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MONEY MARKET INSTRUMENTS

October 16, 1987

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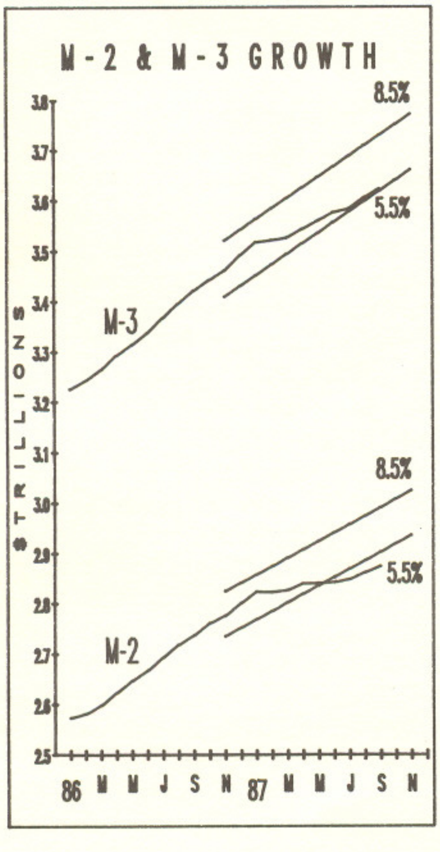


Long Bond Authority

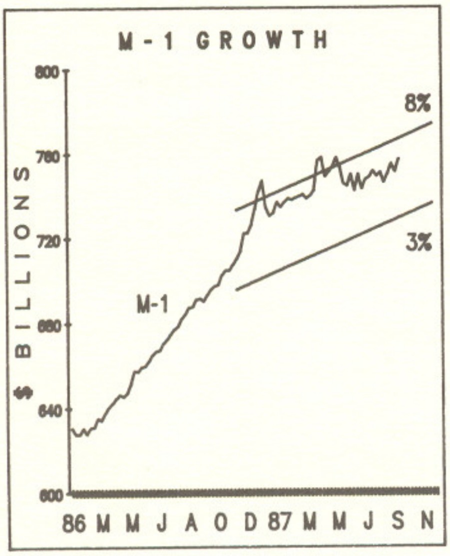
The U.S. Treasury's long bond authority is a little-known, rarely controversial proviso that limits the Treasury's ability to issue long term debt. Enacted by Congress more than two decades ago, the law was designed in a futile attempt to hold down interest costs to the U.S. government by limiting the interest rate that could be paid on long-term debt. Congress decided to make the payment of excessively high rates of interest on government debt illegal, which at the time of passage meant 4.25%. The long bond authority is similar to the law that places a limit on the overall level of government debt, currently set at $250 billion. "Long-term" debt is defined here as any debt with a maturity greater than 10 years.

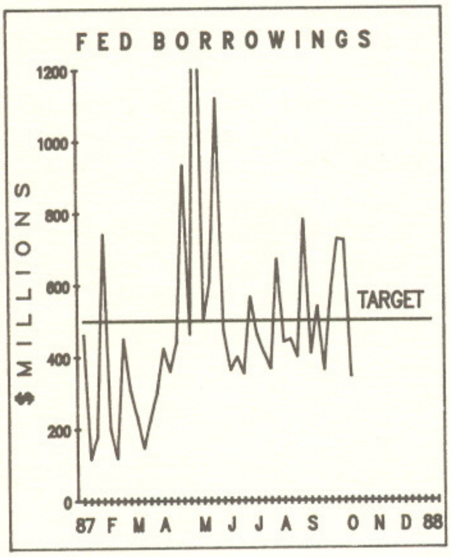
As recently as 15 years ago, the long bond authority limit was less than $10 billion; today, that is the size of a <u>single</u> long bond auction. The following is a complete history of the few changes enacted in the long bond authority in this decade:

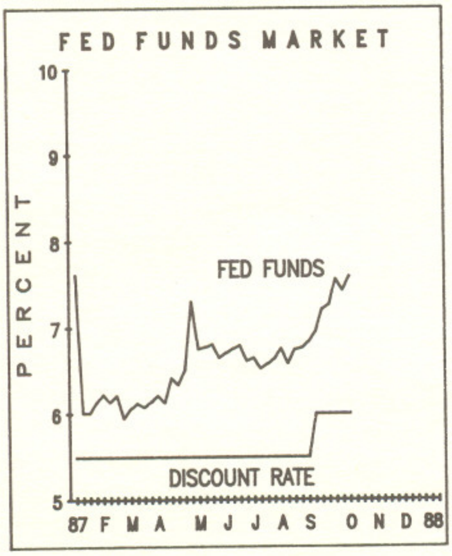
DATE	FROM	TO
4/7/86	$200	$250
5/25/84	$150	$200
5/26/83	$110	$150
9/3/82	$70	$110
10/1/80	$50	$70
9/29/79	$40	$50

Congress has typically raised the limit in quiet response to a Treasury request. In the August refunding of 1980, the Treasury was forced to scale back its 30-year bond issuance from the previously auctioned level of $2.0 billion to a more modest level of $1.5 billion. As can be seen from the table above, however, the Congress raised the long bond authority limit in October. The next refunding in November contained a full, $2.0 billion issuance of a new 30-year bond.

The most contentious experience in recent times with the long bond authority came in 1982. Although the February refunding went off as planned, an intended April offering of about $1.3 billion in 20-year bonds had to be cancelled. From there, the Treasury was forced to cancel one more 20-year auction, as well as the next two 30-year bond auctions. The markets went almost <u>eight</u> months without receiving any new government paper longer than a ten-year note. Auctions of







other instruments were subsequently increased, such as the ten-year, which was doubled from a $2.5 billion offering to $5.0 billion.

To resolve the 1982 long bond squeeze, then-Treasury Undersecretary Beryl Sprinkel requested that Congress repeal the limit altogether. A bill favoring that idea was attached to a bill then moving through Congress to raise the overall debt limit. It seemed a sure bet for passage, until public criticism caused Congressional supporters to back down. Eventually, a bill that simply raised the long bond authority was attached to a tax bill that was raising almost $100 billion in taxes. President Reagan was one of the tax bill's major supporters and he signed it apparently without misgivings.

Currently, we are approaching another long bond authority crisis, although despite the market's reaction, Treasury has not formally changed its auction schedule. The facts of the matter are simple: With the issuance of $9 billion long bonds in August, the Treasury has outstanding $245.5 billion in bonds applicable to the cap of $250 billion. Without an increase or repeal of the long bond authority, the Treasury could issue at most $4.5 billion of the long bond. Many market participants believe that the Treasury would forego the 30-year bond and increase other auction sizes.

Earlier in the year, the Treasury recognized its proximity to the long bond authority and sent a request to the appropriate committees of Congress to repeal the law. The House Ways and Means Committee approved the request and attached it to their FY88 budget bill. Yesterday, the Senate Finance Committee also approved a repeal of the long bond authority and also attached it to their version of the FY88 budget. Presumably, when the differences in the two budgets are ironed out, the rider to repeal the long bond authority will pass.

Does this mean we will soon be rid of this decades-old white elephant? Probably not, and definitely not in time to give the Treasury the flexibility to issue a normal-sized 30-year bond. Both bills await scrutiny by the full Congress, reconciliation in a joint committee (assuming there are differences), and then the President's signature. Both bills contain about $12 billion in tax increases and President Reagan went on record yesterday promising to veto the bills in their current form. If the Congress does not pass a FY88 budget bill that the President can sign, then automatic cuts are implemented according to the Gramm-Rudman formula by the Office of Management and Budget. That would leave the long bond authority in a state of limbo. The deadline for the automatic cuts is November 20, 1987, long after the November refunding must settle.

Does this mean that it is a foregone conclusion that the markets will not see even a partial 30-year auction? No. There are several alternatives available. First, on any given day Congress could pass a temporary or permanent increase to the long bond authority. Second, the Treasury could delay, rather than cancel, the 30-year bond, perhaps replacing it with a short-term cash management bill until such time as the authority is raised or repealed. Third, the Treasury could simply proceed with a scaled-down version of the refunding, as it did in November of 1980.

The most likely course of action would be for Congress to raise the long bond authority temporarily in time for a normal-sized auction. If it does not, then the Treasury will probably forego a 30-year bond auction this quarter and replace its cash needs with increases in the other auctions.

Economic Indicators for the Coming Week

We have revised our estimate of third quarter GNP growth to 3.1% (from 2.8%). This number reflects a strong perfomance by the consumer sector. Consumption expenditures are expected to rise by 5.9% in the quarter. The contribution of the foreign trade sector, which was subdued in the second quarter, should remain weak. We also estimate the deflator rose 3.8% in the third quarter, unchanged from the previous quarter.

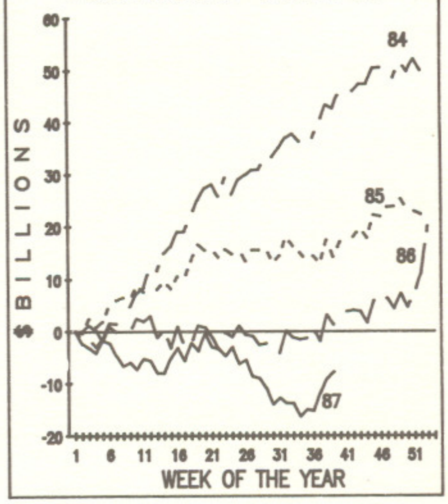
Fed Intervention for the Period 10/14 to 10/27

The discount window borrowings figure this week was perplexing. After a two-week average of 7.50% in the Fed funds rate and $725 million discount window borrowings, it seems odd that this first week of the period could begin with a 7.59% Fed funds level, yet only $345 million in borrowings.

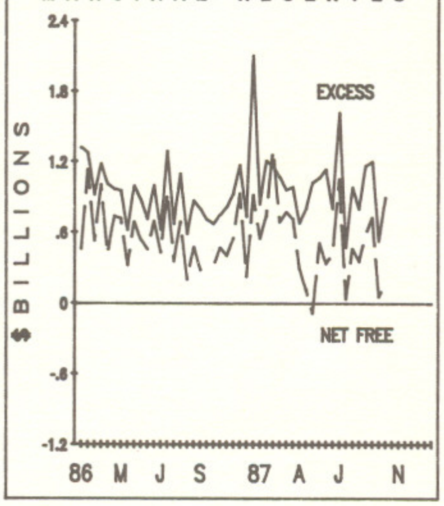
Has the market, especially the Fed funds market, overreacted to previous borrowings data? We don't think so. First, this was the first week of a maintenance period, when borrowings are typically lower than in the second week. Second, this first week contained a three-day bank holiday weekend. Fed funds traders are reluctant to lock in borrowings from the window for four consecutive days. Third, the Fed reported a large amount of float later in the week that possibly kept many banks liquid despite the level of Fed funds. Fourth, it seems a reasonable presumption that most banks foresaw a higher funds rate in the second week of this maintenance period. The settlement of the 4-year and 7-year notes, bringing in $14 billion of new cash to already strained TT&L accounts, was a well-known fact in the markets. Many banks may have anticipated that Fed funds would be higher after this surge occurred on the 15th, and decided to reserve their borrowing privilege for when it would most be needed, in the second week. Consequently, next week's discount window borrowings are likely to be high, at least $800 million.

The settlement of the two Treasury notes will keep Treasury balances high for several days. Unlike the typical settlement of Treasury securities, there is not a concomitant payment of a large amount of coupons on the 15th, nor is there an imminent Social Security payment, both of which normally would draw down the balances. Thus, the pressure on Treasury balances will be with us for at least a week or two. This pressure will necessitate frequent and perhaps multi-day System RPs, and will also probably lead to a higher than expected Fed funds rate for most of the time.

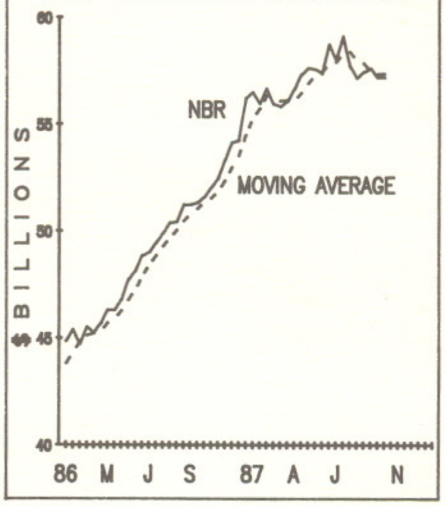
BUSINESS CREDIT



MARGINAL RESERVES



NON-BORROWED RESERVES



FACTS & FIGURES

INTEREST RATES

Money Market Instruments

Week	3-mth CD	3-mth LIBOR	3-mth CP
Oct 07	8.19	8.24	8.02
Sep 30	7.80	7.79	7.64
Sep 23	7.43	7.54	7.44
Sep 16	7.41	7.44	7.45
Sep 09	7.38	7.40	7.40
Sep 02	7.00	7.11	6.96

Short Treasuries

Week	3-mth Bill	6-mth Bill	2-year Note
Oct 09	6.85	7.44	8.83
Oct 02	6.83	7.21	8.58
Sep 25	6.67	7.12	8.37
Sep 18	6.56	6.97	8.31
Sep 11	6.58	6.84	8.39
Sep 04	6.39	6.66	8.11

Long Treasuries

Week	7-yr Note	10-yr Note	30-yr Bond
Oct 09	9.65	9.78	9.84
Oct 02	9.48	9.61	9.75
Sep 25	9.29	9.45	9.61
Sep 18	9.27	9.27	9.61
Sep 11	9.29	9.43	9.60
Sep 04	9.00	9.18	9.36

DAILY FED OPEN MARKET OPERATIONS

Day	Daily Funds Avg	Daily OMO	Funds Last Traded	Stop Out Rate	Tax & Loan Accts	Treas Balan
Oct 14	7.59	O/N CRPs	7.63	7.42	23.59	3.75
Oct 13	7.65	O/N CRPs	7.63	7.52	22.89	3.68
Oct 12	NA	HOLIDAY	NA	NA	NA	NA
Oct 09	7.58	O/N CRPs	7.56	7.55	24.64	2.92
Oct 08	7.55	O/N CRPs	7.50	7.38	24.34	3.86
Oct 07	7.30	NO FED	NA	NA	25.00	2.82
Oct 06	7.32	NO FED	NA	NA	26.65	2.11
Oct 05	7.45	O/N CRPs	7.44	7.20	25.30	4.15
Oct 02	7.42	O/WKND CRPs	7.44	7.12	17.34	6.13
Oct 01	7.71	NO FED	NA	NA	25.65	9.92

WEEKLY FUNDS AND BORROWINGS

Week	Fed Funds	Disc Rate	Funds To Disc	Disc Wind Borr	Add/ Drain Need
Oct 14	7.59	6.00	1.59	0.345	+1.29
Oct 07	7.43	6.00	1.43	0.725	+1.21
Sep 30	7.56	6.00	1.56	0.728	+5.44
Sep 23	7.26	6.00	1.26	0.578	+11.37
Sep 16	7.21	6.00	1.21	0.363	+0.50
Avg:	*7.41*	*6.00*	*1.41*	*0.548*	*+4.00*

BI-WEEKLY RESERVES

2-Weeks Ending	Total	Non-Borrow	Reqrd	Excess	Disc Borr	Net Free
Oct 07	+0.26	+0.06	-0.16	0.94	0.727	+0.21
Sep 23	-0.41	-0.77	+0.26	0.52	0.471	+0.05
Sep 09	+0.05	+0.13	+0.02	1.20	0.474	+0.73
Aug 26	+0.42	+0.26	+0.04	1.17	0.591	+0.58
Aug 12	-0.62	-0.53	-0.44	0.80	0.446	+0.36
Avg:	*-0.06*	*-0.17*	*-0.04*	*0.92*	*0.551*	*+0.38*

	LOS ANGELES	NEW YORK	TOKYO	LONDON	SINGAPORE	FRANKFURT	HONG KONG	SYDNEY
GOVERNMENT SECURITIES	213-229-1024	212-836-5550	813-587-4820	441-374-1530	65-224-5333			
FOREIGN EXCHANGE	213-229-1100	212-836-5500	813-587-4865	441-374-1620	65-224-3900	496-972-6242	852-525-7163	612-232-3611