

Research Department Federal Reserve Bank of San Francisco

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Treasury Prospects

The big news on the Treasury front is the lack of heavy financing needs. Normally, in the second half of the calendar year, the Treasury makes very substantial demands on the securities markets. Last year, it was \$16 billion, and the year before, \$21 billion. This year, in contrast, the Treasury is likely to play only a modest role in the markets, largely as a consequence of its much-improved budgetary position.

Fiscal 1973 wound up with a \$14-billion deficit, but the budget was within \$2 billion of balance in the January-June period, and the Administration actually plans to balance its books in the new fiscal year. Inflation is a notably successful tax collector, given the progressivity of our income-tax structure, and thus the budget benefitted in recent months from an unanticipated inflow of tax revenues, brought about by the inflationary boom in income and profits.

Another contributing factor was the Administration's success in holding expenditures well below the \$250-billion ceiling set in January. Labor Department outlays were close to \$1.0 billion below the January estimate, because of unexpectedly low spending for unemployment benefits; defense spending was below estimate by roughly the same amount, because of reductions in personnel and operations; and HEW outlays were \$1.6 billion below estimate, because of unanticipated reductions in spending for social services and coal miners' "black lung" benefits.

Foreign buying

The Treasury's cash-management position benefitted not only from this upsurge in revenues, but also from the substantial increase in foreign purchases of U.S. Government securities early in the year. Following the international monetary turmoil in February and March, foreign central banks converted U.S. dollars obtained in dollar-support operations into Treasury securities, both marketable and nonmarketable. Foreign ownership of the publicly held debt thus increased by almost \$7 billion in February and by \$2 billion more in March. (These acquisitions were double the amount sold off by domestic commercial banks in their attempt to accommodate domestic loan demands.) For a brief period, foreign purchases resulted in a scarce supply of bills and hence a lower level of bill rates, but this situation then reversed itself as the exchange markets eased and as official foreign institutions began to sell off bills in large amounts.

Still, foreign participation in the Treasury securities market has increased substantially over time, as a consequence of the substantial increase in foreign dollar holdings caused by the steady succession of U.S. payments deficits, along with the increasing degree of international capital-market integration. Last year, foreign purchases accounted for \$8.4 billion of the \$14.6-billion increase in the privately held Treasury debt, or five times as much as the increase in debt holdings by the commercial banks. Altogether,

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the foreign share of the total privately-held public debt has jumped from 7 to almost 24 percent over the past decade.

Extending out

The Treasury opened its relatively light financing schedule for the current half-year period with a \$4.5-billion refunding, which was highlighted by the attempt to place a moderate amount of long-term securities into private hands. The refunding offer included \$500 million of a 7½-percent 20-year bond, along with \$2 billion in 7¼-percent 4-year notes and \$2 billion in 35-day tax-anticipation bills.

The long-term bond resulted in a yield to maturity of about 8 percent, but despite that yield only \$260 million of the issue was placed in private hands, partly as a result of investors' caution in this period of rapidly rising interest rates. The issue thus was not as successful as two earlier bond issues this year, which placed a total of \$1.3 billion in 20-25 year maturities.

Nonetheless, the Treasury recently has managed rather well to extend the average maturity of the public debt. In particular, by offering issues of modest size, it has avoided placing unreasonable demands on the long-term market. The improvement has been moderate—about a two months' increase in the average maturity of the debt—but at least it has reversed the prolonged downward trend which began about the

middle of the past decade. Between 1965 and 1972, the average maturity of the debt declined from 5 years, 4 months to only 3 years, 3 months.

The Treasury's efforts over the years to extend the average maturity have been partly stymied by the statutory 4¼-percent ceiling on the bond coupon rate, which of course has frequently lagged behind the market rate on Treasury bonds. The attempts to solve the problems created by that limitation have taken several forms.

In the early 1960s, the Treasury conducted several advance-refunding operations, by offering holders of Government securities the opportunity to exchange their holdings for longer-term Treasury issues. In 1967, Congress increased (from 5 to 7 years) the maximum allowable maturity on Treasury notes, which are not subject to the 4¼-percent coupon ceiling. In following years the Treasury relied increasingly on such note financing, since long-term Governments could be sold only at a prohibitive discount during that period of high-interest rates. Then, in 1971, Congress ruled that the Treasury could offer up to \$10 billion in bonds outside the 4¼-percent ceiling-rate limitation, and that set the stage for this year's offering of three long-term issues.

Looking ahead

With the August refunding out of the way, Treasury demands on the capital markets are expected to be

light for the remainder of the year, especially in view of the boom-related upsurge in tax revenues. The only major refunding on the schedule is a \$4.3-billion bond maturing in mid-November. The lack of Treasury demand thus should ease the market pressures from this source.

In contrast to the Treasury's relatively easy position, the field is littered with a large number of major offerings by Federal agencies. For example, the Federal Home Loan Bank System has recently announced plans for a \$1.8 billion offering, on top of the \$3.4 billion raised in three major offerings in the first half of the year. (Looming large in this offering is the 9½-percent \$700-million issue maturing in February, which is certain to compete with Treasury bills.) Long-term agency issues at the end of July were yielding 30-40 basis points more than long-term Governments. This spread has narrowed recently, however, and the new 20-year Treasury issue may cause the spread to narrow even further.

The corporate-bond market has been having problems recently, even though there has been a scarcity of new issues in the market for most of the year to date. Corporate prices fell sharply after the Treasury announced plans to offer its 20-year issue; some Aa and Aaa utility issues fell 5 to 6 points in July and early August, resulting in yields as high as 8.44 percent. Moreover, despite the scarcity of new supply,

the corporate market is increasingly sensitive to the rapid rise in short-term rates, exemplified by increases of close to ½ percentage point in commercial-paper and CD rates in a single week in late July. In addition, the recent rise to 9¼ percent in the bank prime-loan rate suggests the extent of the continuing pressures on the business borrowing side.

The recent bond-market slump cannot be explained in terms of market demand, in view of the fact that Treasury and corporate requirements are so small at present. Rather, short-term rates now exceed long-term rates far more than in earlier tight-money periods, and thus provide an attractive reward to investors who temporarily wish to invest in the short-term end. In addition, increasing disintermediation has forced thrift institutions and life-insurance firms to sell both long-term and short-term securities to meet their commitments, including mortgages for the S&L's and contractual policy loans for the life insurers. Heavy commercial-bank lending to industrial firms and more recently to the liquidity-hungry nonbank institutions also has created market pressures, since it has forced the banks to sell off their Governments and aggressively seek out CD funds. Above all, inflationary expectations have by now become well entrenched in the calculations of both lenders and borrowers, thereby creating pressures for higher rates and lower security prices.