# The Money and Bond Markets in August

A sharp and persistent rise in interest rates amid an atmosphere of considerable uncertainty was the dominant feature of the money and securities markets through most of August. Technical rallies appeared on occasion, but they tended to fade rather quickly under the weight of a steady stream of economic and financial news that underscored both the continued heavy demand for credit and the limited availability of funds. As the month progressed, the view became widespread that monetary policy might tighten further, possibly increasing pressures on the market in September when commercial banks would be facing substantial seasonal loan demands and heavy maturities of certificates of deposit. However, the atmosphere in the securities markets improved somewhat at the close of the month in response to renewed talk of a possible tax increase. On September 1, after the close of the period covered in this article, the Federal Reserve System issued a policy statement which is reprinted on page 211.

Among the specific factors affecting the securities markets in August was the increase in the prime lending rate of commercial banks, from 5¾ per cent to 6 per cent, that was announced on August 16 and 17. The boost was the fourth in less than nine months and raised the banks' minimum lending rate to the highest level in over thirty years. Then, on August 17, the Board of Governors of the Federal Reserve System announced a further increase from 5 per cent to the statutory ceiling of 6 per cent in reserve requirements against certain time deposits of member banks. The new 6 per cent reserve requirement will apply to each member bank's time deposits —other than passbook savings accounts—in excess of $5 million. (Passbook savings deposits and the first $5 million of other time deposit accounts will continue to be subject to a 4 per cent reserve requirement.) The increase, which follows a midyear rise from 4 per cent to 5 per cent in such requirements, will go into effect at reserve city banks in the reserve computation period beginning September 8, and will first apply to other member banks during the reserve computation period beginning September 15. In announcing this increase in reserve requirements, the Board of Governors explained: "Like [the] earlier measure, [this] action is designed to exert a tempering influence on bank issuance of time certificates of deposit, and to apply some additional restraint upon the expansion of bank credit to businesses and other borrowers. Monetary actions already taken have resulted in some moderation of the rate of bank credit growth thus far this year. However, in view of increasing pressures on prices stemming from recent developments in the economy, [this latest] action is being taken to reinforce the anti-inflationary effects of overall monetary restraint."

Contributing to the upward pressure on interest rates during the month were the steady addition of prospective issues to an already sizable calendar of future corporate bond offerings, heavy commercial bank selling of tax-exempt securities, an increase in the supply of Treasury bills with the sale of $3 billion of March and April tax anticipation bills, and expectations that the Federal National Mortgage Association (FNMA)) would sell a large issue of participation certificates in September. Furthermore, dealer financing costs were persistently high during the month, making dealers hesitant to add securities to their inventories.

Under the various pressures, yields on Treasury notes and bonds rose by as much as 77 basis points in August to their highest levels since the 1920's. Yields on corporate bonds reached thirty-year highs, and even at these levels investors proved to be only cautious buyers. In the tax-exempt bond market, yields also rose sharply over the month in a generally weak atmosphere. Treasury bill rates climbed to record levels, with average issuing rates on three- and six-month bills set at 5.09 per cent and 5.57 per cent, respectively, in the auction of August 29.

The money market generally remained quite firm in August. Federal funds traded mainly in a 5½ to 5⅞ per cent range, with the effective rate first reaching a record 5⅞ per cent level on August 5. Commercial paper dealers raised their rates on two occasions during the month, bringing their offering rate on prime four- to six-month paper to 5⅞ per cent. Rates on bankers' acceptances also rose during the period, reaching 5⅞ per cent (bid) for 31- to 90-day unendorsed acceptances. Rates posted by the

### Table I

### FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, AUGUST 1966

In millions of dollars; (+) denotes increase, (—) decrease in excess reserves

| Factors | Changes in daily averages—week ended | | | | | Net changes |
|---|---|---|---|---|---|---|
| | Aug. 3 | Aug. 10 | Aug. 17 | Aug. 24 | Aug. 31 | |
| **"Market" factors** | | | | | | |
| Member bank required reserves* | + 40 | + 221 | + 91 | + 230 | — 210 | + 369 |
| Operating transactions (subtotal) | — 613 | — 234 | + 338 | + 50 | — 628 | —1,087 |
| Federal Reserve float | — 336 | — 115 | + 200 | + 17 | — 766 | —1,000 |
| Treasury operations† | — 29 | + 203 | + 29 | + 13 | — 18 | + 198 |
| Gold and foreign account | — 249 | + 181 | + 7 | — 16 | — 66 | — 142 |
| Currency outside banks* | — 83 | — 405 | + 94 | + 144 | + 199 | — 51 |
| Other Federal Reserve accounts (net)‡ | + 82 | — 90 | + 8 | — 108 | + 23 | — 94 |
| Total "market" factors | — 573 | — 13 | + 429 | + 286 | — 847 | — 718 |
| **Direct Federal Reserve credit transactions** | | | | | | |
| Open market instruments | | | | | | |
| Outright holdings: | | | | | | |
| Government securities | + 414 | — 56 | — 422 | + 4 | + 734 | + 724 |
| Bankers' acceptances | — 15 | — 1 | — 2 | — | + 2 | — 16 |
| Repurchase agreements: | | | | | | |
| Government securities | + 168 | + 194 | — 159 | — 194 | — | — |
| Bankers' acceptances | — | — | — | — | — | — |
| Member bank borrowings | + 98 | + 4 | — 52 | — 11 | — 28 | + 11 |
| Other loans, discounts, and advances | — 2 | + 4 | — 3 | — | + 1 | — |
| **Total** | + 653 | + 145 | — 638 | — 201 | + 759 | + 718 |
| **Excess reserves*** | + 80 | + 132 | — 209 | + 85 | — 88 | — |

| | Daily average levels | | | | | |
|---|---|---|---|---|---|---|
| **Member bank:** | | | | | | |
| Total reserves, including vault cash* | 22,987 | 22,898 | 22,598 | 23,447 | 22,578 | 22,702§ |
| Required reserves* | 22,638 | 22,417 | 22,326 | 23,090 | 22,309 | 22,356§ |
| Excess reserves* | 349 | 481 | 272 | 357 | 269 | 346§ |
| Borrowings | 778 | 782 | 730 | 719 | 691 | 740§ |
| Free reserves* | — 429 | — 301 | — 458 | — 362 | — 422 | — 394§ |
| Nonborrowed reserves* | 22,209 | 22,116 | 21,868 | 21,728 | 21,887 | 21,962§ |

| | Changes in Wednesday levels | | | | | |
|---|---|---|---|---|---|---|
| **System Account holdings of Government securities maturing in:** | | | | | | |
| Less than one year | + 662 | — 197 | — 732 | + 38 | + 847 | + 618 |
| More than one year | — | — | — 83 | — | — | — 83 |
| **Total** | + 662 | — 197 | — 815 | + 38 | + 847 | + 535 |

Note: Because of rounding, figures do not necessarily add to totals.
* These figures are estimated.
† Includes changes in Treasury currency and cash.
‡ Includes assets denominated in foreign currencies.
§ Average for five weeks ended August 31.

### Table II

### RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS AUGUST 1966

In millions of dollars

| Factors affecting basic reserve positions | Daily averages—week ended | | | | | Average of five weeks ended August 31* |
|---|---|---|---|---|---|---|
| | August 3 | August 10 | August 17 | August 24 | August 31* | |
| **Eight banks in New York City** | | | | | | |
| Reserve excess or deficiency(—)† | 18 | 8 | 35 | — 4 | 46 | 21 |
| Less borrowings from Reserve Banks | — | 120 | 39 | 1 | — | 32 |
| Less net interbank Federal funds purchases or sales(—) | 482 | 339 | 531 | — 11 | — 132 | 242 |
| *Gross purchases* | *1,245* | *1,114* | *1,228* | *920* | *913* | *1,084* |
| *Gross sales* | *763* | *775* | *697* | *931* | *1,045* | *842* |
| Equals net basic reserve surplus or deficit(—) | — 464 | — 452 | — 535 | 5 | 178 | — 254 |
| Net loans to Government securities dealers | 230 | 185 | 171 | 70 | 281 | 187 |
| **Thirty-eight banks outside New York City** | | | | | | |
| Reserve excess or deficiency(—)† | 1 | 32 | 28 | 16 | 20 | 19 |
| Less borrowings from Reserve Banks | 223 | 139 | 193 | 100 | 61 | 143 |
| Less net interbank Federal funds purchases or sales(—) | 681 | 796 | 738 | 724 | 570 | 702 |
| *Gross purchases* | *1,556* | *1,681* | *1,651* | *1,670* | *1,686* | *1,649* |
| *Gross sales* | *875* | *885* | *913* | *946* | *1,117* | *947* |
| Equals net basic reserve surplus or deficit(—) | — 904 | — 902 | — 903 | — 808 | — 611 | — 826 |
| Net loans to Government securities dealers | 105 | 4 | 58 | — 7 | 214 | 75 |

Note: Because of rounding, figures do not necessarily add to totals.
* Estimated reserve figures have not been adjusted for so-called "as of" debits and credits. These items are taken into account in final data.
† Reserves held after all adjustments applicable to the reporting period less required reserves and carry-over reserve deficiencies.

### Table III

### AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

In per cent

| Maturities | Weekly auction dates—August 1966 | | | | |
|---|---|---|---|---|---|
| | August 1 | August 8 | August 15 | August 22 | August 29 |
| Three-month | 4.834 | 4.826 | 5.048 | 5.020 | 5.087 |
| Six-month | 4.969 | 5.050 | 5.315 | 5.410 | 5.566 |

| Maturities | Monthly auction dates—June-August 1966 | | |
|---|---|---|---|
| | June 23 | July 26 | August 25 |
| One-year | 4.697 | 4.964 | 5.844 |

* Interest rates on bills are quoted in terms of a 360-day year, with the discounts from par as the return on the face amount of the bills payable at maturity. Bond yield equivalents, related to the amount actually invested, would be slightly higher.

major New York City banks on call loans to Government securities dealers were in a 6¼ to 6⅝ per cent range until late in the month, when rates as low as 5½ per cent were quoted. Leading commercial banks continued to pay the ceiling rate of 5½ per cent for negotiable time certificates of deposit maturing in thirty days or more.

#### THE GOVERNMENT SECURITIES MARKET

Prices of Treasury notes and bonds declined sharply through most of August but recovered somewhat in the closing days of the month. As the month opened, the Treasury's August refunding operation, then in progress, held the market spotlight.[1] Immediately following the Treasury's July 27 refunding announcement, prices of many outstanding coupon issues moved down by as much as half a point, partly in adjustment to the additional supplies of five-year maturities which would arise out of the refunding. In addition, the market anticipated a considerable amount of switching out of outstanding coupon issues into the new refunding offerings—particularly into the new 5¼ per cent notes of 1971. Some such switching did indeed occur, particularly out of the 5 per cent notes of 1970 into the refunding issues. On balance, however, investor interest in the new 5¼ per cent certificates and notes—trading in the secondary market on a "when issued" basis—was rather limited. Against this background, prices of outstanding coupon issues and the new refunding issues fluctuated narrowly in dull trading during the August 1-3 subscription period.

After the refunding subscription books closed on August 3, prices of outstanding intermediate- and long-term issues drifted lower in light trading as the market awaited the results of the refinancing operation. Dealers became progressively more anxious to make sales—even at lower prices—as they reacted to reports that the calendar of scheduled corporate and Government agency financing was growing rapidly, and to predictions that credit demands would be exceptionally large in the autumn. At the same time, investor offerings expanded when some switching from outstanding long-term Treasury issues into higher yielding corporate bonds developed. During this period, market participants also assessed the potential impact of the increase in steel prices upon the general level of prices and interest rates.

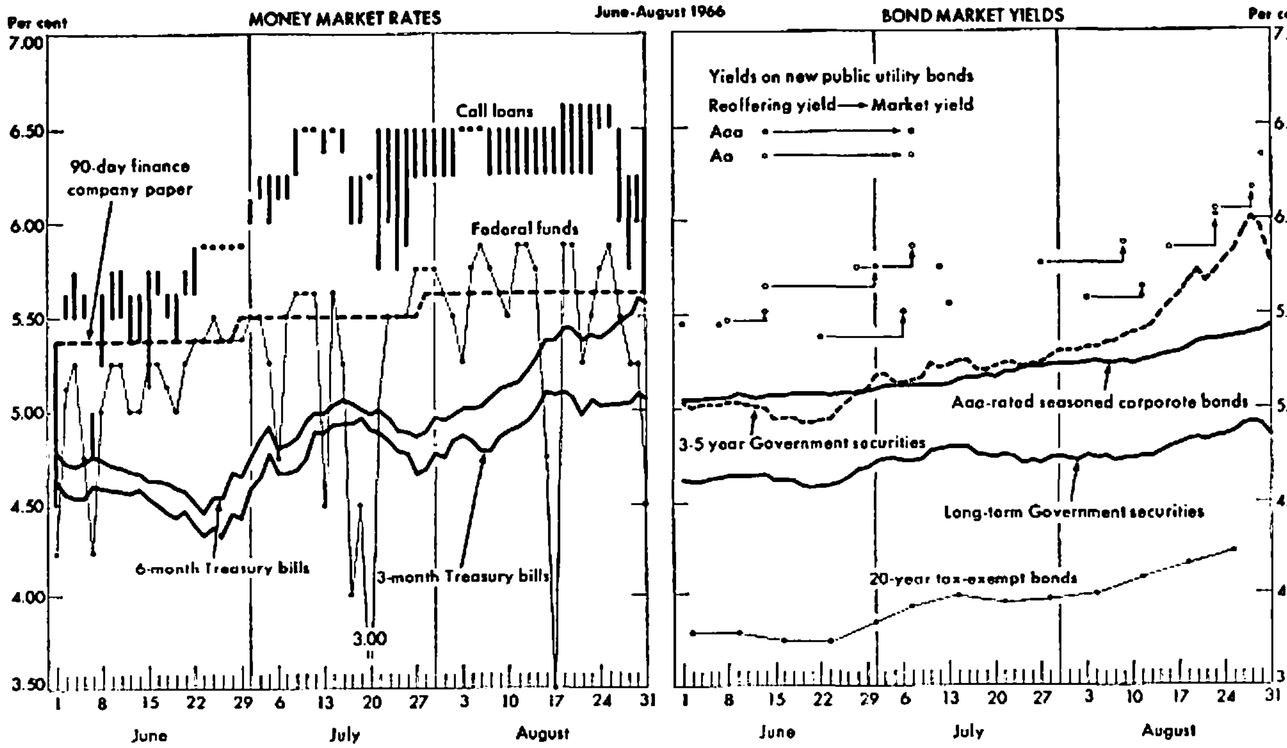
On August 5, the Treasury announced the results of the refunding. Approximately $10.1 billion of the $14.9 billion outstanding August and November issues eligible for exchange was converted into the new offerings. Subscriptions totaled approximately $5.9 billion for the new 5¼ per cent certificates of 1967 and almost $4.3 billion for the new 5¼ per cent notes of 1971. Public holders of the eligible maturing securities exchanged about $2.5 billion—or 78.5 per cent—of their $3.2 billion holdings of August 15 maturities, and $1.6 billion—or 33.5 per cent—of their $4.9 billion holdings of November 15 maturities. The amount of August maturities exchanged was approximately in line with market expectations, while the amount of November maturities refunded somewhat exceeded earlier market estimates, leaving only routine refinancing on the Treasury calendar for November.

The refunding results had little effect upon price quotations in the coupon sector, where attention was increasingly focusing upon other considerations. The tone of the market deteriorated considerably in the wake of an August 9 feature article in the financial press which predicted that heavy loan demands might soon trigger another increase (subsequently confirmed) in the prime lending rate of commercial banks. The coupon sector was also adversely affected by the heavy atmosphere evident elsewhere in the capital markets where new corporate and agency issues floated at record yields were encountering investor apathy. Dealer offerings continued to expand, some commercial bank sales took place, and prices of the new refunding issues and of outstanding securities steadily gave ground. The price decline gathered momentum around midmonth and, for some time afterward, daily price losses of up to ½ point on individual issues became commonplace. The August 16-17 rise in the prime lending rate of commercial banks further depressed the securities market and reinforced apprehension that monetary policy would become more restrictive. In this atmosphere, the increase in reserve requirements against certain time deposits, announced by the Board of Governors on August 17, triggered another sharp downward adjustment in prices of coupon issues. (The right-hand panel of the chart on page 208 illustrates the rise in yields which accompanied this decline in prices.)

As the month progressed, market participants also became increasingly concerned over the ability of commercial banks to replace the heavy volume of certificates of deposit soon to mature, since rates on several competing money market instruments had risen above the 5½ per cent ceiling rate on time certificates. The feeling was widespread among market participants that, should commercial banks encounter difficulty in rolling over their maturing certificates, bank sales of Government securities and/or tax-exempt issues would accelerate. In addition, dealers became ap-

[1] For details of the offering, see this *Review* (August 1966), page 177.

SELECTED INTEREST RATES*




Note: Data are shown for business days only.

* MONEY MARKET RATES QUOTED. Daily range of rates posted by major New York City banks on new call loans (in Federal funds) secured by United States Government securities (a point indicates the absence of any range); offering rates for directly placed finance company paper; the effective rate on Federal funds (the rate most representative of the transactions executed); closing bid rates (quoted in terms of rate of discount) on newest outstanding three- and six-month Treasury bills.

BOND MARKET YIELDS QUOTED. Yields on new Aaa- and Aa-rated public utility bonds are plotted around a line showing daily average yields on seasoned Aaa-rated corporate bonds (arrows point from underwriting syndicate reoffering yield on a given issue to market yield on the same issue immediately after it has been released from syndicate restrictions); daily averages of yields on long-term Government securities (bonds due or callable in ten years or more) and of Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields on twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, and The Weekly Bond Buyer.

prehensive about the availability of funds to finance their positions. New York City bank rates on dealer loans were quoted as high as 6⅝ per cent, and only a limited amount of funds was available from out-of-town sources. A somewhat improved market tone developed at the end of the month when participants responded favorably to renewed discussion of a possible anti-inflationary tax increase. Demand for coupon issues expanded and prices rebounded, erasing a portion of their earlier losses.

A very cautious atmosphere was also evident in the Treasury bill market through most of August. The rapid general rise in interest rates—including the increase in the prime lending rate of commercial banks—compounded the uneasiness of bill market participants as they weighed the rate outlook in their own sector. In the opening days of August, investment demand favored the short-dated bills, which were in scarce supply in the market, and rates receded slightly in the under-three-month maturity area. At the same time, however, little investor interest was evident in longer bills, which continued to edge higher in rate. Market sentiment was dampened considerably when the magnitude of reinvestment demand for bills of various maturities from sellers of "rights" to the Treasury's August refinancing of coupon issues fell short of earlier market expectations.

From August 8 onward, the upward rate movement spread into the shorter bill maturity area as well (see the left-hand panel of the chart). Offerings of these issues increased and demand for them tapered off. On August 11, the Treasury announced that it would auction $2 billion of March 1967 tax anticipation bills and $1 billion of April 1967 tax bills on August 18. In the wake of the announcement, which came at a time when market uncertainty over the interest rate outlook was growing, rates on outstanding bills moved sharply higher, largely as a result of aggressive dealer offerings. At the regular weekly bill auction on August 15, where bidding was quite restrained, average issuing rates climbed to 5.048 per cent for the new three-month bill and 5.315 per cent for the six-month issue (see Table III). Another marked increase in bill rates took place in reaction to the rise in the prime rate announced by most commercial banks on August 16 and 17. At the August 18 auction of the tax anticipation bills, effective bidding was confined to commercial banks, which were permitted to make full payment through credits to Treasury Tax and Loan Accounts—a privilege estimated by the market to be worth about 30 to 35 basis points to the banks. Nevertheless, banks anticipated some difficulty in distributing the tax bills in the secondary market and therefore bid very cautiously. Average issuing rates were set at 5.338 per cent for the March bills and 5.433 per cent for the April bills, historic highs for such securities.

For a brief period following the tax bill auction, the bill market rallied when demand expanded somewhat. Rates for outstanding bills edged lower with the sharpest declines recorded by short bill maturities. Subsequently, however, the bill sector weakened again. At the regular monthly auction of one-year bills on August 25, an average issuing rate of 5.844 per cent was set, almost 90 basis points higher than the average rate at the preceding monthly auction. (When measured on a bond yield equivalent basis, the yield on this issue was 6.20 per cent.) The bill market rallied late in the month, when demand expanded somewhat and rates turned downward. Nevertheless, at the end of the month, the newest outstanding three- and six-month Treasury bills were bid at rates of 5.06 per cent and 5.58 per cent, respectively, 29 and 62 basis points above the rates quoted on comparable issues a month earlier.

In the market for United States Government agency obligations, participants displayed considerable concern over the general outlook for interest rates and the expanding calendar of scheduled agency flotations. Consequently, prices in this market fell back steadily through most of the month. Several new agency issues, which were floated at or close to record high yields, were accorded mixed investor receptions. Early in the period, the FNMA publicly offered $300 million of new two-year debentures priced to yield 5.91 per cent, and sold an additional $50 million of the issue to Treasury trust accounts. The publicly offered debentures encountered investor resistance and their yield rose in subsequent secondary market trading. Around mid-month, a public offering by the Federal Home Loan Banks of $500 million of one-year bonds, priced to yield a new record high for agency financing of approximately 6 per cent, also encountered investor apathy. Later in the month, the market was further restrained by discussion of the possibility that a sizable offering of participation certificates might be made in September. However, some improvement in the atmosphere of the agency market occurred at the end of August following press reports that no firm decision had yet been made with respect to this offering.

## OTHER SECURITIES MARKETS

In the markets for corporate and tax-exempt bonds, prices generally fell back sharply until late in August as participants became increasingly concerned over the mounting demands for credit converging upon their markets. A better atmosphere emerged in both sectors at the end of the month, however, when participants reacted to renewed discussion of a possible tax increase. Historically, a lull in new issue activity has generally developed in the capital markets during August, but such was not the case this year. New publicly offered corporate bonds totaled $1.2 billion in August, the largest volume ever recorded in a single month. Early in the month, market attention focused upon the American Telephone and Telegraph Company $250 million flotation of Aaa-rated 5⅝ per cent debentures maturing in 1995 which were sold at the highest net interest cost to the company in over forty years. These securities, which carried five-year call protection, were aggressively bid for by underwriters. When first reoffered to yield 5.58 per cent, the debentures attracted good interest from small investors. Subsequently, however, distribution of the issue slowed considerably, syndicate price restrictions were removed, and the debentures initially jumped 6 basis points in yield when they began to trade freely. By the end of the month, the telephone issue was trading to yield as much as 5.82 per cent. Other new corporate issues were generally accorded mixed receptions during the month. Only issues that carried extended protection against early call, had delayed delivery provisions, and were reoffered at considerably reduced prices drew any investor interest. Prices of recent corporate offerings and seasoned issues also fell sharply during the month (see the comparable rise in yields illustrated in the right-hand panel of the chart), although a steadier tone emerged at the end of the period.

In the tax-exempt sector, prices of new offerings and seasoned issues dropped sharply through most of the month in an uncertain atmosphere and yields rose to their highest levels in more than thirty years. Commercial banks continued to reduce their holdings of tax-exempt securities on a fairly large scale, while dealers were able to make sales from their inventories only after progressive price concessions. New tax-exempt bond flotations totaled about $735 million in August, as against $630 million (revised) the month before and about $720 million in August 1965. Several new tax-exempt issues which had been scheduled for sale during the month failed to reach the market either as a result of postponements or because prevailing market yields exceeded certain local statutory interest rate limitations. The largest new tax-exempt bond offering of the month consisted of $100 million of Aa-rated state bonds. The bonds were reoffered just after midmonth to yield from 4 per cent in 1967 to 4.20 per cent in 1987, and were fairly well received due in part to their relatively attractive yield.

Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds rose by 21 basis points to 5.44 per cent, while *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues (carrying ratings ranging from Aaa to Baa) climbed by 28 basis points to 4.24 per cent (see the right-hand panel of the chart). These indexes are, however, based on only a limited number of seasoned issues and do not necessarily reflect market movements fully, particularly in the case of new and recent issues.

## THE MONEY MARKET AND BANK RESERVES

The money market was quite firm during most of August, although a slightly easier tone emerged toward the end of the month. Nationwide net borrowed reserves averaged $394 million during the five weeks ended August 31, little changed from the revised level of the month before (see Table I). Reflecting the persisting pressures on commercial bank reserve positions, Federal funds were strongly bid through most of the month. The effective rate on such funds generally ranged from 5½ per cent to a record 5⅞ per cent and, for the first time, some trading occurred at 6 per cent—1½ per cent above the Federal Reserve discount rate. Member bank borrowings from the Federal Reserve Banks averaged $740 million during the five-week August period, as against $739 million during the four weeks ended July 27.

The distribution of reserve pressures shifted somewhat in August from the pattern that had prevailed during most of July. The reserve positions of banks outside the major money centers came under increased pressure, and these banks turned more frequently to the Federal Reserve "discount window" to fill their residual reserve needs. At the same time, the reserve positions of money market banks—particularly those located in New York City—were under somewhat reduced pressure (see Table II). The improvement in the reserve positions of banks in the central money market largely reflected a decline in their lending to Government securities dealers who, faced by call loan rates of 6¼ per cent to 6⅝ per cent at New York banks, kept their inventories low and increasingly sought out less expensive sources of funds to fill their limited financing needs.

Rates on a variety of short-term money market instruments continued to move upward during the month. By the end of August, offering rates on commercial paper placed by dealers were ¼ of a per cent higher than a month earlier, and rates on bankers' acceptances were generally ⅛ of a per cent higher. The major New York City banks continued to pay the 5½ per cent ceiling rate on all maturities of new negotiable time certificates of deposit. Rates on prime certificates trading in the secondary market edged steadily higher, reaching a 5¾ to 6 per cent range on three-month maturities and a 5.8 to 6¼ per cent range on six-month maturities by the end of the month. Over $3.7 billion of outstanding negotiable certificates of deposit matured at large commercial banks in August, and an additional $6.7 billion is scheduled to come due over the September-October period. With interest rates on most competing money market instruments above the 5½ per cent ceiling rate applicable to new time certificates, commercial banks were faced with the prospect of mounting difficulties in replacing maturing certificates. In August, negotiable time certificates outstanding at weekly reporting member banks in New York City declined by $263 million.