

COMMENTARY

One important issue that has not been discussed today concerns the mechanisms and goals of enhanced liquidity in the Treasury market. In particular, can enhanced liquidity have spillover effects in all fixed-income markets? Market participants who trade U.S. Treasuries will feel more comfortable venturing out into other markets, which will improve market liquidity. So the ramifications are not just for the Treasury market, but for all fixed-income markets. I think this is an important point that we need to highlight.

The paper by Paul Bennett, Kenneth Garbade, and John Kambhu has made a number of interesting findings. In addition to discussing this paper, I want to talk more generally about the role of the U.S. Treasury market as I see it from the dealer community.

The first issue I would like to focus on is STRIPS fungibility. Here, I have a couple of points to make. First, when one considers the size of the ten-year note and its current reopened form, at about \$22 billion, one realizes that the marginal supply of new ten-year notes would be relatively small. As a result, reopening the ten-year note is not going to add appreciably to the supply of the rich, liquid benchmark. Unfortunately, as I will argue, at the same time there would be a negative ramification—given the Treasury’s current penchant for conducting reopenings, as opposed to having a regularly scheduled new issue every quarter—that could create distortions in the yield curve. Second, as was touched upon earlier, the whole reconstitution-fungibility issue would make

the total size of an outstanding issue uncertain at any given time. An unstable level of an outstanding size of an issue could potentially hurt liquidity.

I want to address this first point in some detail. Currently, the ten-year note matures in August 2009. The Treasury, in its most recent refunding auction, chose to reopen the August ten-year issue instead of issuing a security maturing in November 2009. Presumably, the Treasury plans to issue a new ten-year security in February 2010 that would mature in 2010. So what you have is holders of the August 2009 and February 2010 STRIPS feeling very comfortable that they can effectively tap into the liquidity of the ten-year sector through a reconstitution. Even if they do not conduct the reconstitution themselves, they know others can do it. The holder of a November 2009 STRIP, by comparison, has no such luck, since there will be no outstanding principal payment in the market. It is reasonable to say that a November 2009 coupon STRIP would trade 25 to 35 basis points cheaper than the two issues around it, creating a distortion in the yield curve. I do not believe that this is what the authors, or anyone else, have in mind when they propose these strategies.

I would like to digress a little bit here because, in terms of the fungibility issue, one thing that struck me as a very obvious mechanism that could greatly enhance overall market liquidity would be to make all bonds strippable. I believe that all bonds issued after 1984 are currently eligible to be stripped. As result, you have a whole crop of bonds, particularly high-coupon

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bonds, that perpetually trade cheap because they are not strippable. These bonds, which mature between 2002 and 2014, are liquidity-impaired because they cannot be stripped. Making them strippable would truly enhance the overall liquidity of the market because it would create a fresh supply of coupon STRIPS, which in turn would actually facilitate the reconstitution process.

As a final point on this topic, it struck me while considering the fungibility of coupon and principal STRIPS that there is a whole class of securities in the marketplace created by the dealer community during the 1982-85 period. I am referring specifically to CATS, TRs, and TIGRs. Believe it or not, these securities are still traded on the Street, but I can tell you without equivocation that they have traded with very poor liquidity, especially after the 1998 crisis. However, these financial instruments are Treasury obligations pure and simple. Like other Treasury obligations, they are AAA-rated. Furthermore, three or four years ago, the creators of CATS and TIGRs—like Salomon Brothers and Merrill Lynch—decided to change their agreements with the custodian banks to allow for, effectively, fungibility across the instruments. One could argue that making coupon STRIPS fungible with like-maturity CATS, TRs, and TIGRs would have a positive impact on Treasury liquidity. The ability to interchange these financial instruments would greatly enhance the overall liquidity of the market as well.

With regard to the two-year issue, I have just a few comments. I do not see the appeal of putting the two-year note at a mid-quarter funding (that is, mid-quarter of maturity date). From a stripping standpoint, there would be no demand for a STRIP of a recently auctioned security. Furthermore, there are plenty of old five-year notes, ten-year notes, and thirty-year bonds that have rolled down into the front end of the yield curve that would trade cheaper and would be eligible for stripping. I do believe, however, that the 104-week bill concept does have some merit for the reasons mentioned by the authors: enhancing liquidity and potentially providing the Treasury with better funding. Certainly, in conjunction with any kind of exchange facility, it is very clear to see the appeal there.

I would also like to discuss the exchange program. When Bennett, Garbade, and Kambhu talk about micro exchanges, it is my impression that what they actually are referring to on this micro level is the buyback proposal that the Treasury has talked about on a macro level. Considering the dramatic yield differences that exist in the market today, issuing ten-year and thirty-year securities and buying back twenty-year bonds is not very different from what the authors have talked about. In some sense, the Treasury already is thinking along those lines.

However, one very large problem with the program is that I do not see the Treasury willing to carry assets on its books that it is not issuing. The Treasury does not issue STRIPS. Instead, it issues coupon-bearing bonds that the Street then strips. I do not believe that the Treasury will want to have a liability that looks like a STRIP. One possible way around the premium accounting issue associated with buybacks would be for the Treasury to purchase debt in the market and, instead of retiring it, to place it in the Social Security trust fund.

In reading the exchange proposal, I found the 2.5 basis points to be a very modest amount for the Treasury to consider capturing. Frankly, if the Treasury was going to do something like that, I would recommend a significantly wider band because 2.5 basis points is too small an amount to induce the Treasury to get excited—particularly considering the fact that existing assets issued several years back, which effectively have a Treasury guarantee, do not trade 2.5 basis points cheap to the curve. Instead, these assets trade anywhere from 15 to 25 basis points cheap. Here, I am referring to Refcorps. Refcorps were issued around 1989 as second-generation savings and loan bailout bonds. The bonds carry a Treasury guarantee and trade significantly cheaper today than they did a year ago. The liquidity crisis of 1998 hurt Refcorps. Thus, if the Treasury wanted to consider “arbitraging” cheap securities effectively, I do not think that a spread of 2.5 basis points is anything to get excited over—especially since there are other significant opportunities in these markets that could save a lot of money for the Treasury and enhance liquidity at the same time.

I also want to turn to some of the comments made by Under Secretary Gary Gensler and other discussants. Despite rumors to the contrary, the Treasury market is still the benchmark market of fixed-income markets. It is where market participants go to hedge interest rate risks, whether for on-the-run Treasuries or futures contracts. I believe that this is not going to change tomorrow or in the near future. The steady supply of on-the-run securities, as has been alluded to, will assure the continuation of that status. Frankly, the benchmark status, which Gensler said may eventually move away from the Treasury market, has been beneficial to taxpayers and bondholders.

In addition, I would like to address the unique role that the thirty-year bond plays in the market. There are really three separate premiums, if you will, associated with issuance of benchmark securities: the repo premium, the liquidity premium, and the sector premium. I will focus on the ten-year and thirty-year sectors first. The repo premium is related to the fact that Treasuries trade tight in the repo market after they have been issued. In some cases, this premium can last up to a year and a half, especially for long-term securities such as ten-year notes and thirty-year bonds. Hence, the Treasury issues those

securities at a significantly lower yield than it would otherwise; this benefit to the Treasury comes to about 20 basis points in the ten-year sector and about 15 basis points in the thirty-year sector. The liquidity premiums are approximately 5 basis points. This means that because these benchmarks have better liquidity, people are willing to accept a lower yield, which is worth around 5 basis points.

The sector premium is a premium that typically is not talked about or recognized. This premium is particularly important in the ten-year and thirty-year sectors. In 1986, the Treasury discontinued the auctioning of twenty-year securities because it correctly recognized that the demand for this maturity was no longer there. The demand for ten-year issues exists primarily because a lot of foreign markets do not issue beyond the ten-year maturity. As a result, over the years ten-year securities have served as the benchmark for many international investors. By comparison, the demand for thirty-year bonds is there for long-duration players, who typically have long-duration liabilities. Moreover, the scarcity of comparable-maturity thirty-year paper, particularly of high quality, has also enhanced the demand for thirty-year bonds relative to that for twenty-year securities. Indeed, there truly are three separate premiums associated with Treasury securities. If the Treasury decides to reduce issuance in the ten-year or thirty-year sectors or to allow some other mechanism to replace the current Treasury benchmarking, it will effectively result in a large loss to taxpayers.

I would also like to point out the fact that the Treasury not only issues bills, notes, and bonds in conventional forms, but it also issues inflation-linked notes and SLUGS (that is, special State and Local Government Securities). I am not going to dwell much on the inflation-linked program. However, I would like to say that the premiums that I just mentioned, which exist for the ten-year and thirty-year sectors, are absent in inflation-linked notes. It is therefore a very inefficient way for the government to raise money, particularly in an era in which the government does not actually need it. Furthermore, SLUGS, which are issued essentially on a tap basis for deficit-financing programs, once again are priced a little bit like Treasuries but nothing like the on-the-run Treasury securities. So one could argue that perhaps the Treasury should discontinue those programs.

Finally, I want to talk briefly about the thirty-year sector because I think it is very important. I have already noted the scarcity of long-duration high-quality assets. If investors lend

you money for a long period of time, they generally want to know that you are going to be around for a while. Clearly, the Treasury plays a special role as an institution free of credit risk. This is particularly true in the STRIPS market. Consider the cycle of a security that does not get stripped in the first couple of years. As the security ages, it cheapens up and tends to get stripped when it is about twenty-five to twenty-seven years old because of the demand for long-duration assets. By the time the security rolls up the yield curve into the twenty-year sector, it typically starts getting reconstituted because people no longer need that duration; rather, they prefer to be further out on the curve. There is a natural inversion on the long end of the curve, and the thirty-year issue effectively takes advantage of it and the value accrues to the Treasury and the taxpayer.

Another point that I want to stress is that bond futures are really the biggest source of market liquidity, possibly aside from on-the-run securities. Any interruptions of the supply of thirty-year bonds potentially hampers the liquidity in the bond futures market, which may not be good for anyone involved in the fixed-income markets.

Perhaps as a cautionary tale we should look at the yield curve in the United Kingdom. There, the curve is very distorted relative to that of other European countries. One reason for this distortion is a real supply-demand imbalance in the long end of the curve because of recent pension law changes and requirements that have led to a dearth of supply. To be honest, I do not think that we would ever get to that extreme, with the absence of the Treasuries supply, but I believe that the U.K. experience could serve as a warning and illustrate the important role of the Treasury market. As an aside, the agency issues obviously are trying to usurp the Treasury issues' role as the benchmark. However, the agencies are not equipped to issue in the thirty-year sector because they do not have assets with durations approaching that of a thirty-year security. One might say that the agencies currently are being opportunistic in issuing thirty-year bonds. It is not clear whether they would actually continue to issue these securities over the long haul. Thus, from my perspective, the Treasury has a unique role to play.

In closing, I think that many of the ideas discussed here have a lot of merit. Perhaps with some tweaking and some enhancements, one could significantly increase or maximize the liquidity of the Treasury market. Maximizing liquidity in the Treasury market is coincident with minimizing the Treasury's long-term interest expense. I think it is in everyone's best interest to achieve that goal.

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