The Money and Bond Markets in February

Short-term and long-term interest rates moved in opposite directions during February. Short-term rates continued to fall sharply, in some cases to the lowest levels seen since 1964. In response to declines in other short-term rates, the Federal Reserve discount rate was also reduced by ¼ percentage point to 4¾ percent. This marked the fifth such reduction in the discount rate since the beginning of November.

In contrast to short-term rates, yields rose in the capital markets during February. The deterioration in the market atmosphere was especially pronounced in the corporate bond sector, where the calendar of prospective offerings mounted steeply. Yields on new Aa-rated utilities increased by about 70 basis points over the month. The rise in municipal bond yields was somewhat less pronounced. *The Weekly Bond Buyer's* twenty-bond index rose to 5.34 percent at the end of February, up 18 basis points from four weeks earlier but 29 basis points above the two-year low reached early in February. Yields on most long-term Treasury bonds increased by 15 to 22 basis points over the month.

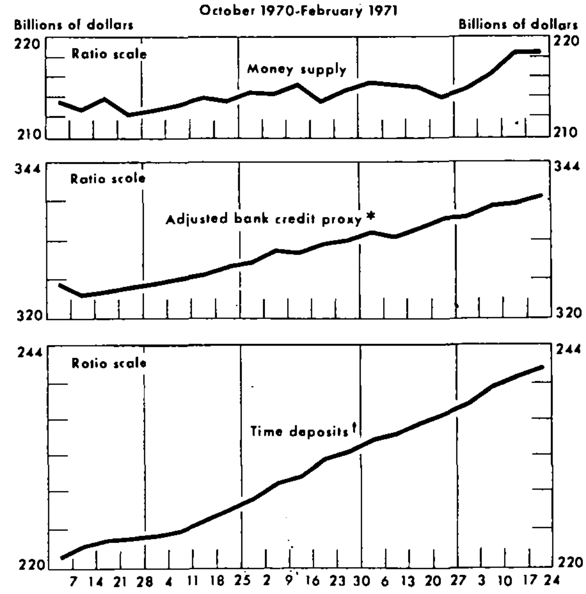
The monetary and credit aggregates rose sharply in February (see Chart I). For example, the narrowly defined money supply—demand deposits and currency held by the public—grew at a rapid seasonally adjusted annual rate of about 12 percent. Over the three months ended in February, the annual growth rate of the money supply averaged about 6½ percent. In comparison, during all of 1970 the money supply increased by 5.4 percent. The adjusted bank credit proxy[1] rose at a seasonally adjusted annual rate of about 13 percent in February and 13½ percent over the three months ended in February. During all of 1970, the adjusted bank credit proxy expanded by 8.3 percent.

[1] A measure of bank liabilities, which includes deposits subject to reserve requirements and nondeposit items such as Euro-dollar liabilities and bank-related commercial paper.

THE MONEY MARKET

Money market conditions continued to ease in February, as System open market operations provided a sizable volume of reserves. The average effective rate on Federal funds fell to 3.72 percent in February, down 42 basis points from January's average and the lowest monthly average since November 1964. Yields on all other money market instruments also fell substantially (see Chart II). The offering rate on dealer-placed four- to six-month prime

Chart I
CREDIT AND MONETARY AGGREGATES
Seasonally adjusted weekly averages
October 1970-February 1971

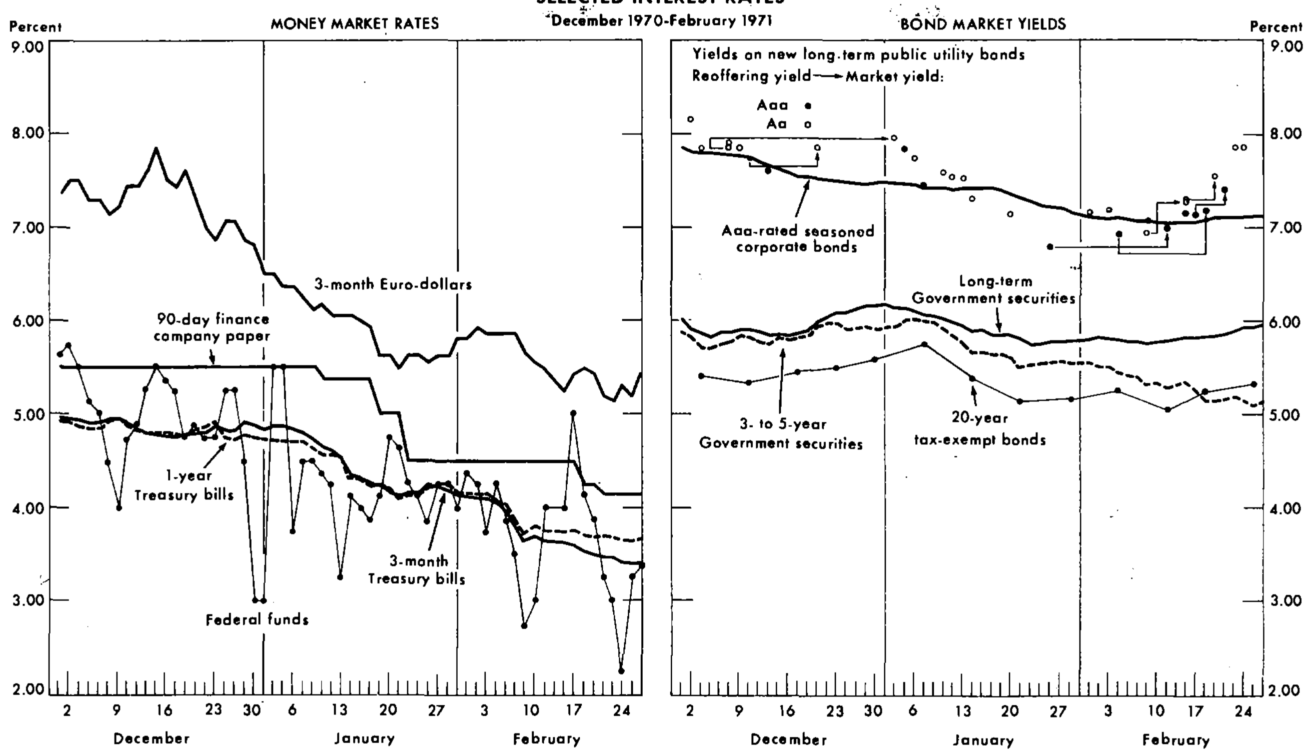


Note: Data for February are preliminary.
* Total member bank deposits subject to reserve requirements plus nondeposit liabilities, including Euro-dollar borrowings and commercial paper issued by bank holding companies or other affiliates.
† At all commercial banks.

Chart II

SELECTED INTEREST RATES

December 1970-February 1971



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Bid rates for three-month Euro-dollars in London; 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-month and one-year 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.

commercial paper fell to 4¼ percent, down ⅜ percentage point from the end of January. Likewise, interest rates on directly placed commercial paper and bankers' acceptances moved appreciably lower during the month, and some major banks trimmed as much as ½ percentage point off the rates they were willing to pay on negotiable certificates of deposit (CD's). As short-term market interest rates continued to post steep declines, the twelve Federal Reserve Banks reduced the discount rate from 5 percent to 4¾ percent. This was the fifth ¼ point reduction in the discount rate in three months.

Reflecting the general ease of conditions in the money market, the prime rate was cut by ¼ percentage point in February to 5¾ percent. This was the latest in a series of nine reductions that began in March 1970, when the prime rate stood at 8½ percent. Despite these reductions, commercial bank business loans had been quite weak during the last quarter of 1970. Modest growth resulted in January, however, and picked up further in February.

Member bank borrowings from the Federal Reserve Banks averaged $336 million during the four weeks ended February 24 (see Table I), $34 million below the January average. The decline would have been greater but for a bulge in member bank borrowings that occurred in the third statement week. Banks in some states—including those in New York—were closed for four consecutive days during this week, which was the longest bank holiday since the compulsory closing of banks in 1933. The extended holiday weekend complicated commercial banks' estimation of their reserves and compounded the difficulties of

Table I
FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, FEBRUARY 1971

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

Factors	Changes in daily averages— week ended Feb. 3	Feb. 10	Feb. 17	Feb. 24	Net changes
"Market" factors					
Member bank required reserves	+ 168	+ 167	− 358	+ 340	+ 317
Operating transactions (subtotal)	− 229	+ 17	− 976	+1,004	− 184
Federal Reserve float	− 402	+ 543	− 554	+ 839	+ 426
Treasury operations*	+ 289	− 256	− 50	+ 418	+ 401
Gold and foreign account	+ 16	− 4	− 10	+ 2	+ 4
Currency outside banks	+ 3	− 229	− 577	− 108	− 911
Other Federal Reserve liabilities and capital	− 135	− 37	+ 215	− 146	−103
Total "market" factors	− 61	+ 184	−1,334	+1,344	+ 133
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 79	− 200	+1,209	− 617	+ 471
Outright holdings:					
Government securities	− 26	− 61	+ 439	− 9	+ 343
Bankers' acceptances	− 2	− 1	− 5	+ 1	− 7
Repurchase agreements:					
Government securities	+ 87	− 110	+ 643	− 509	+ 111
Bankers' acceptances	+ 14	− 12	+ 47	− 32	+ 17
Federal agency obligations	+ 6	− 16	+ 85	− 68	+ 7
Member bank borrowings	− 71	− 36	+ 317	− 315	− 105
Other Federal Reserve assets†	+ 8	+ 20	− 118	− 369	− 459
Total	+ 16	− 216	+1,408	−1,301	− 93
Excess reserves	− 45	− 32	+ 74	+ 43	+ 40

	Daily average levels				Monthly averages
Member bank:					
Total reserves, including vault cash	29,959	29,760	30,192	29,895	29,952
Required reserves	29,722	29,555	29,913	29,573	29,691
Excess reserves	237	205	279	322	261
Borrowings	283	247	564	249	330
Free, or net borrowed (−), reserves	− 46	− 42	− 285	73	− 75
Nonborrowed reserves	20,676	29,513	29,628	29,646	29,616
Net carry-over, excess or deficit (−)§	120	142	101	129	123

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 February 24.
§ Not reflected in data above.

System reserve management. As a result, when the holiday ended on Tuesday, February 16, commercial banks found themselves extremely short of reserves with only two days to cover their reserve deficiencies. Although the System injected massive amounts of funds to alleviate this shortage, operating factors during the statement week—including a drop of $554 million in Federal Reserve float and an increase of $577 million in currency outside banks—absorbed a large volume of reserves. Consequently, the Federal funds rate rose sharply and banks borrowed heavily from the System on Tuesday and Wednesday, bringing the average level of member bank borrowings to $564 million for the week.

Turning to the monetary aggregates, the narrowly defined money supply expanded in February at a rapid seasonally adjusted annual rate of about 12 percent, according to preliminary data. This rise follows gains of 6.2 percent in December and only 1.1 percent (revised) in January. As was the case over this most recent three-month interval, this aggregate often displays wide short-term fluctuations. However, since the short-term fluctuations generally arise from technical distortions of one type or another, it is usually more useful and relevant to look at growth rates extending over at least several months. In this vein, over the three months ended in February, the narrow money supply expanded at a seasonally adjusted annual rate of about 6½ percent, compared with the 5.4 percent growth recorded over 1970 as a whole. The adjusted bank credit proxy rose at an annual rate of about 13 percent in February and 13½ percent over the three months ended in February. Most of the growth of the credit proxy in February was in time and savings deposits other than large negotiable CD's. The latter rose by only $281 million (not seasonally adjusted) in February, following increases averaging $2.0 billion over the seven previous months. Bank-related commercial paper continued to trickle off, falling by $129 million to a level of $1.9 billion by the end of February, and liabilities to foreign branches were reduced by $875 million to $5.8 billion. (These data are not seasonally adjusted.)

THE GOVERNMENT SECURITIES MARKET

Yield trends were mixed in the market for Government securities during February. Yields on Treasury bills and intermediate-term coupon issues continued their steep decline which began in early 1970. However, investor enthusiasm in the long-term Treasury bond market dampened, and yields on most securities rose by 15 to 22 basis points over the month.

The upward drift in long-term Treasury bond yields during February reflected principally the weak climate in the corporate bond market, which diminished expectations of further declines in long-term interest rates. A longer run factor was the February 18 approval by the

House Ways and Means Committee of a proposal to permit the Treasury to sell a total of $10 billion of long-term bonds at rates above the statutory 4¼ percent ceiling rate established in 1918. Because long-term market rates have been higher than the ceiling, the Treasury has been unable to sell securities with maturities longer than seven years since 1965. (The statutory ceiling rate does not apply to Treasury notes, which range up to a maturity of seven years.) Consequently, only $17.7 billion of privately held[2] Federal debt outstanding represents bonds of longer than seven years' maturity, compared with $44.9 billion in mid-1965. Prospects that the Congress might approve of the Committee's action generated mild market concern. On the other hand, many market participants expected that passage of the legislation would facilitate judicious extension of the Treasury's debt and contribute to improved investor interest in long-term Government securities.

Although the rally of recent months faltered in the long-term market, a firm tone prevailed in February in the market for bills and intermediate-term Treasury issues. Yields on intermediate-term notes declined 36 to 60 basis points below their January lows for most issues, and bill rates generally declined by a net of 65 to 80 basis points. Market participants were encouraged early in the month by reports of Federal Reserve System repurchase agreements at a rate ½ percentage point below the discount rate. This served to increase expectations of a reduction in both the Federal Reserve discount rate and the commercial bank prime rate.

Some market disappointment was felt when the ¼ percentage point cut in these two rates was less than some observers had anticipated. However, large Federal Reserve System purchases, including coupon-bearing securities, and the Federal Home Loan Banks' decision not to refinance $600 million of its maturing issues more than offset any adverse effect on prices. Some brief market hesitation occurred in the bill market during the second week of the month, when the Treasury announced the offering of a $1.2 billion strip of bills consisting of six $200 million additions to outstanding weekly issues due from May 27 to July 1. When auctioned on February 18, the new strip of bills was aggressively bid for by commercial banks, which could pay for the bills through credit to Treasury Tax and Loan Accounts. Thereafter, the downward trend in yields continued and sizable buying interest developed in the weekly bill auctions. The average issuing rate on the one-year bill plummeted to 3.675 percent in the monthly auction on February 23 (see Table II). This was over 57 basis points below the rate set in the auction of four weeks earlier and the lowest such yield since July 1964.

Table II

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—February 1971			
	Feb. 1	Feb. 8	Feb. 11	Feb. 22
Three-month	4.110	3.845	3.640	3.497
Six-month	4.114	3.839	3.679	3.590
	Monthly auctions—December 1970-February 1971			
	Dec. 23	Jan. 26	Feb. 23	
Nine-month	4.949	4.268	3.691	
One-year	4.886	4.248	3.675	

* 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.

OTHER SECURITIES MARKETS

The record-setting seven-month rally in the corporate and municipal bond markets halted in February, as investors grew increasingly apprehensive over the mounting volume of new and planned corporate offerings. The final week's total of $863 million was the largest weekly amount of corporate bonds issued in over two months. The projected $3.2 billion schedule of public offerings for March is a record monthly volume and is substantially above the monthly average of $2.1 billion in 1970. Included in the schedule for March is a large volume of securities of commercial banks and bank affiliates. This is the first time since 1965 that banks have borrowed so heavily in the capital market. It weighed heavily on market attitudes, since some investors took it to mean that many bankers did not expect further declines in long-term interest rates in the near future.

The pressure of this increasing supply pushed the yield on newly issued prime corporate bonds up 70 basis points over the month, nearly retracing the full percentage point decline recorded for February. The rise on newly issued

[2] Other than those of the Federal Reserve Banks and United States Government investment accounts.

municipals was more moderate, and *The Weekly Bond Buyer's* twenty-bond index of municipal bond yields closed the month at 5.34 percent, 18 basis points above its level at the end of January.

Investor enthusiasm in the corporate bond market showed signs of receding late in January when a $200 million Southwestern Bell issue, priced to yield 6.80 percent, remained largely unsold at the close of the month. During the first week of February, new offerings of bonds continued to sell slowly as investors waited to see what terms would be set on the giant $500 million American Telephone and Telegraph Company issue. On February 9, the thirty-year AT&T bond issue reached the market, priced to yield 7.06 percent. The entire issue was very well received and quickly sold, sparking new sales of previously slow-moving issues still in syndicate hands. On the same day, a $36 million Aa-rated thirty-year first-mortgage bond issue of the Central Power and Light Company was offered to the public at a yield of 6.95 percent. This was the lowest yield offered on new high-grade electric utility bonds since January 1969 and 2.45 percentage points less than the record 9.40 return on similarly rated bonds in June 1970. However, the Central Power and Light Company bond issue was priced too aggressively to suit most investors. A pessimistic atmosphere began to pervade the bond market, and this bond issue was finally permitted to trade at an unrestricted price on February 16, lifting its yield to 7.26 percent. Several other corporate issues—including the $200 million of Southwestern Bell debentures first offered on January 26—were also freed from syndicate price restrictions in the middle of February, resulting in upward yield adjustments by as much as 33 basis points. Toward the close of the month the rise in yields on new issues accelerated, as underwriters probed for yield levels that would stimulate investor interest. Such a level seemed to be found near the end of the month, when two Aa-rated utility issues were marketed successfully at a yield of 7.87 percent.

A somewhat similar pattern characterized the municipal bond market. The downturn in prices of municipal bonds began late in January and continued through the first week of February. Syndicates were able to move large unsold balances of municipal offerings only by raising yields by as much as 50 basis points, while new issues attracted selective attention. Although the successful marketing of AT&T debentures sparked a brief recovery in the second week of February, investor enthusiasm again weakened and syndicate inventories began to accumulate. The Blue List of advertised dealer inventories climbed to $950 million on February 19, up from $700 million on February 10, prompting dealers to make further cuts on their asking prices during the remainder of the month.