The Money and Bond Markets in December

The securities markets were dominated in December by shifting expectations, first concerning the possibility of an exchange rate realignment and then concerning the repercussions of the realignment which emerged from the Group of Ten meeting in Washington on December 17-18. The primary focus of apprehension in the market was the massive volume of United States Treasury securities held by foreign central banks. At the beginning of the month, the Federal Reserve Banks held $24.6 billion of such securities in custody for foreign and international accounts, and by December 22 the holdings had risen to $27.7 billion—an increase of $16.6 billion from a year earlier. These securities were acquired by the foreign central banks primarily with dollars absorbed to prevent or limit appreciation of their own currencies in the foreign exchange markets. It was feared that a sudden reversal of dollar flows across the exchange markets might precipitate large-scale liquidations of these holdings after the currency realignment.

The agreement among the Group of Ten industrial nations, which is still subject to the settlement of other international issues, would result in an increase in the official price of gold from $35 per ounce to $38 per ounce—an effective devaluation of the dollar of 8.57 percent against gold. In addition, until formal parities could be established, new "central rates" were set for other major currencies, resulting in effective upward revaluations (in terms of the dollar price of foreign currencies) of 16.88 percent for the Japanese yen, 13.58 percent for the German mark, and 11.57 percent each for the Dutch guilder and the Belgian franc. The governments of the United Kingdom and France, among others, did not plan to change the gold parities for their currencies, which were thus revalued by 8.57 percent against the dollar. The Swiss franc, already revalued by 7.07 percent last May, was adjusted to provide a further 6.36 percent effective revaluation against the dollar. The Italian authorities announced that they would adjust the gold parity of the lira downward slightly, so that the net revaluation against the dollar would be about 7.48 percent. In addition, the bands of allowable fluctuations in the currency values between the intervention points were widened to 2.25 percent above and below the new central rates. Finally, in contrast to the other major currencies, the Canadian dollar continued to float.

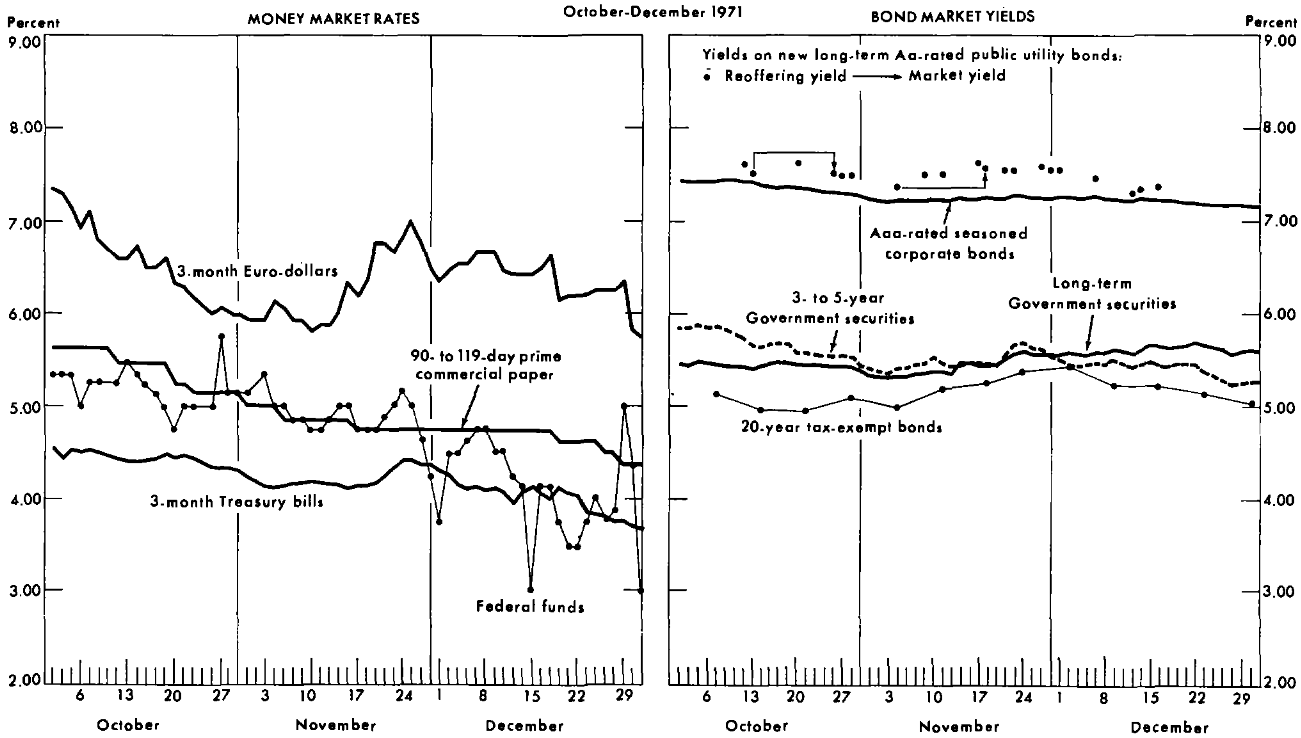
In the wake of the agreement, the reflux of dollars during the last two weeks of December was much smaller than had been generally expected. Consequently, after some momentary hesitancy, the Government securities market actually strengthened over the latter half of the month. The buoyant atmosphere was further encouraged by ample provision of reserves through Federal Reserve open market operations, by reductions in the Federal Reserve discount rate and rates on repurchase agreements, and by lower Federal funds rates. The corporate and municipal bond markets also ended the year with a firm tone.

THE MONEY MARKET

Money market conditions were quite easy in December, as indicated by the sharp decline in rates on Federal funds. The effective Federal funds rate averaged 3.94 percent in the latter half of December, down from 4.35 percent during the first half of the month and 4.91 percent in November (see Chart I). Earlier in the year the average effective Federal funds rate had ranged from 3.71 percent in March to 5.57 percent in August. On December 10, the Board of Governors of the Federal Reserve System announced the approval of reductions in the discount rate of four Federal Reserve Banks to 4½ percent from 4¾ percent. The Board explained that this action, a month after the previous cut, "was taken in recognition of the prevailing levels of market interest rates and to assist the progress of economic expansion". By December 24 the eight remaining Federal Reserve Banks had taken similar action, bringing the discount rate to the lowest level since March 1968.

With Federal funds trading at rates well below the discount rate during most of December, member banks were usually under no pressure to borrow from the Federal Reserve Banks. Consequently, such borrowings dropped to frictional minimum levels with the exception of two Wednesdays, December 22 and December 29. At the end

Chart I
SELECTED INTEREST RATES
October-December 1971



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Bid rates for three-month Euro-dollars in London; offering rates (quoted in terms of rate of discount) on 90- to 119-day prime commercial paper quoted by three of the four dealers that report their rates, or the midpoint of the range quoted if no consensus is available; 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 Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new 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.

of these statement weeks, money market conditions tightened unexpectedly and member banks turned to the Federal Reserve discount window en masse. Even with these bulges, member bank borrowings averaged only $108 million for the month. This was the lowest monthly level since September 1967 and contrasted sharply with borrowings averaging $820 million as recently as last July, when the Federal Reserve System was restraining the availability of nonborrowed reserves with the aim of reducing the growth rates of the monetary and credit aggregates.

The easier money market climate in December was reflected in substantial declines in virtually all short-term interest rates that are sensitive to market forces. For example, the three-month Euro-dollar rate, which had risen sharply in November, fell ¾ percentage point during December to 5¾ percent by the end of the month. Rates on bankers' acceptances were reduced by ⅝ percentage point, while rates on commercial paper placed through dealers fell by ⅜ to ½ percentage point.

In response to declines in short-term interest rates, as well as to relatively sluggish loan demand, two large New York City banks reduced their prime business lending rate on December 13 to 5¼ percent from 5½ percent. This move came approximately a week after two other large money market banks—which now tie their basic lending rate to commercial paper rates—had reduced their prime rate below the 5½ percent level. Subsequently, a number of other banks reduced their prime rate to 5¼ percent. Among these was a large New York City bank which announced on December 29 the adoption of a flexible base rate related to the rates paid on newly issued 89-day negotiable certificates of deposit (CDs) as well as to rates on 90-day dealer-placed commercial paper. Although the rate was initially maintained at 5¼ percent, it was dropped to 5 percent early in January after the floating prime rates of two other New York City banks had been reduced to 5⅛ percent and 5 percent, respectively. The move was quickly followed by widespread reductions of commercial bank prime rates to 5 percent.

Most of the major West Coast commercial banks maintained their prime rate at 5½ percent until the end of December, when they also came down to 5¼ percent. In part, the slower response of these banks in cutting the rate can be attributed to their reliance on consumer time and savings deposits for lendable funds. In contrast, the major New York City banks obtain proportionately more of their funds through large commercial deposits, including negotiable CDs. While CD rates have fallen considerably over the past three months, there have been few reductions posted in rates paid on consumer time and savings deposits, which are usually changed only at the beginning of a quarter. Thus, on December 29, the 4½ percent rate on savings deposits exceeded the prevailing rate on 89-day CDs by ½ percentage point. At the same time, rates of up to 5¾ percent on consumer time deposits with maturities of two years or longer exceeded rates on similar maturities of CDs by about ¾ to 1¼ percentage points. On December 31, however, a large West Coast bank announced that, in response to current market developments, it was reducing its rate on regular passbook accounts to 4 percent and its rate on special accounts to 5¼ percent.

Preliminary estimates, which are subject to revision, indicate that the narrow money supply (M_1)—demand deposits adjusted and currency held by the public—inched up in December at a seasonally adjusted annual rate of about 2½ percent. This increase, although small by historical standards, followed four months of virtually no change in M_1 and brought the annual rate of growth over the six months that ended in December to 2½ percent, down from the large 10.0 percent rate of rise recorded during the first half of the year. Over the year as a whole, M_1 increased by about 6¼ percent, compared with the 5.4 percent gain in 1970.

The growth of the broader money supply (M_2)—which consists of M_1 plus commercial bank savings and time deposits other than large CDs—also picked up in December. According to preliminary estimates, M_2 grew at a seasonally adjusted annual rate of about 10 percent during the month. This brought the annual growth rate over the final quarter of 1971 to about 8 percent, up from 4.4 percent in the third quarter. The strengthening of M_2 growth primarily reflected faster growth of consumer-type time

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, DECEMBER 1971

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

Factors	Changes in daily averages—week ended: Dec. 1	Dec. 8	Dec. 15	Dec. 22	Dec. 29	Net changes
"Market" factors						
Member bank required reserves	−113	+85	−349	−231	−413	−1,021
Operating transactions (subtotal)	−242	+152	+597	−368	−44	+95
Federal Reserve float	−188	+63	+383	+998	+213	+1,469
Treasury operations*	+53	+151	+193	−312	−420	−335
Gold and foreign account	−46	+36	−10	−283	−45	−348
Currency outside banks	+48	−37	−157	−732	+247	−631
Other Federal Reserve liabilities and capital	−109	−59	+186	−41	−39	−62
Total "market" factors	−355	+237	+248	−599	−457	−926
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+570	−71	−187	+227	+625	+1,164
Outright holdings:						
Treasury securities	+545	+249	−61	−23	+55	+765
Bankers' acceptances	+3	+1	+3	+8	+11	+26
Federal agency obligations	+69	+92	—	+125	+20	+306
Repurchase agreements:						
Treasury securities	−58	−322	−88	+88	+445	+65
Bankers' acceptances	−3	−43	−10	+22	+58	+24
Federal agency obligations	+14	−48	−31	+7	+36	−22
Member bank borrowings	+167	−646	−34	+119	+72	−322
Other Federal Reserve assets†	+63	+33	+34	+61	+108	+299
Total	+801	−684	−187	+407	+803	+1,140
Excess reserves	+446	−447	+61	−192	+346	+214

	Daily average levels					Monthly averages
Member bank:						
Total reserves, including vault cash	31,275	30,743	31,153	31,192	31,951	31,263‡
Required reserves	30,685	30,600	30,949	31,180	31,593	31,001‡
Excess reserves	590	143	204	12	358	261‡
Borrowings	705	59	25	144	216	230‡
Free, or net borrowed (—), reserves	−115	84	179	−132	142	31‡
Nonborrowed reserves	30,570	30,684	31,128	31,048	31,735	31,033‡
Net carry-over, excess or deficit (—) §	88	272	147	151	13	134‡

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 five weeks ended December 29.
§ Not reflected in data above.

and savings deposits. Recent declines in interest rates on competing instruments have made these deposits relatively attractive. Over the year as a whole, M_2 rose by about 11 percent, compared with 8.1 percent in 1970.

The growth of the adjusted bank credit proxy over the past year has been somewhat more steady than the growth of M_1 or M_2. The adjusted proxy consists of total member bank deposits subject to reserve requirements together with such nondeposit sources of bank funds as Euro-dollar borrowings and commercial paper sold by bank affiliates. During December, the credit proxy rose at an estimated seasonally adjusted annual rate of about 12½ percent. This brought the growth of the adjusted credit proxy over the year to 9¼ percent, compared with 8.3 percent in 1970. In addition to the growth of time deposits, the December increase reflected a large rise in United States Treasury deposits that were built up in anticipation of redemptions of special issues by foreign central banks after the realignment of currencies. At the same time, with funds readily available at favorable rates in the domestic money market, banks sharply reduced their borrowings in the Euro-dollar market in December. During most of the month, overnight Euro-dollar rates ran more than a full percentage point above Federal funds rates.

THE GOVERNMENT SECURITIES MARKET

Attention in the market for Treasury securities was focused on the international monetary situation during December. In an effort to limit the appreciation of their currencies in the foreign exchange markets, foreign central banks continued to accumulate vast amounts of dollars during the first half of the month. These large dollar accumulations, in turn, generated a strong demand for short-term Treasury obligations. For example, marketable Treasury securities held by the Federal Reserve in custody for foreign authorities jumped by $1.3 billion during the week of December 8 alone. This demand, in conjunction with the impetus provided by the reductions in the prime and discount rates, helped to create a firm undertone in the Government securities market during the first two weeks of the month.

Treasury bill rates declined steadily during the first half of December amid sizable domestic as well as foreign demand. In spite of the overhang of $2.0 billion of June 1972 tax anticipation bills (TABs) that were auctioned on December 8, the average issuing rates for the new three- and six-month bills fell to their lowest levels in more than seven months (see Table II). On December 16 the Treasury announced that $1.5 billion of April 1972 TABs and $1 billion of June 1972 TABs would be auctioned on December 22, with full Treasury Tax and Loan Account privileges. This announcement caused only a momentary hesitation, but the prospect of a much larger supply of bills emanating from foreign central banks in the wake of a settlement of the international monetary crisis tended to weigh heavily on the market.

After December 18, when the feared reflux of dollars failed to materialize immediately to the extent expected, Treasury bill rates fell precipitously. Average issuing rates in the weekly auction held on December 27 declined to 3.731 percent on the three-month bills and to 3.952 percent on the six-month bills, the lowest weekly levels since the April 5, 1971 auction. On the following day, the issuing rates on the nine- and twelve-month bills sold at the monthly auction fell to 3.930 percent and 3.927 percent, respectively, the lowest since the March auction. In part, these sizable declines over the last two weeks in December reflected market reaction to the Federal Reserve's injection of reserves by arranging repurchase agreements at rates below the discount rate and even below the latest issuing rate on three-month Treasury bills, which along with the discount rate has usually served as a "floor" for the repurchase rate. During this period, repurchase agreements were made at rates as low as 3⅝ percent. The lower rates were needed to make the repurchase agreements reasonably competitive in relation to other sources of financing available to Government securities dealers.

Table II

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—December 1971			
	December 6	December 13	December 17	December 27
Three-month	4.091	3.944	4.023	3.731
Six-month	4.207	4.144	4.263	3.952

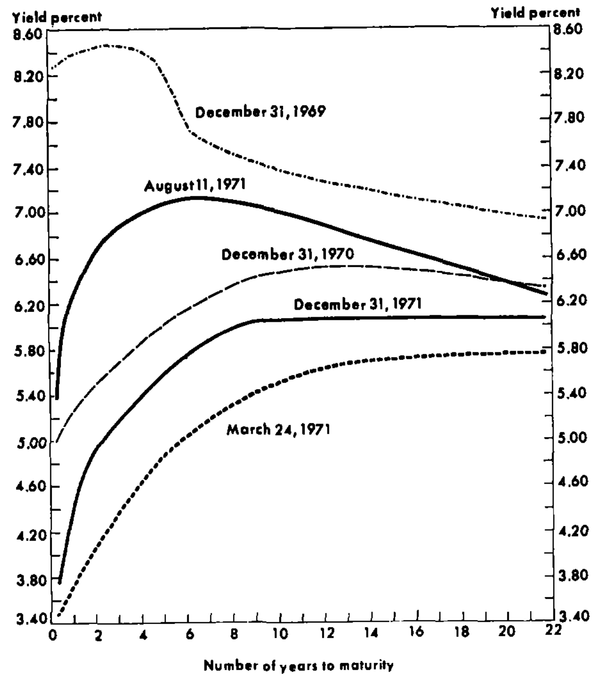
Maturities	Monthly auction dates—October-December 1971		
	October 26	November 23	December 28
Nine-month	4.495	4.581	3.930
One-year	4.490	4.563	3.927

* 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.

Over the first half of December, prices of Treasury notes and bonds fluctuated in response to the same factors affecting the bill market. The steady tone of the short- and intermediate-term sectors of the market reflected not only strong technical conditions following reductions in the prime and discount rates, but sizable foreign purchases in this area as well. Although during the second half of the month the uncertainty associated with the announced realignment of exchange rates caused some concern among market participants, this development was outweighed by the Federal Reserve's willingness to supply funds, and prices continued to drift upward. For the month as a whole, short- and intermediate-term prices rose above the levels established in late November and long-term bond prices, reflecting in part the seasonal lull of new corporate financings, also closed mainly higher.

Chart II

YIELDS ON UNITED STATES GOVERNMENT SECURITIES



Throughout most of 1971, the Government securities market responded to a variety of forces which significantly altered not only the level of interest rates but the relationship among rates as well. For most of the first quarter, the steep decline in short-term interest rates that had begun in late 1970 continued, while the money supply began to grow rapidly after the sluggish fourth quarter of 1970. By the third week in March, Treasury bill rates had fallen almost 150 basis points below their levels in late December while most short- and intermediate-term rates had declined about 140 basis points. At the same time, yields on long-term Government bonds, reflecting divergent trends in the various sectors of the capital markets, had also fallen on balance over most of this period, albeit within a much narrower range of about 65 basis points. The combination of sharply lower Treasury bill yields, a substantial decline in intermediate-term yields, and a smaller decline in long-term yields had eliminated the last vestige of a hump in the Government yield curve which had been so prevalent during the previous two years. As Chart II indicates, the yield curve on March 24 exhibited a gentle upward slope, typical of most yield curves during a period of economic recovery.

Beginning in early April, the Federal Reserve moved to resist the rapid growth of the monetary aggregates by firming money market conditions. Uncertainty over the international monetary situation also began to weigh heavily on the market. The unwinding of sizable speculative positions that had been built up by dealers and trading banks gave impetus to the run-up in short- and intermediate-term rates. By mid-August, Treasury bill rates had increased by more than 180 basis points, while rates in the intermediate sector had jumped on average by more than 230 basis points. Long-term yields, reflecting in part some reduction in the rate of corporate bond flotations which had been very heavy early in the year, rose by an average of only about 40 basis points. The result was a return to the humped-shaped yield curve.

With the announcement of the Administration's new economic program in mid-August, the marked slowing of the growth rates of the monetary aggregates, and the easing of member bank reserve positions, interest rates throughout the maturity spectrum have fallen sharply since mid-August, with short- and intermediate-term rates declining more than longer term rates. Although in most cases yields at the end of the year were still above those prevailing in mid-March, the yield curve again exhibited the upward slope that prevailed in mid-March and throughout most of the first quarter.

OTHER SECURITIES MARKETS

In the corporate and municipal bond markets, yields on both new and seasoned issues exhibited sizable declines during December. Encouragement over the prospect for a settlement of the international monetary situation, the reduction in the discount and prime rates, and the lighter forward calendar after midmonth all contributed to the improved tone in these markets.

As the month opened, yields on new and seasoned corporate bonds moved lower in active trading in which dealers were able to sell a heavy backlog of issues that had been overhanging the market in prior weeks. The month's largest corporate offering was a $200 million issue of Aaa-rated telephone bonds reoffered on December 8 to yield 7.28 percent. This return was 17 basis points below the reoffering yield of a similarly rated Bell System issue on November 15 and was the lowest such yield in nine months. The aggressively priced issue, however, failed to elicit much investor response, and only about 20 percent of these bonds was initially sold. Despite the poor reception given to this and several other aggressively priced issues, three Aa-rated utilities were brought to market around midmonth at yields of 7.30 percent to 7.35 percent, compared with 7.55 percent on a similar offering that had been successfully sold on December 1. All three issues sold slowly at first. However, these bonds—along with the telephone issue—sold swiftly toward the end of the month, as the market displayed unusual strength at a time of year when there has typically been a seasonal lull in trading.

The tax-exempt sector was highlighted in December by a record volume of financings in the calendar week ended December 17. In that week, a total of $1.3 billion of tax-exempt state and local government bonds was sold. This topped the previous high of $937 million in new tax-exempts sold during the last week of September. Despite the fact that the Blue List of dealers' advertised inventories rose to $1,056 million from its level of $744 million in the preceding week, *The Weekly Bond Buyer's* twenty-bond yield index managed to register a nominal decline of 2 basis points to 5.21 percent for the week. Thereafter, the schedule of offerings dwindled sharply and the twenty-bond index closed the year at 5.02 percent, 34 basis points below the level at the end of November.