The Money and Bond Markets in December

An atmosphere of deepening pessimism and caution pervaded the money and capital markets in December. Yields on a wide range of obligations—including Treasury, corporate, and tax-exempt securities—soared to levels unmatched in modern history.

The first of two successive ¼ percentage point increases in the prime lending rate of commercial banks was initiated on the first business day of the month. The new 6½ percent rate was largely unexpected by the market and triggered apprehension that upward adjustments in other key interest rates would soon follow. Steadily mounting indications that inflationary pressures were persisting, despite the imposition of fiscal restraint, led many market participants to predict that monetary policy would soon be tightened, possibly through an increase in the discount rate of the Federal Reserve Banks. In this setting, yields on Treasury obligations and most other debt instruments throughout the maturity range moved sharply higher on balance during the first half of the month.

After the close of business on December 17, the Board of Governors of the Federal Reserve System announced that it had approved an increase from 5¼ percent to 5½ percent in the discount rate of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, and

Dallas, effective December 18.[1] The Board stated that:

> This discount rate increase was approved in recognition of the advances that have taken place in other market interest rates in recent months and also in light of the resurgence in inflationary expectations that is impeding the restoration of economic stability. The objective of Federal Reserve policy is to foster financial conditions conducive to the reduction of inflationary pressures, with a view toward encouraging a more sustainable rate of economic expansion and attaining reasonable equilibrium in the country's balance of payments. The present action is being taken in furtherance of a policy of restraint. . . . The increase restores the rate to the level prevailing between April 19 and August 15, 1968. This level is the highest in nearly four decades.

No changes were made in the ceiling rates which member banks may pay on time deposits under the provisions of Federal Reserve Regulation Q. This omission tended to confirm the belief that the central bank had decided to act more forcefully to limit credit expansion.

The money and bond markets responded to the Federal Reserve action in an orderly fashion on December 18. Initially yields even receded slightly, reflecting momentary relief in some quarters that the discount rate increase had not been larger. Later that same day, however, the market atmosphere weakened again after the major commercial banks throughout the nation swiftly announced a second round of increases in the prime rate, boosting this key interest rate to a record level of 6¾ percent. Subsequently, prices fell precipitously and market yields rose to unprecedented levels. With the firm intent of monetary policy clearly evident and with discussion in some quarters of the possibility of a new credit "crunch", market participants remained pessimistic during the remainder of the month, although there was some improvement in the tone of the Government securities market toward the year-end.

A rather sharp expansion of reserve availability due to seasonal factors contributed to relatively comfortable money market conditions during the first half of December. When reserve availability contracted thereafter, however, the money market tightened markedly. Federal funds traded predominantly at 5⅞ percent on most days through December 18, and thereafter mainly in a 6¼ to 6½ percent range. The high rates were particularly discouraging to money and bond market participants, while member bank borrowings at the Reserve Banks rose near the year-end statement date to levels that had not been exceeded for many years.

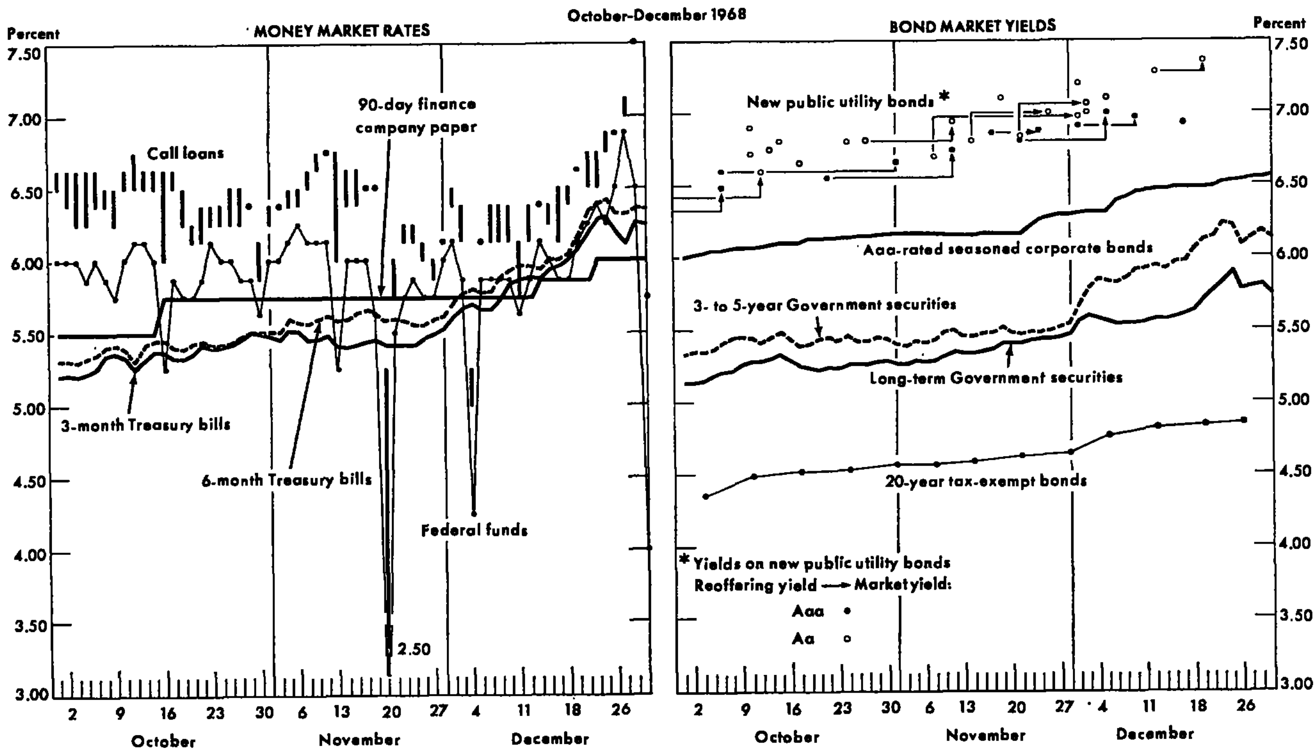
THE GOVERNMENT SECURITIES MARKET

A very cautious tone prevailed in the market for Treasury notes and bonds in December, and prices adjusted sharply lower during the period. (Associated yield increases are illustrated in the right-hand panel of the chart.) In initial reaction to the prime rate increase to 6½ percent, prices of intermediate-term coupon issues declined on December 2 by as much as 19/32 point. Longer term Treasury issues, which were also adversely affected by sharply rising yields for corporate and tax-exempt obligations, recorded price losses of as much as 1 5/16 points that day. As the month progressed, an atmosphere of nervousness predominated in the Government securities market. Indications of continued buoyancy in the domestic economy, accompanied by the persistence of inflationary pressures, gave rise to a feeling on the part of many in the market that monetary policy would soon be tightened. Against this background, prices of intermediate-term coupon issues declined fairly steadily during the first half of December, and yields on some issues climbed to historic highs (see chart). To be sure, demand sporadically improved when some market participants were attracted to the high prevailing yields. In the longer term maturity area, where very sharp price losses had boosted yields to record levels during the first few days of December, demand also improved modestly at times and scattered price gains partially offset the losses suffered at the very beginning of the month. However, trading in the coupon sector remained fairly light during the first half of December, chiefly involving year-end tax switching and professional activity. Despite the bearish undertone of the market and the persisting uncertainty over the near-term outlook for interest rates, excessive selling pressures did not develop.

The coupon sector initially took in stride the Federal Reserve discount rate rise which was announced shortly after midmonth. Market participants had considered the possibility of more severe action by the monetary authorities, and some modest price improvement actually occurred in early trading on December 18. Later that day, however, many of the nation's large commercial banks announced another ¼ percentage point increase in the prime rate, boosting it to a record 6¾ percent. This

[1] The Board later approved an increase in the discount rate of the other three Federal Reserve Banks—those of San Francisco, St. Louis, and Kansas City—effective December 20.

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 (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 seasoned Aaa-rated corporate bonds; daily averages of yields on long-term Government securities (bonds due or callable in ten years or more) and on 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.

move triggered an immediate and fairly sharp decline in prices of Treasury notes and bonds amid predominantly professional activity. The tone of the coupon sector continued to deteriorate over the next week, and prices dropped sharply throughout the maturity spectrum in response to greatly expanded offerings from professional and investor sources. Market participants became increasingly convinced that, in view of the rapid pace of domestic economic expansion and the current posture of monetary restraint, interest rates would continue to rise in the short run. Nevertheless, despite the persistence of a cautious undertone, prices rallied at times toward the end of the year in response to some investor demand and professional short covering. Over the month as a whole, prices of most issues maturing within five years declined by from ¼ point to as much as 2⁵⁄₃₂ points, while prices of longer term issues were 1⅞ points to as much as 4⅜ points lower.

Treasury bill rates rose steeply during December in response to pressures emanating from several sources. The prime rate increase that was initiated on December 2 induced a rapid rise in bill rates in the early days of the month, as professional participants cautiously marked prices lower in an attempt to lighten their inventories. Moreover, offerings of June tax anticipation bills by commercial banks expanded. These bank offerings reflected both underlying concern that bill rates might rise still further and portfolio adjustments linked to large calls on Treasury Tax and Loan Accounts immediately following the December 2 payment date for the tax bills.

Basically, however, the primary factor responsible for the heavy undertone in the bill sector during the first half of December was the widespread conviction that current domestic economic conditions would necessitate some new action by the monetary authorities, probably involving a discount rate increase. The upward trend in bill rates during this period pushed bond-equivalent yields on many key issues, including six-month bill maturities, well above 6 percent. Nevertheless, a strong investment demand for bills occasionally emerged during the interval.

The Federal Reserve discount rate announcement removed an element of market uncertainty, and bill rates initially declined slightly on December 18. A weaker tone soon reappeared, however, when market participants reacted to the prompt increase in the commercial bank prime rate that followed the discount rate action. Over most of the remainder of the month, bill rates moved sharply higher, on balance, mainly in response to selling pressures from professional sources and commercial banks. In the closing days of the month, the unusually high yield levels stimulated improved demand, including bank buying for year-end statement purposes, and bill rates receded somewhat.

At the last monthly auction of the year, held on December 23, average issuing rates on the new nine- and twelve-month bills were set at record levels of 6.483 percent and 6.412 percent, respectively, 79 and 84 basis points higher than average rates at the comparable November auction (see Table III). The bond-equivalent yield in both cases was 6.84 percent. At the final regular weekly auction of the month, held on December 27, average issuing rates for the new three- and six-month bills were set at 6.199 percent and 6.332 percent, respectively, 75 and 76 basis points above average rates established a month earlier but 8 and 7 basis points, respectively, below the record rates set at the December 20 weekly auction.

OTHER SECURITIES MARKETS

A heavy tone persisted in the markets for corporate and tax-exempt bonds in December and, as in other market sectors, a steady price decline boosted yields to record levels. Market sentiment grew quite bearish following the rise early in the month in the commercial bank prime rate. The weakness of both sectors was reflected in the upward trend in yields on new offerings, the price adjustments on slow-moving recent issues following the removal of syndicate price restrictions, and the postponement of several scheduled flotations because of adverse market conditions. Investment interest improved somewhat around midmonth in response to the unusually high yield levels, and several new corporate and tax-exempt offerings were accorded fairly good receptions. Subsequently, however, prices of tax-exempt and corporate bonds declined further in the wake of the increase in the Federal Reserve discount rate that was announced on December 17 and the rise in the prime rate that followed soon after. The end-of-year lull in activity, however, limited the price reaction in these sectors to moderate proportions.

At the close of the year, *The Weekly Bond Buyer's* yield index of twenty seasoned tax-exempt issues was quoted at 4.85 percent, 21 basis points higher than a month earlier and 78 basis points higher than the year's low reached in August. Moody's index for seasoned Aaa-rated corporate bonds closed the year at 6.55 percent, 26 basis points higher than a month earlier. The Blue List of advertised dealer inventories of tax-exempt securities contracted steadily, as underwriting activity declined, and totaled $547 million at the end of the month as against its November 29 level of $858 million.

BANK RESERVES AND THE MONEY MARKET

A fairly firm tone prevailed in the money market at the beginning of the month, and Federal funds traded predominantly in a 5⅞ to 6⅛ percent range on December 2 and 3. The basic reserve position of the eight major New York City banks improved, as the rise in private deposits that had begun at these institutions in mid-November continued. This gain was offset elsewhere, however, for the average basic reserve deficit of thirty-eight large banks in money centers outside New York increased, partly reflecting a contraction in Government deposits. Nevertheless, excess reserves were accumulated by the major New York City banks, and reserve availability was enhanced by a rise in Federal Reserve float. Consequently, money market conditions eased as the week progressed, and the effective rate on Federal funds dropped to 4¼ percent on the final day of the December 4 statement period.

A relatively comfortable tone prevailed in the money market over the December 11 statement week. Member banks carried a substantial amount of excess reserves into the period. More significantly, however, "market" factors—notably Treasury deposits at the Reserve Banks which were depleted preceding the midmonth tax date and Federal Reserve float—released a considerable volume of reserves to member banks throughout the nation (see Table I). Reserve distribution generally favored smaller banks, while forty-six large banks in the major money centers experienced a $1.4 billion deterioration in their average basic reserve position, principally as a result of a contraction in demand deposits and an expansion in loans to Government securities dealers. However,

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, DECEMBER 1968

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

Factors	Changes in daily averages— week ended on				Net changes
	Dec. 4	Dec. 11	Dec. 18	Dec. 25	
"Market" factors					
Member bank required reserves	+ 23	— 34	— 305	— 86	— 402
Operating transactions (subtotal)	+ 30	+ 510	+ 871	— 308	+1,103
Federal Reserve float	+ 30	+ 346	+ 747	+ 347	+1,470
Treasury operations*	+ 68	+ 415	+ 125	— 391	+ 217
Gold and foreign account	— 6	— 8	— 1	+ 17	+ 2
Currency outside banks	— 215	— 194	— 282	— 185	— 876
Other Federal Reserve accounts (net)†	+ 151	— 48	+ 281	— 95	+ 289
Total "market" factors	+ 53	+ 476	+ 566	— 394	+ 701
Direct Federal Reserve credit transactions					
Open market instruments					
Outright holdings:					
Government securities	+ 307	— 797	— 722	+ 435	— 777
Bankers' acceptances	— 2	—	— 1	— 2	— 5
Special certificates	—	+ 13	+ 326	— 339	—
Repurchase agreements:					
Government securities	+ 28	— 28	—	+ 60	+ 60
Bankers' acceptances	—	—	—	+ 7	+ 7
Federal agency obligations	+ 1	— 1	—	+ 4	+ 4
Member bank borrowings	— 50	— 97	+ 139	+ 285	+ 277
Other loans, discounts, and advances	—	—	—	—	—
Total	+ 285	— 909	— 258	+ 449	— 433
Excess reserves	+ 338	— 433	+ 308	+ 55	+ 268
	Daily average levels				
Member bank:					
Total reserves, including vault cash	26,840	26,441	27,054	27,195	26,883‡
Required reserves	26,383	26,417	26,722	26,808	26,583‡
Excess reserves	457	24	332	387	300‡
Borrowings	532	435	574	859	600‡
Free, or net borrowed (—), reserves	— 75	— 411	— 242	— 472	— 300‡
Nonborrowed reserves	26,308	26,006	26,480	26,336	26,283‡
Net carry-over, excess or deficit (—)§	56	200	25	162	111‡
	Changes in Wednesday levels				
System Account holdings of Government securities maturing in:					
Less than one year	— 568	—1,233	— 55	+1,606	— 250
More than one year	—	—	— 358	—	— 358
Total	— 568	—1,233	— 413	+1,606	— 608

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† Includes assets denominated in foreign currencies.
‡ Average for four weeks ended on December 25, 1968.
§ Not reflected in data above.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS DECEMBER 1968

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on				Averages of four weeks ended on Dec. 25
	Dec. 4	Dec. 11	Dec. 18	Dec. 25	
Eight banks in New York City					
Reserve excess or deficiency(—)*	165	— 107	100	91	62
Less borrowings from Reserve Banks	69	86	104	275	134
Less net interbank Federal funds purchases or sales(—)	395	938	1,154	1,389	969
Gross purchases	*1,524*	*1,918*	*1,997*	*1,966*	*1,851*
Gross sales	*1,129*	*981*	*843*	*578*	*883*
Equals net basic reserve surplus or deficit(—)	— 299	—1,131	—1,158	—1,572	—1,040
Net loans to Government securities dealers	641	776	1,151	848	854
Net carry-over, excess or deficit(—)†	— 25	77	— 31	57	20
Thirty-eight banks outside New York City					
Reserve excess or deficiency(—)*	43	— 24	20	— 5	9
Less borrowings from Reserve Banks	152	114	256	368	223
Less net interbank Federal funds purchases or sales(—)	1,896	2,417	2,003	1,831	2,037
Gross purchases	*3,149*	*3,495*	*3,324*	*3,088*	*3,264*
Gross sales	*1,253*	*1,078*	*1,322*	*1,257*	*1,228*
Equals net basic reserve surplus or deficit(—)	—2,004	—2,555	—2,239	—2,204	—2,251
Net loans to Government securities dealers	362	486	590	345	446
Net carry-over, excess or deficit(—)†	19	38	12	25	24

Note: Because of rounding, figures do not necessarily add to totals.
* Reserves held after all adjustments applicable to the reporting period less required reserves and carry-over reserve deficiencies.
† Not reflected in data above.

Table III

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

In per cent

Maturities	Weekly auction dates—December 1968				
	Dec. 2	Dec. 9	Dec. 16	Dec. 20	Dec. 27
Three-month	5.633	5.788	5.966	6.278	6.199
Six-month	5.730	5.906	6.017	6.401	6.332

Maturities	Monthly auction dates—October-December 1968		
	Oct. 24	Nov. 22	Dec. 23
Nine-month	5.446	5.693	6.483
One-year	5.401	5.568	6.412

* 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.

Federal funds were readily available during most of the period from banks outside the large money centers, and in this setting Federal funds traded predominantly at a fairly comfortable 5⅞ percent.

The tone of the money market grew slightly firmer as midmonth approached. The leading New York City banks transferred a reserve deficiency into the December 18 statement period, while major banks outside the central money market carried only a relatively small amount of eligible excess reserves into the period (see Table II). Although the basic reserve deficit of the eight major New York City banks was little changed during the week on a daily average basis, caution was engendered by a rise in loan demand over the December 16 corporate tax payment date and by the possibility of a rapid loss of tax payments credited to Government deposit accounts. Moreover, System open market operations during the week absorbed a portion of the continued high level of reserves released through changes in "market" factors. Against this background, a fairly good demand for Federal funds developed over the statement period and most trading took place in a 5⅞ to 6⅛ percent range.

The money market grew substantially firmer in the latter part of December. As time passed, float fell from the abnormally high levels of prior weeks, and reserves were absorbed in volume by the replenishment of the Treasury's low balances at the Reserve Banks. In addition, reserve requirements increased sharply, as the earlier deposit growth was reflected with a two-week lag under the new accounting method. Reserve management by the major money market banks became especially cautious in the face of the usual year-end pressures, apprehension over further loss of time deposits, and a tighter monetary policy. Federal funds traded predominantly in a 6⅛ to 6⅜ percent range during the statement week ended on December 25 and mainly in a 6½ to 6⅞ percent range from December 26 through December 30, with some trading at rates as high as 7⅛ percent on Friday, December 27. (The effective rate fell to 4 percent on December 31 under the weight of a massive accumulation of excess reserves.) In this atmosphere, the nation's banks resorted to borrowing at the "discount window" in dramatic volume. Member bank borrowings from the Federal Reserve averaged $859 million over the December 25 statement period. For the four statement weeks ended on December 25, borrowings averaged $600 million, and in the statement period ended on January 1, borrowings soared to a $1.3 billion average. Mainly reflecting cautious reserve management in the uncertain climate which prevailed during much of December, excess reserves of all member banks averaged $300 million during the four weeks ended on December 25, $58 million more than during the four statement weeks ended on November 27. In the January 1 statement period, excess reserves rose to an average level of $862 million.

In the wake of the two ¼ percent increases in the prime lending rate of commercial banks, which raised this key rate to 6¾ percent, and the upward adjustment in the Federal Reserve discount rate from 5¼ percent to 5½ percent, rates for a wide spectrum of money market instruments moved higher in December. Rates quoted by dealers in bankers' acceptances on ninety-day instruments rose by ½ percent to 6⅝ percent bid-6½ percent offered, rates on dealer-placed prime four- to six-month commercial paper rose generally by ¼ percent to 6¼ percent offered, while offering rates on directly placed commercial paper moved ⅜ percent higher to 6¼ percent. Offering rates posted in December by the major New York City banks on time certificates of deposit (C/D's) were predominantly at the Regulation Q ceiling levels throughout the maturity range. As rates on virtually all competing money market instruments, including Treasury bills, rose progressively during the month, C/D's were at a widening yield disadvantage and commercial banks were unable to replace all the heavy volume that matured over the quarterly corporate dividend and tax payment period. The volume of C/D's outstanding at the weekly reporting banks in New York City declined by $1 billion between November 27 and December 31 (including a $554 million loss during the December 18 statement week) as against a $523 million rise in November. Liabilities of United States banks to their foreign branches declined by $1.2 billion, compared with an increase of $193 million in November.