The Money and Bond Markets in August

Short-term interest rates moved higher in August. The rate on Federal funds rose in response to a somewhat less generous supply of nonborrowed reserves in relation to the demand of member banks for reserves. Other short-term rates responded in similar fashion and, by the end of August, rates on most short-term instruments were ⅛ to ¾ percentage point higher than a month earlier. To some extent, the reversal in the direction of short-term rates was an indirect consequence of the strengthening of the dollar on the foreign exchange markets, which sharply diminished foreign official demand for Treasury bills. In addition, expectations of increased private demands for credit as the economic recovery continues to gather momentum helped to raise interest rates. Finally, market participants looked forward with some apprehension to the large cash needs of the Federal Government in prospect for the next several months. Underscoring the potential impact that these demands may have on the markets, Treasury bill rates rose sharply upon the disclosure by the Treasury of plans to raise $1.8 billion by late October in conjunction with a restructuring of the monthly bill auctions.

The bond market resisted until late in the month the upward pressures on yields emanating from the money market. Indeed, long-term rates continued to drift downward until after midmonth. Underwriters of corporate and municipal bonds took advantage of the seasonally light calendar of flotations to price new issues aggressively. Many issues failed to sell out quickly, however, and investor resistance to the aggressive pricing in both sectors became more intense as the month progressed. By the end of August, long-term bond yields had joined short-term rates in moving upward. They remained, however, far below the levels that had prevailed before the initiation of the Economic Stabilization Program on August 15, 1971. The decline in interest rates that has occurred since then has reflected both a reduction in the inflation premium demanded by investors and a moderation of demands placed on the bond market by borrowers.

BANK RESERVES AND THE MONEY MARKET

Conditions in the money market grew somewhat firmer during August. The average effective Federal funds rate rose to 4.80 percent, 25 basis points above the July average and the highest monthly average rate since November 1971. The upward pressure on the Federal funds rate was symptomatic of the less generous supply of nonborrowed reserves available to member banks in relation to their demand for reserves in the wake of the surge in deposits during July. Money market conditions typically firmed toward the end of statement weeks during August, as banks which found themselves short of reserves needed to meet their requirements bid up the Federal funds rate. As the rate rose well above the 4½ percent Federal Reserve discount rate, banks turned to the discount window to satisfy more of their reserve needs. Over the five weeks ended August 30, such borrowings averaged $372 million, up $151 million from the four weeks ended in July. Net borrowed reserves averaged $153 million in the five weeks of August (see Table I), compared with $27 million in the four preceding weeks.

With the less generous provision of nonborrowed reserves being partly offset by increased borrowings at the discount window, daily average reserves available to support private nonbank deposits (RPD), seasonally adjusted, increased at an annual rate of about 9 percent in August, slightly greater than the 8.6 percent rate of growth in July. The fact that the sharp deceleration in the growth rates of the monetary aggregates in August, which is discussed below, was not reflected in RPD is partly a consequence of the way in which reserve requirements are assessed. In general, member banks are required to hold in each statement week reserves equal to a percentage of their average deposit liabilities of two weeks previously. Hence, the July surge in deposits resulted in higher levels of required reserves in August as well as in July. The relatively rapid growth of RPD recorded for August also stemmed in part from the convention of computing growth rates on the basis of monthly averages of daily figures. Inasmuch as the spurt in deposits in the first two weeks of July was not reflected in required reserves until the last two weeks of the month, the average level of reserves for the month as a whole was low in relation to the month-end level. This tended to exaggerate the growth of reserves in August on a daily average basis.

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, AUGUST 1972

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

Factors	Changes in daily averages— week ended					Net changes
	Aug. 2	Aug. 9	Aug. 16	Aug. 23	Aug. 30	
"Market" factors						
Member bank required reserves	+ 64	— 106	— 90	+ 309	+ 22	+ 199
Operating transactions (subtotal)	— 236	— 106	+ 387	+ 311	+ 217	+ 573
Federal Reserve float	— 495	+ 106	+ 12	+ 425	— 510	— 462
Treasury operations*	+ 75	— 41	+ 435	+ 366	+ 172	+1,007
Gold and foreign account	+ 121	— 9	— 8	— 10	— 6	+ 88
Currency outside banks	+ 164	— 138	— 217	— 444	+ 625	— 10
Other Federal Reserve liabilities and capital	— 101	— 24	+ 166	— 24	— 65	— 48
Total "market" factors	— 172	— 212	+ 297	+ 620	+ 239	+ 772
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+ 88	+ 123	— 57	— 329	— 276	— 451
Outright holdings:						
Treasury securities	— 8	— 6	— 63	— 191	— 295	— 563
Bankers' acceptances	— 2	+ 4	— 1	+ 2	— 1	+ 2
Federal agency obligations	— 11	+ 83	+ 18	—	— 80	+ 10
Repurchase agreements:						
Treasury securities	+ 92	+ 42	— 17	— 117	+ 75	+ 75
Bankers' acceptances	+ 9	+ 7	+ 1	— 17	+ 8	+ 8
Federal agency obligations	+ 8	— 7	+ 5	— 6	+ 17	+ 17
Member bank borrowings	+ 191	— 76	+ 94	— 31	+ 127	+ 305
Other Federal Reserve assets†	+ 56	+ 53	— 153	— 442	+ 59	— 427
Total	+ 335	+ 100	— 116	— 800	— 90	— 571
Excess reserves	+ 163	— 112	+ 181	— 180	+ 149	+ 201
	Daily average levels					Monthly averages
Member bank:						
Total reserves, including vault cash	33,139	33,133	33,404	32,915	33,042	33,127‡
Required reserves	32,897	33,003	33,093	32,784	32,762	32,908‡
Excess reserves	242	130	311	131	280	219‡
Borrowings	368	287	381	350	477	372‡
Free, or net borrowed (—), reserves	— 121	— 157	— 70	— 219	— 197	— 153‡
Nonborrowed reserves	32,776	32,846	33,023	32,565	32,566	32,755‡
Net carry-over, excess or deficit (—)§	58	118	92	132	52	90‡

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 August 30, 1972.

§ Not reflected in data above.

The downward drift of short-term interest rates that had begun in July continued into early August. For example, rates on commercial paper edged lower during the first few days of August, triggering reductions in the floating prime commercial loan rates of a few large banks by ¼ percentage point to 5¼ percent. Subsequently, however, short-term rates reversed direction and ended the month generally higher on balance. Increases in commercial paper rates were followed by upward adjustments in floating prime rates during the latter half of the month. On August 24, a major New York City bank that does not pursue a floating prime rate policy raised its rate ¼ percentage point to 5½ percent. By the end of the month, most of the other major banks had followed suit. Rates on commercial paper sold through dealers closed generally ¼ percentage point higher over the month, and bankers' acceptance rates were ⅛ percentage point higher.

The general advance in short-term interest rates was accompanied by a moderation in the growth of the monetary aggregates in August following the large increases in July. Nevertheless, the growth of these aggregates remained quite substantial over the three-month period that ended in August. For example, the narrowly defined money supply (M_1)—adjusted private demand deposits plus currency outside banks—increased at a seasonally adjusted annual rate of 8½ percent over the three months ended in August (see Chart I), according to preliminary data that are partly estimated for August. The growth of M_1 over the six months ended in August was also substantial, averaging 8 percent at an annual rate. Taking a longer perspective, however, the rise in M_1 was a more moderate 5½ percent over the year ended in August.

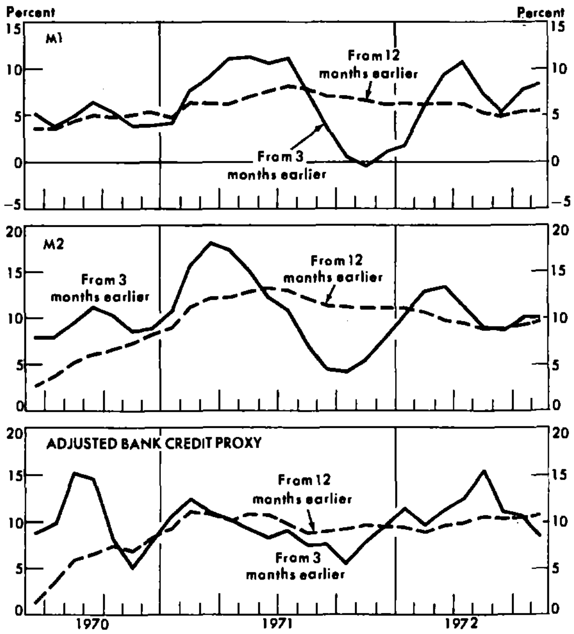
The growth of the broad money supply (M_2)—defined as M_1 plus time deposits at commercial banks other than large negotiable certificates of deposit (CDs)—also slowed somewhat in August from the large July increase. The moderation of M_2 growth was less pronounced than that of M_1, however, because of a pickup in the growth of consumer-type time and savings deposits following a slowing of the growth of these deposits in July. Over the three months ended in August, M_2 rose at a seasonally adjusted annual rate of about 10 percent, according to preliminary estimates. The growth of M_2 was about 9½ percent over the past year.

The adjusted bank credit proxy—which consists of daily

Chart I

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates



Note: Data for August 1972 are preliminary estimates.

M1 = Currency plus adjusted demand deposits held by the public.

M2 = M1 plus commercial bank savings and time deposits held by the public, less negotiable certificates of deposit issued in denominations of $100,000 or more.

Adjusted bank credit proxy = Total member bank deposits subject to reserve requirements plus nondeposit sources of funds, such as Euro-dollar borrowings and the proceeds of commercial paper issued by bank holding companies or other affiliates.

Sources: Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York.

average member bank deposits subject to reserve requirements and certain nondeposit liabilities—behaved similarly to M_2 in July and August. Over the three months ended in August, the proxy rose at an estimated seasonally adjusted annual rate of 8½ percent. During the year ended in August, the proxy increased by about 11 percent. In relative terms, the strongest component in the growth of the proxy in recent months has been CDs issued in amounts of $100,000 or more. Banks have been bidding actively for such funds, and a number of increases in offering rates on CDs were posted during August as other market rates rose. CDs outstanding at weekly reporting banks, seasonally adjusted, rose by $3 billion over the three months ended in August. Over the twelve months ended in August, outstanding large CDs expanded by $8½ billion, or 27½ percent.

THE GOVERNMENT SECURITIES MARKET

Along with other short-term rates, Treasury bill rates continued to decline at the beginning of August, but rates on the shorter maturities soon reversed direction. The early strength in the bill market reflected the absence of a short-term option in the Treasury's August refunding[1] and the expectation that sellers of rights issues would seek bills for temporary lodgment of funds. Against this background, participants bid aggressively for bills in the weekly auction held on July 31. The three-month bills were sold at an average issuing rate of 3.794 percent, 25 basis points below the rate established in the previous week's auction.

After August 2, as demand for bills generated by the refunding subsided, rates on issues maturing within six months began to edge higher. The upward movement of rates was spurred by the firming in the Federal funds market and by the prospect of sizable Treasury cash financing in the short-term area of the market in coming months. The relatively wide spread between rates on bills and rates on other short-term instruments was also conducive to rising bill rates. In this atmosphere, bidding was generally cautious in the weekly bill auctions held during August, and rates climbed at each successive auction. At the auction held on August 14, the average issuing rate for the three-month issue was 3.956 percent (see Table II), 16 basis points higher than the rate set two weeks earlier.

On August 18, the Treasury announced the first steps toward restructuring the monthly bill auctions through the establishment of regular auctions of 52-week bills to replace eventually the nine- and twelve-month bills. At the same time, the Treasury announced plans to raise a total of $1.8 billion in the monthly auctions of August, September, and October. Accordingly, at the maturity of the $1.7 billion of monthly bills due August 31, 1972, the Treasury issued $1.8 billion of bills to mature on Tuesday, August 28, 1973 and $500 million of bills to mature on May 31, 1973. The Treasury also intends in

[1] For a description of the securities involved, together with the preliminary results, see this *Review* (August 1972), page 198. The final results were slightly better than the preliminary results. The rate of attrition of the publicly held issues maturing August 15 was revised downward to 25.9 percent. The public subscribed for $3.9 billion of the new notes due February 1976, $3.1 billion of the new notes due August 1979, and $1.2 billion of the new bonds due August 1984. The subscriptions for the bonds included $41 million of sales to individuals for cash.

Table II

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—August 1972			
	Aug. 7	Aug. 14	Aug. 21	Aug. 28
Three-month	3.928	3.956	4.058	4.332
Six-month	4.431	4.464	4.623	4.818
	Monthly auction dates—June-August 1972			
	June 23	July 25	Aug. 24	
Nine-month	4.754	4.731	5.040	
One-year	4.854	4.918	5.178†	

* 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.

† This was the first auction of a 52-week bill.

coming months to repeat the offerings of $1.8 billion of slightly less-than-one-year bills to mature on Tuesdays at four-week intervals from August 28, 1973. In late September and again in late October 1972, the Treasury plans to sell $0.5 billion of nine-month bills maturing in June and July 1973, respectively. These final sales of nine-month bills will result in equal amounts of maturities of monthly bills through July 1973. These plans will result in the raising of $0.6 billion of new cash at the end of August and $0.6 billion at the end of each of the next two months. The Treasury also indicated that it is studying the desirability of having weekly auctions of 52-week bills and of converting its offerings of six-month bills from a Thursday to a Tuesday maturity to coincide with the weekly maturities of such 52-week bills.

Bill rates spurted upward in reaction to the Treasury announcement. Rates on the longer maturity bills, which until then had been drifting downward since the end of June, joined in the advance. In the first auction under the new program described above, held on August 24, the 362-day bills were sold at an average issuing rate of 5.178 percent, 26 basis points above the rate set on one-year bills in the July 25 auction and the highest comparable rate since September 1971. Rates continued to push higher over the remainder of the month, partly reflecting firmer day-to-day money rates and Federal Reserve sales on behalf of customer accounts and the System Account. At the month's final weekly auction, held on August 28, the three-month bills were sold at an average issuing rate of 4.332 percent. Over the month as a whole, rates on outstanding bills maturing within six months rose about 50 to 80 basis points, while rates on longer maturities climbed about 35 to 50 basis points.

Yields on intermediate-term Treasury securities were generally steady over the first half of August and then began to edge higher. The upward movement in yields gained momentum late in the month, as a cautious atmosphere developed amidst firming money market conditions and rising short-term rates generally. Long-term Treasury bond yields drifted downward until midmonth, when the average yield on such issues stood at its lowest level of 1972. Thereafter, yields on long-term issues rose irregularly but closed the month narrowly mixed, on balance.

The 10 basis point upward jump in the average yield on long-term Treasury bonds shown in Chart II is a statistical artifact resulting from the issuance of the new 6⅜ percent bonds of August 1984. The yield series is a simple average of yields on Treasury bonds due or callable in ten years or more. Consequently, the inclusion of the relatively high-yielding new issue raised the level of the series. The markedly higher rate required for the Treasury to issue long-term bonds, compared with the rates on older outstanding issues, reflects in part the substantial discounts from par at which the older bonds trade because of their relatively low coupons. In consequence, a significant part of the return on the older issues is in the form of capital gains, which for most investors are taxed at preferential rates. Furthermore, many of the older Treasury bonds are accepted at par value in payment of Federal estate taxes. This feature, which generates demand for some of these issues irrespective of their yields to maturity, is no longer offered on newly issued bonds.

The structure of yields on Treasury securities in the middle of August is depicted in Chart III, together with a comparative yield curve for one year earlier, just prior to President Nixon's announcement of the New Economic Policy. Both curves show a fairly sharp positive slope for yields on near-term maturities with a hump in the intermediate-term area and a decline on longer maturities. The most striking difference between the two yield curves is in their respective levels, which depict the declines in yields throughout the maturity spectrum over the past year. The three-month wage and price freeze from August to November 1971 and the subsequent Phase Two controls have helped to reduce the inflation premium in interest rates. In addition, a decline in the rate of borrowings in the bond market relative to last year's record pace has contributed to the downward shift in the yield curve.

OTHER SECURITIES MARKETS

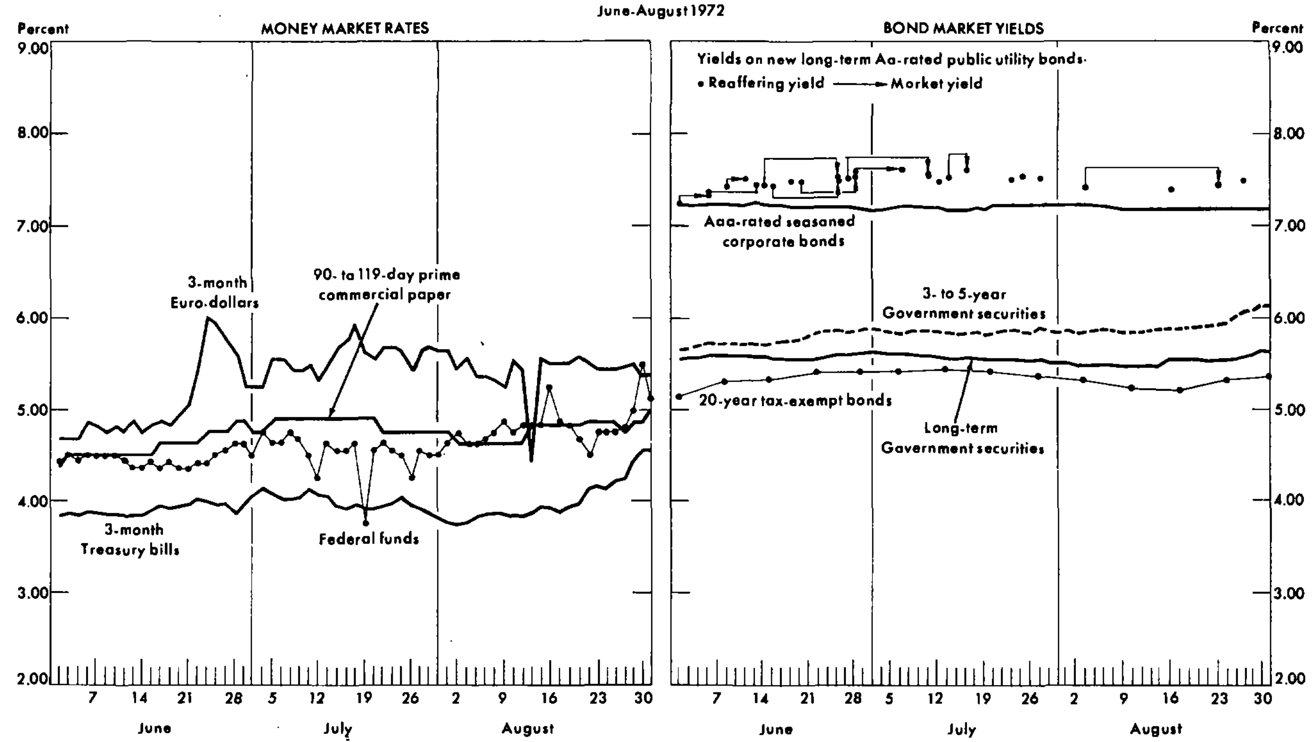
Prices of corporate and municipal bonds continued to edge upward in the first half of August. A combination of light calendars, normal for the summer months, and maintenance of syndicate price restrictions held down yields on new securities, while investor demand in the secondary market reduced returns on older issues. However, a price reversal after the middle of the month signaled some investor dissatisfaction with available yields. This resistance to terms offered became increasingly apparent in the last ten days of August.

The aggressive pricing associated with new issues of corporate bonds during August was exemplified by two issues rated Aaa. One, an electric utility issue awarded on August 1, was reoffered to yield 7.42 percent. The other, a forty-year debenture of a Bell Telephone subsidiary offered on August 8, was priced to yield 7.375 percent; this was the lowest yield on a Bell issue since May. Initial reception was cool in both cases. However, the scarcity of new high-grade securities and the successful distribution of some Aa-rated issues offered at the end of July encouraged the offering syndicates to hold firm, even though the yields were less favorable than those obtainable in the secondary market. On August 27, the underwriters finally released the unsold portion of the

Chart II

SELECTED INTEREST RATES

June-August 1972



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 Bond Buyer.

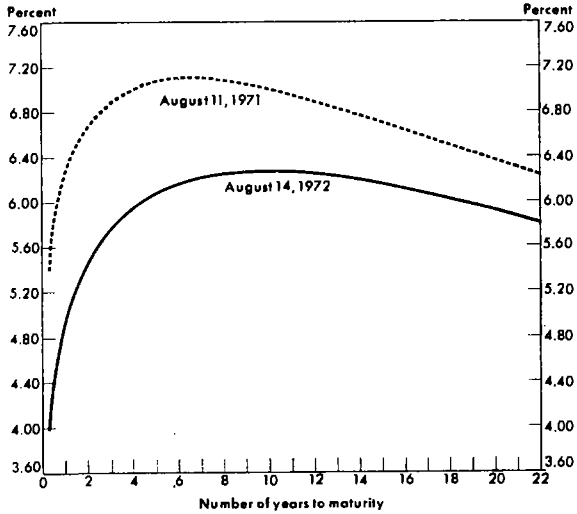
telephone bonds from price restrictions, with a resultant upward yield adjustment of about 10 basis points.

Three new issues of Aa-rated utility bonds were reoffered at the end of July to yield slightly more than 7½ percent. In the first half of August, two comparable issues were priced to yield 7.44 percent and 7.40 percent. Reductions in short-term interest rates, including bank prime lending rates, in late July and early August lent support to the bond market. However, the reversal of these movements late in August prompted accompanying adjustments in the bond market. Consequently, the final Aa-rated utility issue of the month was priced to yield 7.50 percent, but the offering was not enthusiastically received by investors.

In addition to its effects on interest rate expectations in general, the accelerating economic recovery raised the possibility of a larger volume of new issues on top of the usual seasonal increase in supply during the final quarter. Some investors, therefore, preferred to postpone purchases until terms improved. The price declines which occurred in the secondary market during the last week of August reflected both the reduction in demand and increased supply from professional selling and the dissolution of syndicate restraints.

Chart III

YIELDS ON UNITED STATES GOVERNMENT SECURITIES



Prices of tax-exempt securities rose during the first part of August. The Bond Buyer index of twenty municipal bond yields fell 10 basis points between August 3 and August 17. Over this same period, dealers added only $55 million to the Blue List of advertised inventories. New issues sold somewhat more rapidly than was true in the corporate market, despite similarly aggressive pricing, and dealers were willing to accumulate securities in their portfolios. Two large issues rated A-1 were quickly taken in the first ten days of the month. During the last half of August, however, investor interest waned and The Bond Buyer index rose 16 basis points to 5.38 percent on August 31.