Update: U.S. Treasury to Study Issuing Floating-Rate Notes

(Updating to include reaction from investors and economists.)

Washington, Feb. 2 (Bloomberg) -- The U.S. Treasury is studying whether it should issue notes with interest rates that float with rate levels in financial markets, the department said today.

"The Treasury has begun preliminary research into the potential for adding floating-rate securities to the regular Treasury offering cycles," said Darcy Bradbury, deputy assistant secretary for federal finance.

"We have no plans to change the current regular issues cycles" before the study is completed "and we have no bias as to whether or not floating-rate notes would be a viable option for us," Bradbury said.

Investors and economists welcomed the Treasury's plan, saying it would help keep inflation down and lower the government's financing costs.

"The more they act like a corporate issuer, the more as taxpayers we'll save," said Stephen Van Order, a portfolio manager at Calvert Asset Management, with $3.5 billion in fixed-income assets. "I think it's a neat idea."

Right now, only corporations and some government agencies issue floating-rate securities.

Unlike conventional Treasury debt, which pays a fixed interest rate, the rate on "floaters" changes as market rates rise and fall. For the Treasury, floaters would be beneficial if rates fell because it would pay out less interest to investors and save the taxpayers money.

The Treasury began studying the issue at the suggestion of the Public Securities Association group that advises the Treasury on how it should conduct its auctions, a panel called the Treasury Borrowing Advisory Committee.

Treasury officials decided to reveal the continuing study because they want to start getting comments from market participants, Bradbury said.

If floating-rate notes are issued, they would provide a new tool for the Federal Reserve to use in assessing inflationary pressures.

Almost Useless

The Fed's decades-old inflation monitoring tool, growth of the money supply, has been so distorted by financial-industry innovations that it's almost useless, Federal Reserve Board Chairman Alan Greenspan said Monday.

The Treasury will consult with the Fed on the floating-rate note study, Bradbury said.

"We talk to the Fed on a regular basis, and they would certainly be aware" of the Treasury study, she said.

Campbell Harvey, associate professor of finance at Duke University's Fuqua School of Business, said that "floaters" would force the government to keep inflation in check, thereby bringing all interest rates down. That's because a rising inflation rate would boost market rates and cost the Treasury more interest on floaters.

"They'd tie their own hands, which is exactly what you want them to do," said Harvey, who provided testimony to Congress last

arch advocating floating-rate Treasury debt. "It's policy-
onsistent with their low inflation strategy."

If inflation shot up and rates followed, the rate on the loaters would also balloon, Van Order said. With floaters, the reasury "would know pretty quickly when the market was concerned about inflation) because they'd be paying more," he said.

That's what makes floaters such a wonderful tool to contain nflation, Harvey said. If the Fed didn't keep a lid on inflation, t some point the central bank would have to boost rates to cap it. he interest cost of floaters would rise more dramatically than on ixed-rate securities.

"It costs more to inflate with floaters out there," Harvey aid.

The PSA advisory body suggested the floating-rate notes study n a meeting with government officials last June. The panel also et yesterday and today.

"While the (investors') committee did not foresee a need for ny new financing instruments in the near term, it proposed that he Treasury study the potential for adding a floating-rate nstrument to the regular cycles at some unspecinot foresee a need for ny new financing instruments in the near term, it proposed that he Treasury study the potential for adding a floating-rate nstrument to the regular cycles at some unspecified point in ime," say the minutes of this week's meeting.

"The committee suggested that the Treasury solicit information rom people who have special expertise in the floating-rate note arket," the minutes said.

"Meetings with investor groups active in the floating-rate ote market were also suggested."

Wall Street, in other words, will have a say as the Treasury eighs whether to issue the new type of securities.

Attract New Investors

Floating-rate notes might attract a new group of investors to uy government securities and help to finance the rising national ebt, PSA panel members said in their meeting with Treasury fficials this week.

"Floating-rate notes may afford the Treasury access to ubstantial amounts of funds from investors who prefer this nvestment vehicle," the PSA committee said. Such investors now are imited to floating-rate securities offered by private borrowers nd government-sponsored enterprises.

"Furthermore, by issuing floating-rate notes with final aturities of five to seven years, the Treasury would be able to itigate the effect its current debt-management strategy will have n shortening the average life of the debt, the PSA panel said.

Last year, the Treasury decided not to issue more seven-year otes and decided to offer its benchmark 30-year bond just twice a ear instead of quarterly.

Frequent Rollovers

Critics said this exposed the government to sharply higher nterest costs on the national debt if market interest rates rise uickly, because short-term debt must be rolled over frequently.

Some analysts say this "could become a matter of serious oncern in the future as on occasion it has in the past," the PSA anelists said.

At the same time, floating-rate notes would allow the Treasury

› capture the interest rate savings it seeks," the panel said.
The Treasury, in switching to more issues of shorter-term
:urities, is reaping the benefits of borrowing at low interest
:es in the short-term debt market, helping to reduce federal
lget deficits, the PSA panel said.
If the Treasury decides to issue floating-rate notes, it
ould issue them in substantial amounts to assure "sufficient
quidity to sustain a viable market" in the securities, the panel
id.

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