APPENDIX

Material used by Mr. Fisher.

STRICTLY CONFIDENTIAL
(FOMC CLASS II)

SOMA Manager's Report
May 16, 2000

I. Market developments

A. Policy expectations in short-term forward rates

B. The Euro: capital flow leads and lags

C. Current shape of U.S. yield curves

II. Domestic Operations

A. Mix of operations since last meeting

B. Conditions in the Treasury market

C. Impact of Federal revenues and Treasury refunding plans on flow of new Treasury issuance and System operations

D. Proposal for interim System operations for discussion with Treasury

II. Foreign operations: Memorandum of May 11, 2000

A. Renewal of swap arrangements with Mexico and Canada

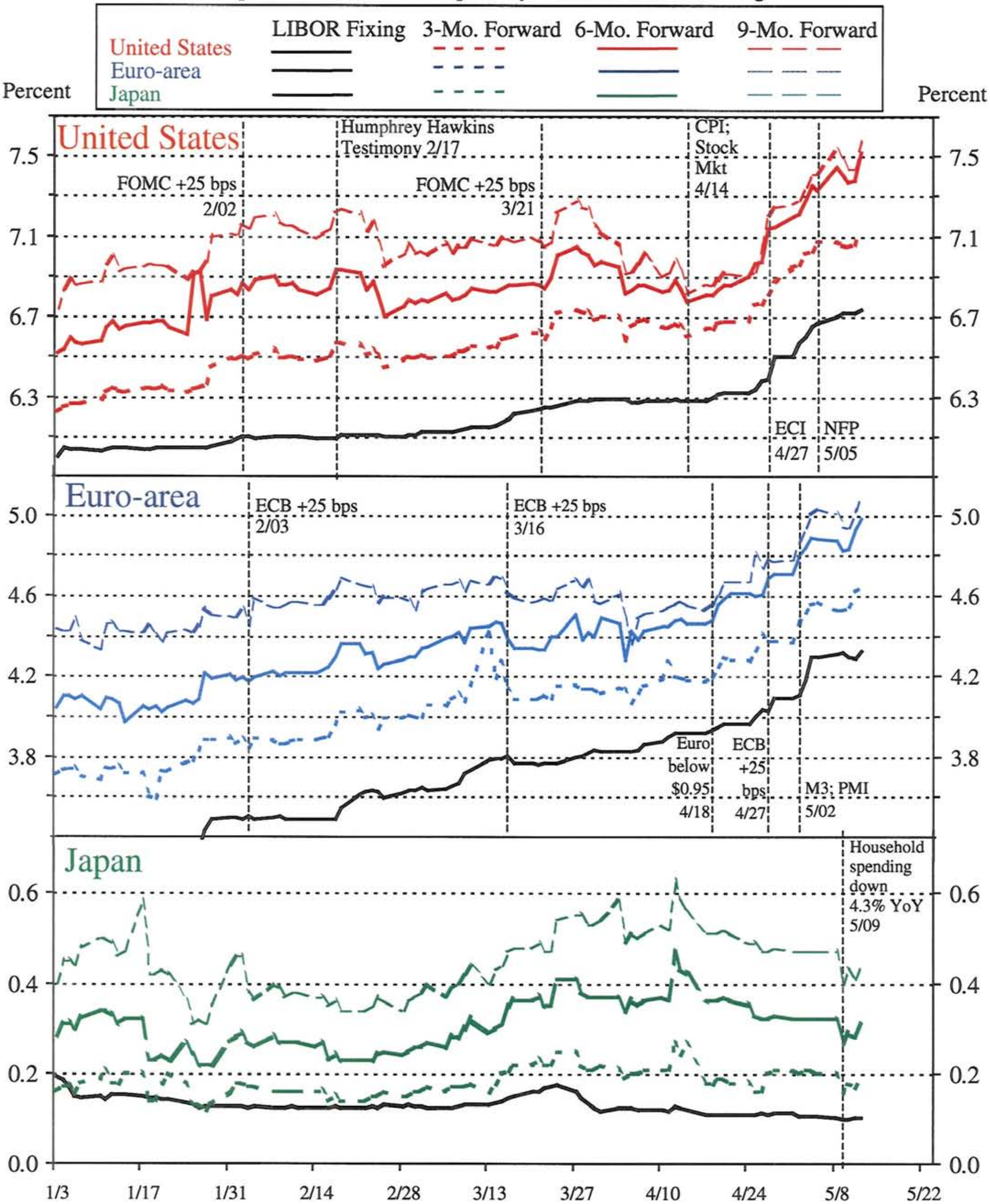
B. Change in Bank of Japan facilities

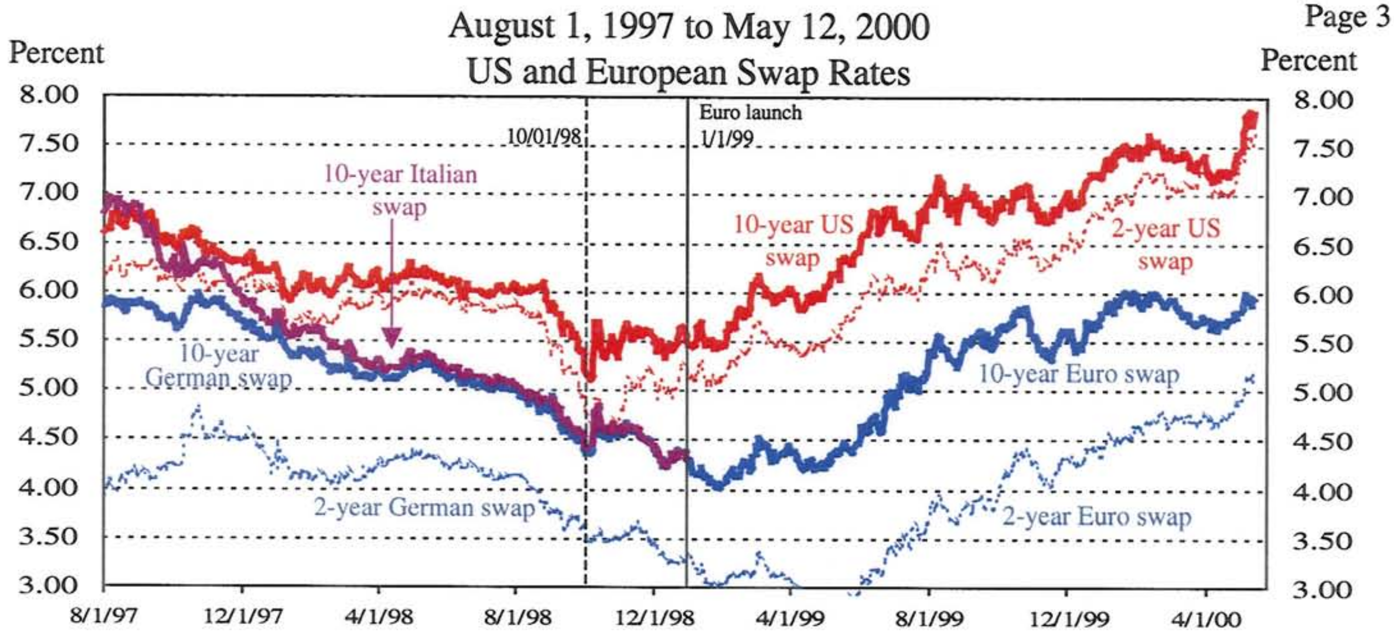
C. Plans to change custodian/tri-party agent

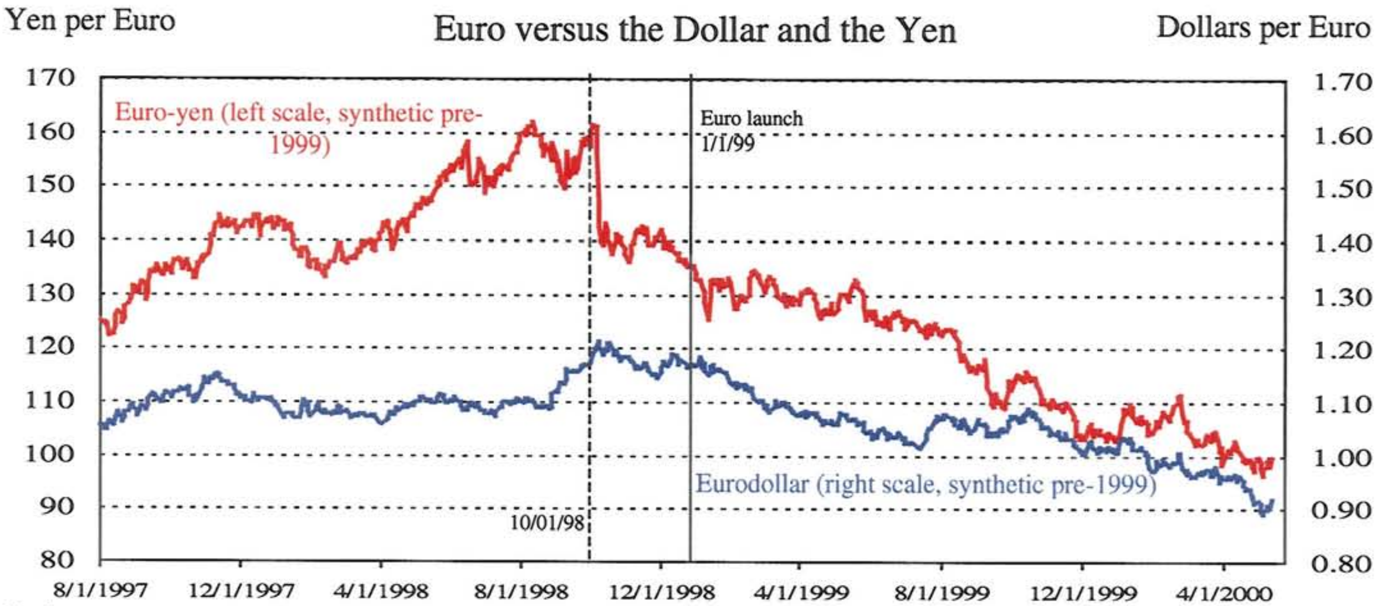
3-Month Deposit Rates

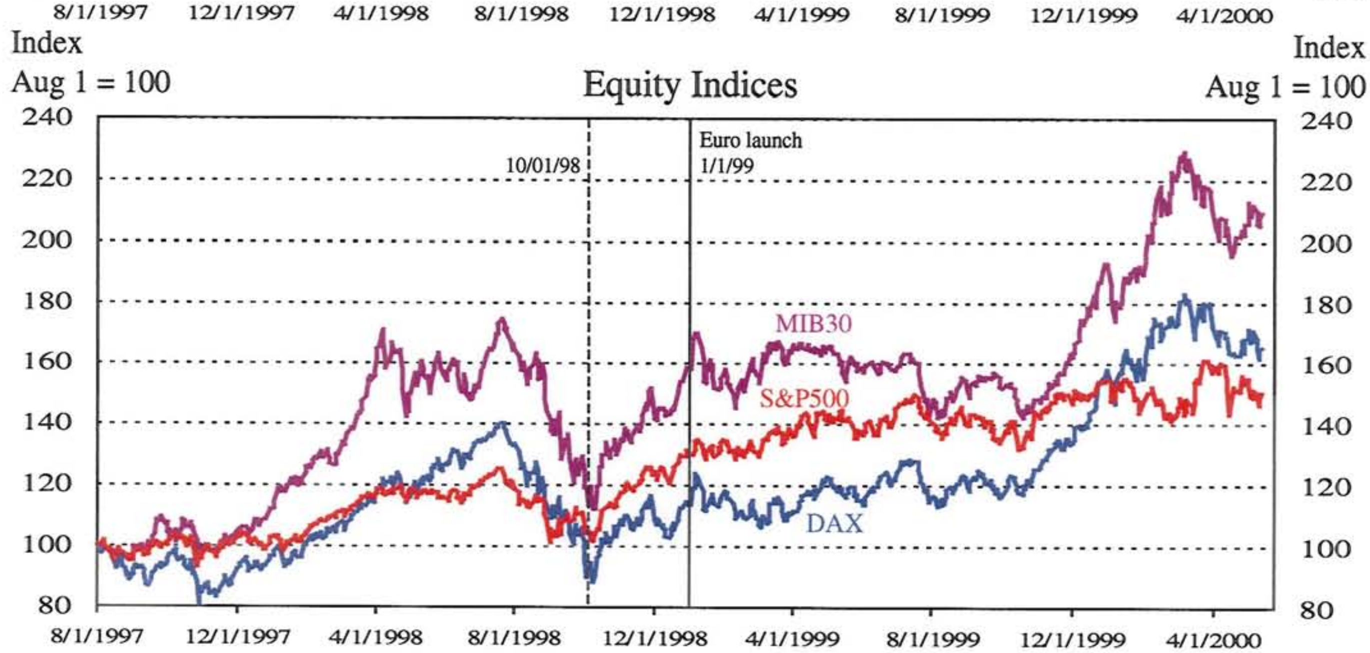
January 3, 2000 - May 12, 2000

Current Deposit Rate and Rates Implied by Traded Forward Rate Agreements

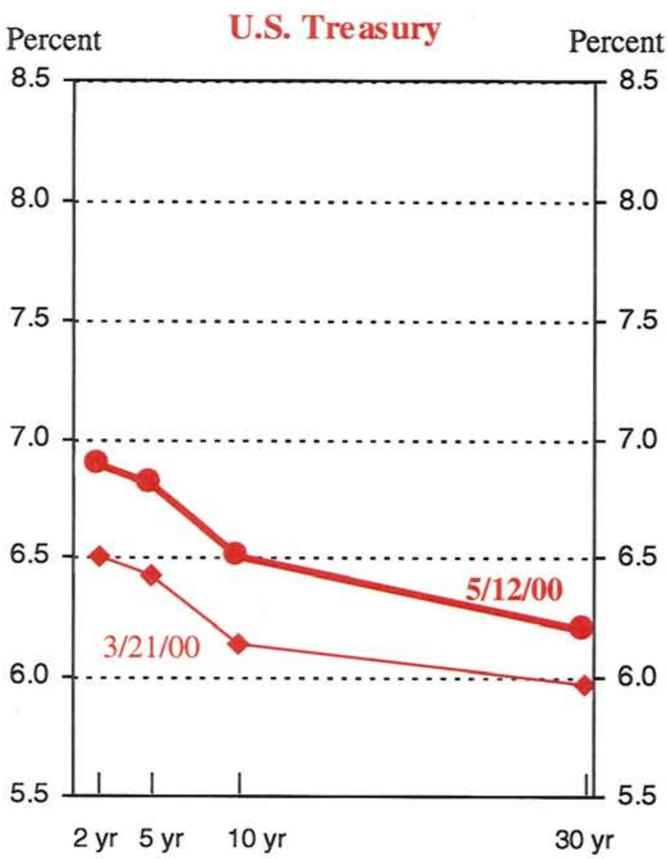


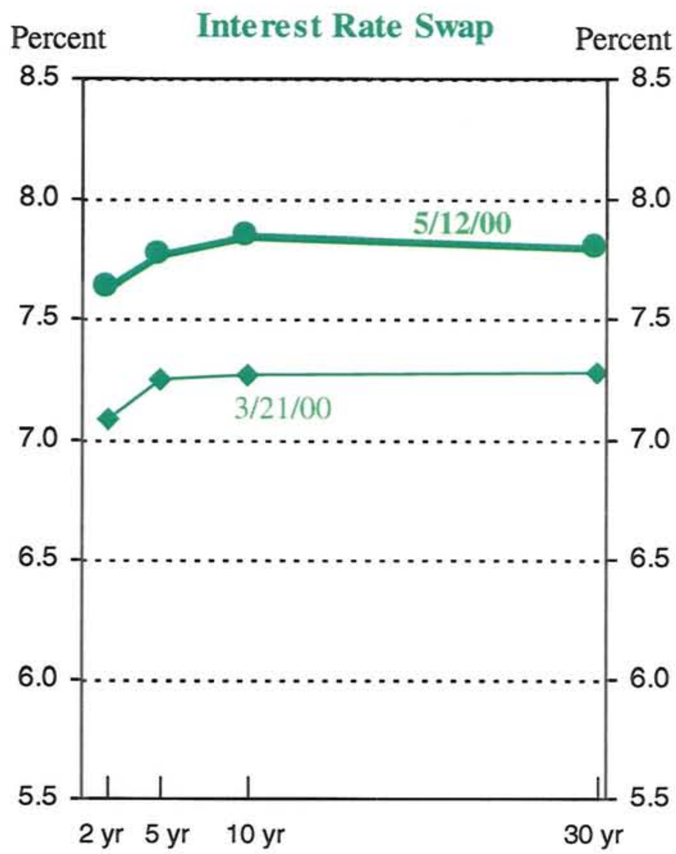

August 1, 1997 to May 12, 2000
US and European Swap Rates
Percent
Percent
8.00
7.50
7.00
6.50
6.00
5.50
5.00
4.50
4.00
3.50
3.00
10/01/98
Euro launch
1/1/99
10-year Italian swap
10-year US swap
2-year US swap
10-year German swap
10-year Euro swap
2-year German swap
2-year Euro swap
8/1/97
12/1/97
4/1/98
8/1/98
12/1/98
4/1/99
8/1/99
12/1/99
4/1/00

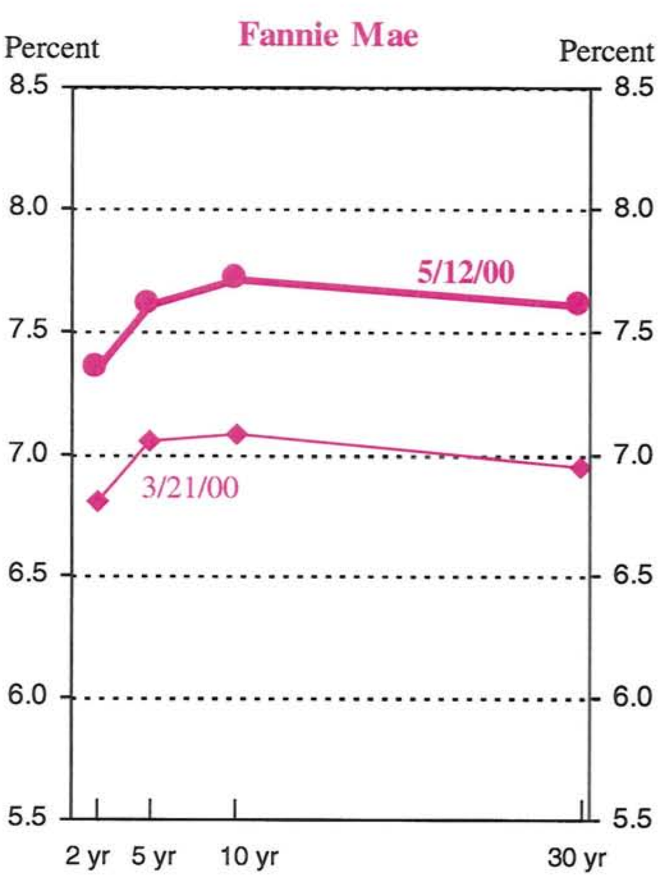

Yen per Euro
Euro versus the Dollar and the Yen
Dollars per Euro
170
160
150
140
130
120
110
100
90
80
1.70
1.60
1.50
1.40
1.30
1.20
1.10
1.00
0.90
0.80
Euro-yen (left scale, synthetic pre-1999)
Euro launch
1/1/99
Eurodollar (right scale, synthetic pre-1999)
10/01/98
8/1/1997
12/1/1997
4/1/1998
8/1/1998
12/1/1998
4/1/1999
8/1/1999
12/1/1999
4/1/2000

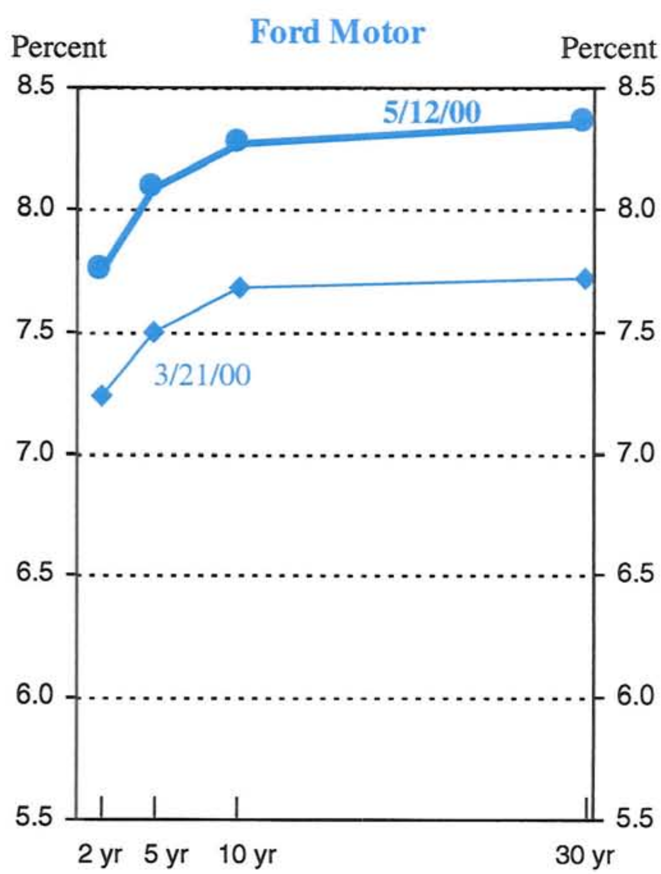

Index
Aug 1 = 100
Equity Indices
Index
Aug 1 = 100
240
220
200
180
160
140
120
100
80
10/01/98
Euro launch
1/1/99
MIB30
S&P500
DAX
8/1/1997
12/1/1997
4/1/1998
8/1/1998
12/1/1998
4/1/1999
8/1/1999
12/1/1999
4/1/2000

Domestic Yield Curves









II. Domestic Operations

A. Mix of operations since last meeting

At your last meeting, I spelled out plans:

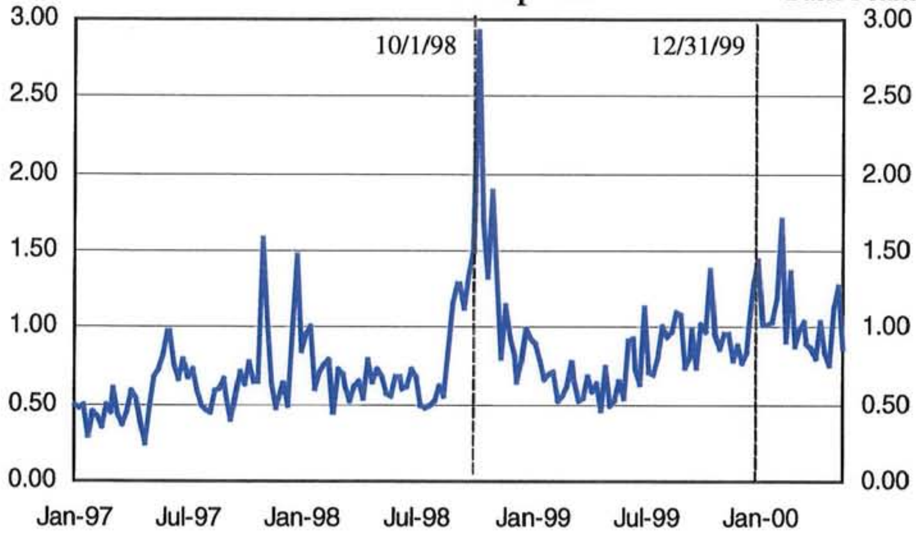
- To "try and see" what would be a comfortable pace of outright purchases of Treasury coupon securities
- To target 35 % for SOMA Treasury bill auction participation
- To use mix of 30/60/90 day repos to meet balance of reserve needs
- Would not purchase bills outright until perhaps after the Treasury refunding announcements

In response to views expressed by Committee members and my assessment of evolving market conditions, since then we:

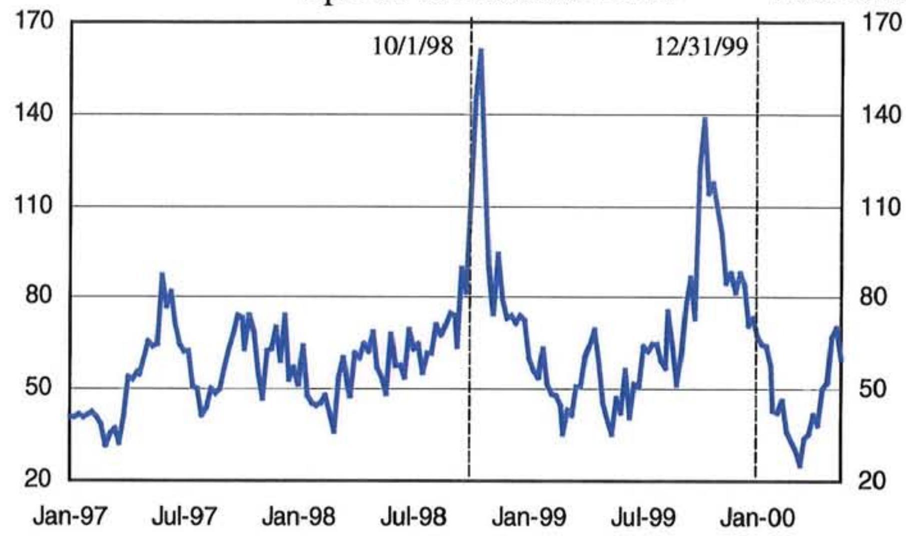
- Purchased $4.2 billion in coupon securities on five different days
- Purchased $2.3 billion in bills on April 11
- Redeemed $1.6 billion at auctions
    - $977 million in bills; $568 million of the last 7-year note
    - We now hold 40% of two bill issues
    - On two other issues, even though we redeemed, ended up with less than 35% because of high levels of add-ons for foreign central banks
- Used occasional 28-day repos to meet underlying reserve needs
    - Now, 4 separate 28-day repos on books, value of $8.2 billion
    - Most of our repo operations of only a few days duration, because of day-to-day volatility in the Treasury account as a consequence of tax inflows

3-Month Bill

Bid/Ask Spread

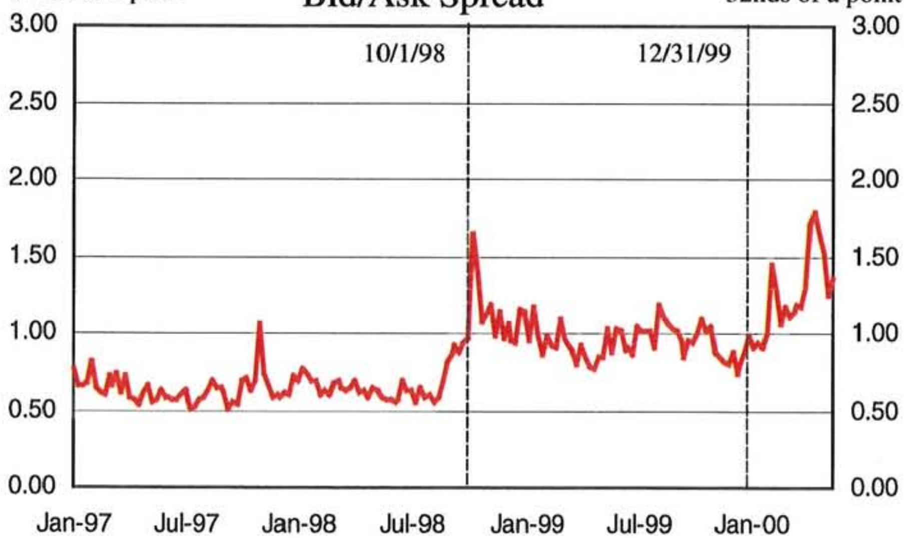


Spread to 3-month Libor

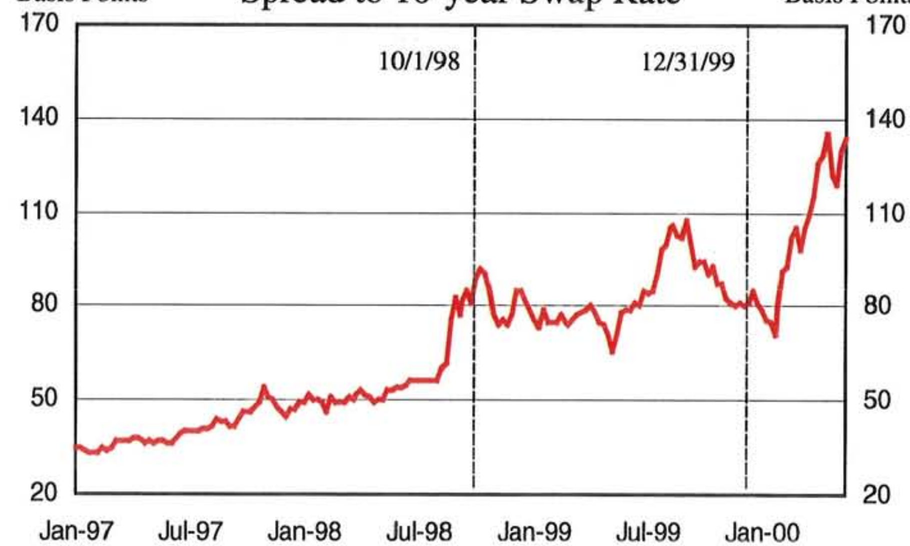


10-Year Note

Bid/Ask Spread



Spread to 10-year Swap Rate



II. Domestic operations, continued

C. Impact of Federal revenues and Treasury refunding plans on flow of new Treasury issuance and System operations

- At the end of March, Treasury's issuance plans reflected the Administration's forecast of a FY 2000 surplus of $176 billion.

- On basis of April receipts, the Administration's current forecast is for a surplus of $226 billion.

- At the quarterly refunding announcement in early May, the Treasury announced their intentions:

    - To buyback (no more than) a total of up to $30 billion this calendar year

    - To maintain the 10- and 30-year programs

    - To eliminate the Year bill, once Congress adopts some technical amendments.

    - To "trim" the size of 2-year note monthly auctions; and

    - That further increases in revenue would likely lead to a switch from monthly to quarterly 2-year note auctions

- In addition, although not announced, Treasury has told us that the amount of bills likely to be auctioned each week for the rest of the year has been reduced by more than 20% ($21 billion to $16 billion).

- These reductions in the Treasury's issuance plans have implications for System operations for the balance of this year

Projections of Treasury Debt Issuance, Percentages of Issue to be Purchased by the System and the System's Redemptions

	Projected in March			Currently Projected		
	Treasury Issuance per Quarter ($ Billions)	System's Average Percentage Holdings of Issues to be Auctioned per Quarter	Implied System Redemptions per Quarter ($ Billions)	Treasury Issuance per Quarter ($ Billions)	System's Average Percentage Holdings of Issues to be Auctioned per Quarter	Implied System Redemptions per Quarter ($ Billions)
Bills						
May 18 - July	348.3	33%	**0.8**	281.2	34%	**9.7**
August - October	411.3	31%	**1.6**	316.1	34%	**19.9**
November - January	421.8	33%	**0.6**	318.5	35%	**12.7**
2-Year Note						
May - July	52.1	**19%**	0.0	40.1	**25%**	0.0
August - October	54.0	**22%**	0.0	42.0	**29%**	0.0
November - January	53.0	**21%**	0.0	41.0	**27%**	0.0
5-Year Note						
May - July	15.5	15%	0.0	15.5	15%	0.0
August - October	13.4	13%	0.0	11.0	14%	0.0
November - January	17.2	13%	0.0	14.0	14%	0.0
10-Year Note						
May - July	11.1	11%	0.0	11.1	11%	0.0
August - October	11.5	13%	0.0	11.7	14%	0.0
November - January	9.1	13%	0.0	9.3	14%	0.0
30-Year Bond						
May - July	0.0	not applicable	0.0	0	not applicable	0.0
August - October	6.1	13%	0.0	6.4	14%	0.0
November - January	0.0	not applicable	0.0	0	not applicable	0.0

II. Domestic operations, continued
D. Proposal for interim System operations for discussion with Treasury

At your last meeting, I thought that we might be able to "comfortably" purchase outright up to $20 billion in Treasury securities. In light of both Committee members' views and the changes in the outlook for new issuance, I have tried to devise a means to increase the amounts we would be purchasing.

Given the uncertainties the Treasury faces in debt management, and the impact of System operations on their primary and secondary markets, I would like to inform them in advance of my plans for managing SOMA over coming months, in part to permit them to adjust their strategy. It will also be vital for us to communicate clearly to market participants about these changes.

In brief, I would like SOMA:

- **to operate on a schedule for participation in Treasury auctions, essentially locking in the status quo in SOMA percentage holdings for the *primary* market**

- **to increase the pace of outright purchases of coupon securities, skewing our purchases both to the middle and shorter-end of the yield curve**

We would also rely on 28-day repos to meet reserve needs that cannot comfortably be filled by outright purchases and as a "buffer" between the timing of redemptions and outright purchases

SCOPE OF THE "INTERIM" PROBLEM

Approximate underlying reserve needs we now anticipate through the end of January 2001:

• Current underlying reserve needs:	$21 billion
• Implied redemption from 35% bill limit:	42 billion
• Forecast growth in currency (8.5% NY staff):	22 billion
• Total:	$ 85 billion

BOTH A "STOCK" AND A "FLOW" PROBLEM

- With $3.09 trillion outstanding in marketable Treasury securities, it seems we "ought" to be able to find sufficient assets to grow SOMA this year from the existing stock
  - There are "only" $433 billion of Treasury securities outstanding (ex. SOMA) with remaining maturities of more than 10 years
    - This amount will decline as a consequence of both the Treasury's buybacks and System purchases
  - Foreign and domestic private portfolios express strong demand for these long-duration Treasury assets, as reflected in the inverted long-end
    - While relatively comfortable with private credit risk for shorter duration assets, they perceive few acceptable long-duration substitutes for Treasury securities
  - Thus, the stock of long-duration Treasuries is not large relative to apparent demand and is expected to decline

- The flow of new Treasury securities into the market has continued to decline, with total new issuance (ex. cash management bills) falling from:
    - $2.06 trillion in '97 to a forecast of $1.74 trillion for this year
  - If the growth of the System's balance sheet too quickly absorbs an expanding share of both the primary market and on-the-run issues, there is a risk that System operations will come to be seen as a major disturbance – even if transitional – in the price discovery process

BASIC SOMA PORTFOLIO OBJECTIVES

- Preference for Treasuries as asset class to grow balance sheet

- Preference for shorter, rather than longer, maturities
  - expressed through bill holdings; limited in recent years
  - reflecting interest in sufficient short-maturity assets to provide adequate maturity liquidity

- Not obvious that SOMA should have much interest in paying a premium for the liquidity of "on-the-run" issues

CURRENT TREASURY DEBT MANAGEMENT OBJECTIVES

- To reduce issuance in line with revenues
- To avoid a lengthening of the average maturity of outstanding debt
- To maintain issue sizes in key benchmark maturities to sustain an active secondary market

RECONCILING SYSTEM, TREASURY AND MARKET INTERESTS

- Limit System share of primary market and on-the-run issues
  - To leave room for private demand – particularly for long-duration securities – to adjust to reductions in supply

- Expand System holdings of off-the-run, shorter duration securities
  - To meet the System's balance sheet needs with as much of preferred asset class as possible
  - To adjust SOMA to a shorter overall maturity that is closer to our basic preference

- However, doing this would have an impact on the average maturity of privately-held Treasury debt outstanding

DETAILS OF PROPOSAL

- We would take roughly the status quo of our maturing holdings as shares of now-anticipated auction sizes as a schedule for SOMA participation in Treasury auctions:

• Bills	35 percent
• 2-year	25 percent
• 5-year	20 percent
• 10- & 30-year	15 percent

- SOMA's bids in auctions would be the lesser amount of (a) SOMA's maturing holdings and (b) the percent limit from the schedule

  - This would have only a limited impact on our currently-forecast rollovers, but in the event of further declines in issuance, this would hold constant the System's share of the primary market and, thus. should increase the amounts available for private demand *from what they otherwise would have been*

  - It should also assist the Treasury in forecasting and managing its cash position (which is also a benefit for the Desk)

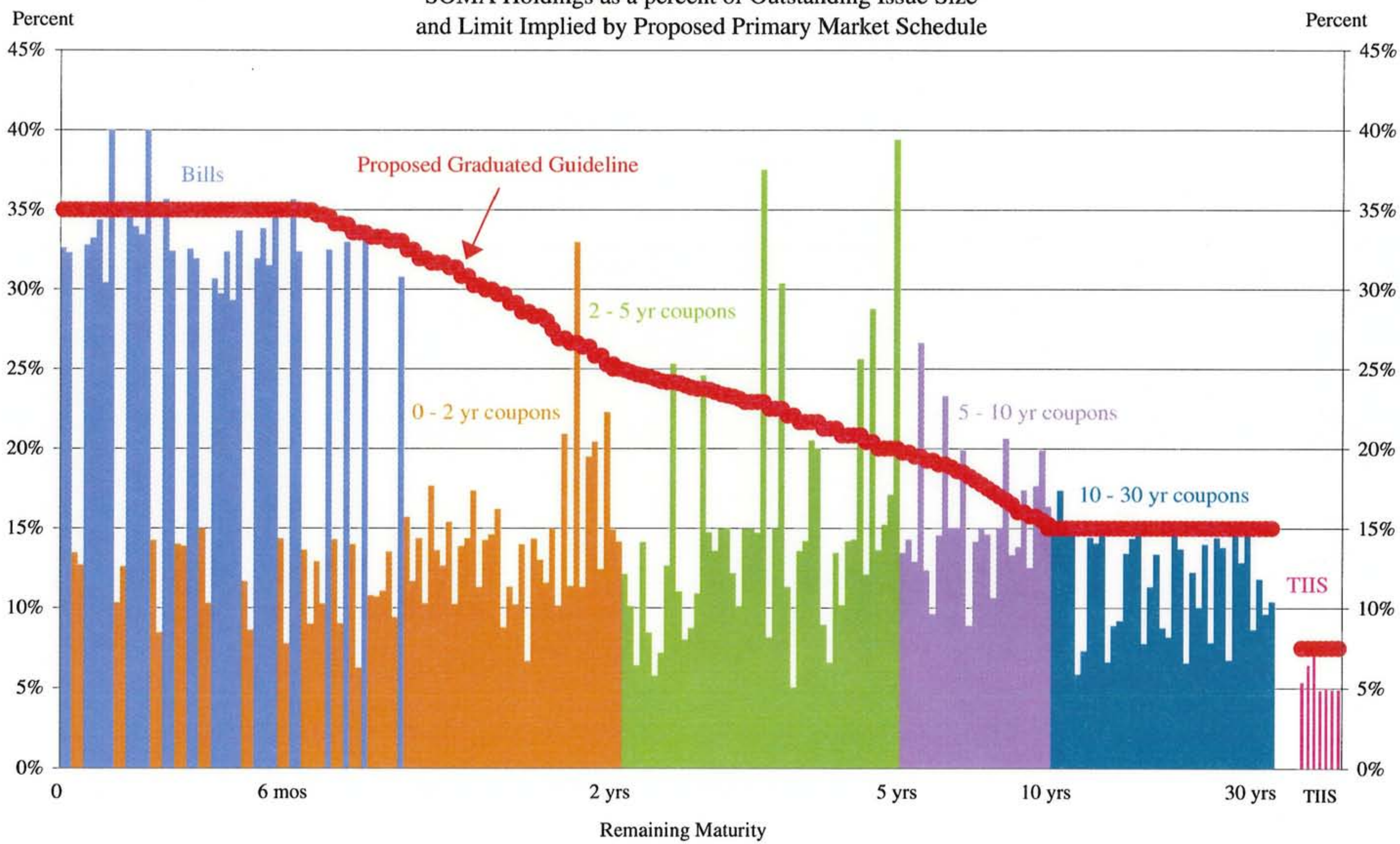
- We would also take the above schedule to imply graduated guidelines for SOMA outright purchases of off-the-run securities, over time purchasing outright:

	with remaining maturities from
• up to 15 percent	30- to 10-years
• from 15 to 20 percent	10- to 5-years
• from 20 to 25 percent	5- to 2-years
• from 25 to 35 percent	under 2-years

- We could continue to bid for 5 percent of inflation-indexed securities at auction, and might be prepared to purchase up perhaps to 7.5 percent in the secondary, off-the-run market

Treasury Securities Outstanding by Remaining Maturity

SOMA Holdings as a percent of Outstanding Issue Size
and Limit Implied by Proposed Primary Market Schedule



- **A rough calculation of the amounts available to be purchased using this graduated guideline would be around $178 billion**

    - **We would continue our current practice of waiting to purchase new issues until they are "thrice off-the-run"**

- **This compares with the comparable reserve need of $88.7 billion through the end of next January (the $85 billion estimate from above, plus $3.7 billion in redemptions of 2-year notes).**

- **The pace of outright purchases could have a strong impact on the Treasury yield curve, tending to lower yields and, at least in the short run, could be seen as being at cross-purposes with the Committee's policy actions**

    - **This could also appear as a reverse "operation twist", even though it is motivated by the System's reasonable portfolio objectives**

- **I doubt that we could "comfortably" purchase the full amount "available" under the schedule within the next six or seven months**

    - **Provided that we clearly communicate to market participants this radical change in SOMA's secondary market behavior, I think we could comfortably purchase considerably more than the $20 billion before year end that I suggested at your last meeting**

- **This is just a "stop gap" measure: it delays the onset of reserve needs**

    - **If Treasury supply begins to expand again in the coming year or two, we will have assets to roll into**

    - **But if Treasury supply continues to decline over coming years, SOMA's need for new assets will only have been delayed**

III. **Foreign operations**: Memorandum of May 11, 2000

A. Renewal of swap arrangements with Mexico and Canada

B. Change in Bank of Japan facilities

C. Plans to change custodian/tri-party agent

VOTES NEEDED:

1. Ratify domestic operations

2. Approve renewal of swap arrangements with Bank of Mexico and with Bank of Canada

ANSWER QUESTIONS:

- Market developments

- Domestic operations since last meeting

- Proposal for discussion with Treasury

- Change in custodian and in yen investment facilities