Vaughn O'Regan

Commentary

Over the years, I have been involved with issues related to the Canadian government's debt management activities and the functioning of capital markets in Canada. Recently, as in the United States, a key issue has been the repercussions of much smaller government borrowing requirements. The Canadian government moved into a fiscal surplus situation three years ago. As we like to point out, this was a year before the United States did.

The focus of this conference is on the implications of a rather substantial pay-down of U.S. Treasury debt over the coming years. In Canada at this time, further pay-down of government debt is part of discussions on how to make use of the improved fiscal situation, but so are tax cuts and reinstated spending in such areas as health and education.

However, regardless of what happens going forward, there already has been a significant change in Canadian debt markets as a result of shifts in government borrowings. The most dramatic impact has been on the treasury bill market, where the outstanding supply has been cut sharply. This has reflected not only the swing from a sizable federal government deficit to a surplus, but also a move to reduce the government's exposure to interest rate changes by substituting bond borrowings for bills. This substitution has limited the reduction in the supply of Government of Canada bonds to a modest amount, at least so far.

Of interest, the decline in trading volumes in both the bill and bond markets is greater than the decline in outstandings. In other words, the rate at which the supply is turning over is down. Turnover ratios had increased through the mid-1990s, but now have returned to the levels of earlier in the decade. Presumably, this reflects the more stable role of "buy-and-hold" investors, compared with trading accounts, and the proportionately lower trading volumes by distributors of new issues when handling smaller offerings.

I will return to the Canadian situation later, as I expect this is where I can most add value to these discussions. In the meantime, I will make some comments on the paper by Paul Bennett, Kenneth Garbade, and John Kambhu. Given my background, I will defer to the experts on the technical workings of the New York debt market and limit my comments to a general nature.

In the preamble to the specific proposals in the paper, I found the discussion of liquidity and Treasury debt management objectives to be quite useful. Several of the issues covered in this section are very familiar to me from discussions of the Canadian situation. While the authors cite three goals and a number of principles used by the U.S. Treasury Department for its debt management, it seems to me that this list could be boiled down to: 1) minimizing borrowing costs and 2) enhancing the workings of the capital market. And since liquid markets help to achieve both of these objectives, steps to improve liquidity are certainly worth serious consideration.

The proposal to reduce the fragmentation of the market for STRIPS is similar to one that we are now considering in

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Canada. We have assured ourselves, after reviewing the authority under which our federal government borrows, that there is no legal impediment to the creation of an issue in excess of the original principal amount; I assume that this is also the case for U.S. Treasury issues.

I would agree with the authors that there is considerable merit to their STRIPS proposal. However, they should note that there are trade-offs involved: some issues will lose liquidity while others (and the overall market) will gain as a result of stepped up stripping and reconstitution activity. That is, irregularities will be dispersed over the market but not eliminated. Also, the placing of a cap on the amount that can be reconstituted can be a source of uncertainty for market participants, in that the gathering of relevant pieces for reconstitution could prove fruitless if it was later discovered that the limit had been reached. To ease these concerns and to provide as transparent a marketplace as possible, a means should be provided for making available on a regular basis information on the amounts of debt pieces outstanding.

As for the proposal to alter the two-year note issues, I see the more natural choice as integrating these issues with the rest of the note and bond programs. A shift to a 104-week bill would introduce a zero-coupon instrument providing no cash flow for two years—an instrument that may not be accepted by a segment of the conventional bill and note markets. For this reason, I would think that this proposition has some risk attached. Also, there is the risk that transferring supply from the note market to the bill market would further widen the liquidity gap that now exists between the two markets.

It is at this gap that the "more adventurous" proposal in the paper is aimed. As an outsider, I clearly am in no position to pass comments on the particular workings of the U.S. market. The proposal assumes that the Treasury is able and prepared to issue and cancel debt expeditiously and that it will accept a shuffling, from one month to another, of refunding requirements. It assumes as well that investors will accept cancelations of pieces of issues that they hold (which has a somewhat different meaning than investors accepting that stripping and reconstitution can affect their holdings).

As a summary comment, I see value in seeking ways to enhance liquidity in a market that is no longer receiving as much new supply. However—and I sense that this may be the case with the paper by Bennett, Garbade, and Kambhu—there can be excessive expectations as to what can be accomplished with technical adjustments. Enhanced stripping and reconstitution possibilities will provide more overall liquidity and will help ease "squeeze" situations, but this can also leave the market with more "loose ends." The exchange proposal would establish more uniform pricing with the market and would help dealers to accommodate transactions, but trading volumes and bid-ask spreads would still not be uniform.

There are, and presumably will continue to be, underlying reasons why anomalies exist even in very sophisticated markets with large numbers of arbitrage players. In the case of the Treasury market, I assume that a major influence can be the number of buy-and-hold investors, who have requirements for a specific issue to match flows or offset liabilities, or who are governed by legislation or guidelines to hold Treasuries, or who simply are risk-averse and are comfortable only with top creditworthiness. These are not investors who will move for a few basis points, and their role vis-à-vis that of opportunistic players will affect market liquidity. The authors do not discuss this underlying situation, perhaps because it is addressed in references and taken as understood.

I will finish with a return to the Canadian situation, making three comments:

1. For some time, the Canadian government has favored the reopening of existing bond issues whenever possible. As a result, the market does not have the same number of different "pieces" as the U.S. Treasury market does, and the reconstitution potential is not as large. Therefore, while a proposal is being examined to allow for full fungibility of interest and principal STRIPS, the potential benefits seem more marginal for the Canadian market.
2. The Canadian government, through the Bank of Canada, has been running a bond buyback program for a year. Off-the-run bonds have been purchased around the time of new issues on six occasions so far. Payment for these bonds has been covered by a larger amount of new issue offerings than would otherwise be the case. The primary goal has been to maintain benchmark issuance size. Of note, with this substitution of benchmarks for off-the-run issues, the spread between the two has not changed much, presumably reflecting the overall spread environment of the past year.
3. While the turnover in Government of Canada debt has fallen recently, in Canada there has been a pick-up in activity in asset-backed securities, futures markets, and, to a degree, in the corporate market. This pick-up in activity does suggest that other markets will fill at least some of the void created by diminished government borrowings.

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