been taken, and which are now beginning to yield concrete results.

First, we can anticipate a shift in the relative rates of growth of the United States and its major trading partners. Our growth rate next year should be at rates compatible with the expansion of productive activity. At the same time, growth rates in Europe and Japan will pick up somewhat under the impact of domestic stimulus measures. Whereas the U.S. growth rate has been well above the average growth of our major trading partners, in 1979 Europe and Japan should show more rapid growth than the U.S. for the first time since the 1975 global recession.

Second, the U.S. competitive position has improved sharply in terms of our major competitors as a consequence of exchange rate changes over the past 18 months. On a trade weighted, price adjusted basis, the U.S. competitive position has improved by some 5 - 10 percentage points since early last year in terms of our major trading partners.

These changes in growth rates and exchange rates are now beginning to affect trade flows, though the real effects continue to be obscured by the immediate price effects of exchange rate changes. Following a solid year of very rapid expansion, the volume of U.S. non-petroleum imports has been slightly down since February. And since about the beginning of the year, U.S. exports -- particularly non-agricultural but also agricultural exports -- have been moving up sharply.

The major effects of these changes in growth and exchange rates are still ahead of us. Thus, we expect further improvement in the U.S. trade position and a substantial reduction -- perhaps on the order of 30 - 40 percent -- in our current account deficit next year. This obviously is a welcome development, and will represent a major contribution to greater international financial stability. But as I mentioned earlier, part of the relatively positive outlook of the Finance Ministers at the IMF was based on expectations about future policy moves. And at this particular point, that largely means moves by the United States.

It is recognized abroad that a major part of the U.S. trade problem lies in the energy sector, and it is accepted that we are at last moving to deal with this problem. It is also recognized that the United States needs to exploit export opportunities more vigorously. Here too, we are embarking on a program to improve our performance.

But what is stressed uniformly is the critical need for the United States to come to grips with its inflation problem and -- more than any other factors I have mentioned -- our policies and performance in this area will determine the outlook for the international financial situation and the dollar.

The President will shortly announce a comprehensive new anti-inflationary program to supplement -- not substitute for -- broad fiscal and monetary restraint with direct measures in the wage and price area. As we have unequivocally indicated on many occasions, we have no intention of imposing wage-price controls. But we do need more rigorous and quantitative standards of behavior in the wage-price area, and the application of those standards will be very broad, with a minimum of exclusions. The wage-price standards are just one of a number of initiatives intended to bring more responsible management to Government in order to deal more effectively with the fundamental underpinnings of inflation.

Without dwelling on the program, I would emphasize that the Administration is determined to pursue a tight and effective fiscal policy. I am sure that you will agree that our efforts are being channeled in the right direction. In fiscal year 1976, the budget deficit was $66 billion. Last year -- under the first budget proposed by President Carter -- the deficit was reduced by $16 billion. For this fiscal year, we intend to cut the deficit by at least another $10 billion. And it is the President's intent to make a further major cut in fiscal year 1980. Our budget policy is designed to reduce Government competition with the private sector for real and financial resources. This policy can only be accomplished by holding Federal expenditures to very little real growth during the next two years. We recognize that, among our anti-inflation efforts, we will be judged most importantly by our critics on this Administration's commitment to fiscal prudence.

On the basis of the policy measures in prospect and the already partly visible results of policies undertaken to date here and abroad, I believe there is a good prospect for a significant improvement in the international payments and financial situtation -- and in the U.S. external position. In this framework, I would anticipate more stable patterns of private capital flows into the United States and, with greater exchange market order, less foreign official acquisitions of dollars in the exchange markets. Combined with very limited amounts of investible funds in OPEC hands, the prospect is, therefore, for substantially less foreign official interest in U.S. Government securities in the coming year.

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