The Money and Bond Markets in May

Interest rates climbed in May amid indications of buoyant economic activity and continued concern about inflation. Most short-term rates of interest rose ⅜ to ⅝ percentage point during the month, in part reflecting Federal Reserve efforts to increase monetary restraint. Major banks raised their prime lending rate for large business borrowers in two ¼ percentage point steps to 7¼ percent. Yields on long-term securities were generally steady during the first half of May, reflecting the relatively light supplies of new issues and the strong technical position of the bond markets. However, long-term yields joined in the general rise in interest rates in the final half of the month.

The Federal Reserve took a number of actions in May aimed at curbing the rapid expansion of bank credit. The actions included the raising of the Federal Reserve discount rate to 6 percent and the imposition of a supplemental marginal reserve requirement on large certificates of deposit (CDs) and bank-related commercial paper. The Federal Reserve also terminated Regulation Q ceilings on rates payable on large CDs with an initial maturity of ninety days or more.

Both M_1—defined as demand deposits adjusted plus currency outside banks—and M_2, which also includes commercial bank savings and time deposits other than large CDs, advanced rapidly in May. The growth of the adjusted bank credit proxy continued to be strong but was somewhat below the growth rates experienced during the three preceding months.

BANK RESERVES AND THE MONEY MARKET

Money market rates moved up sharply in May, as the Federal Reserve resisted the strength evident in the money and credit aggregates. The effective rate on Federal funds averaged 7.84 percent, compared with 7.12 percent in April. Some of the fluctuation in the Federal funds rate early in the month can be attributed to computer malfunctions at the Federal Reserve System's wire transfer center at Culpeper, Virginia, in late April and again during the first week in May. These caused delays in the crediting of reserves to a number of banks, making their reserve positions appear tighter than they actually were. Subsequently, adjustments were made which added back reserves, contributing to a sharp decline in the Federal funds rate on May 2. Further adjustments also complicated reserve management in the following week. In the latter half of the month the Federal Reserve's cautious management of reserves brought additional pressure on bank reserve positions. The Federal funds rate continued to climb, and during the final weeks of the month it frequently exceeded 8 percent.

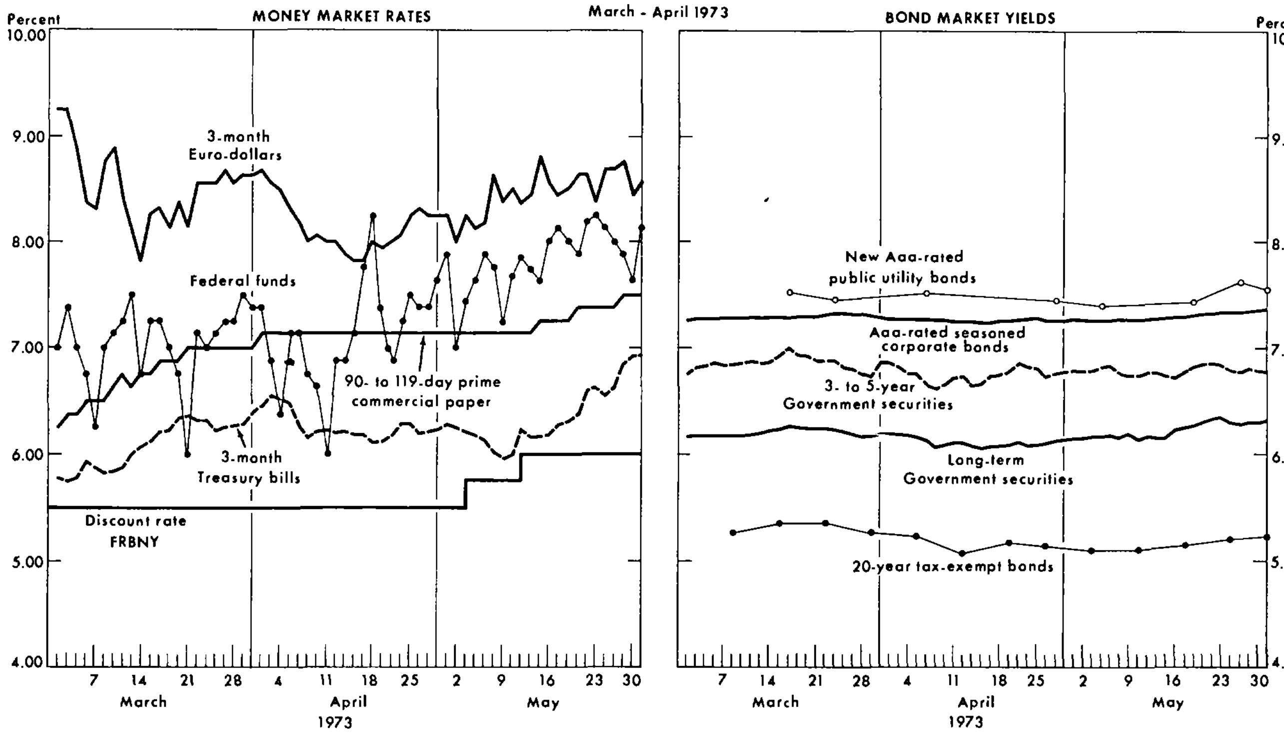
Several other short-term interest rates held steady early in May but began to move up by the middle of the month. Rates on bankers' acceptances advanced ¼ percentage point in the third week in May and another ⅛ percentage point in the fourth week, as did rates on most maturities of commercial paper. The rate on 90- to 119-day dealer-placed commercial paper was raised from 7⅛ percent to 7½ percent in three steps on May 15, May 21, and May 29 (see Chart I). The prime commercial loan rate charged by most major banks for large borrowers was increased to 7 percent early in the month and to 7¼ percent toward the end of the month. The Committee on Interest and Dividends had specified in April that the large business prime rate should be increased only gradually to avoid disruptive market effects.

On May 10, the Board of Governors of the Federal Reserve System announced approval of an increase in the discount rate at eleven of the twelve regional Federal Reserve Banks to 6 percent from 5¾ percent, effective May 11. The Federal Reserve Bank of Kansas City increased its discount rate on May 18. The Board explained that the increase, which was the fourth thus far in 1973, was intended to bring the discount rate into better alignment with short-term rates generally. The current discount rate is equal to the rate prevailing between April 1969 and November 1970, when the discount rate lagged far behind other short-term interest rates even though it stood at its highest level since 1921. While the present interest rate differential is somewhat less than during the 1969-70 interval, member banks have continued to borrow heavily from the Federal Reserve Banks. During the five weeks

Chart I

SELECTED INTEREST RATES

March - April 1973



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 five 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 Aaa-rated public utility bonds are based on prices asked by underwriting syndicates, adjusted to make them equivalent to a standard Aaa bond of at least twenty years' maturity; 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, Inc., and The Bond Buyer.

ended May 30, total member bank borrowings averaged $1.85 billion (see Table I), surpassing the $1.83 billion of average borrowings in March.

On May 16, the Federal Reserve Board announced a series of policy moves designed to curb bank credit expansion and help moderate inflationary pressures. Strong demand for commercial credit combined with an artificially low prime lending rate had encouraged an explosive advance in bank loans to businesses in recent months. To accommodate this loan demand, banks had issued a net of about $15.5 billion of additional CDs (seasonally adjusted) during the first four months of 1973. Most of the new CDs issued since February had initial maturities of under 90 days because Regulation Q ceilings on CDs of 90 days to one year initial maturity were substantially below market rates. Consequently, the maturity structure has been shortened. To enable banks to reestablish a more balanced deposit structure, the Federal Reserve suspended Regulation Q ceilings on all maturities of CDs of $100,000 or more. To slow the rate of CD growth, a marginal reserve requirement of 8 percent is being required, effective June 7, 1973, against further increases in the combined total of large CDs and that portion of bank-related commercial paper currently subject to reserve requirements. A 5 percent reserve requirement continues to be applied to CDs and commercial paper up to the quantity outstanding in the statement week ended May 16. The 8 percent marginal reserve requirement does not apply to banks with a combined total of less than $10 million of CDs and bank-related commercial paper outstanding.

At the same time, several steps were taken to put other bank liabilities, which often serve as substitutes for CDs, on an even footing with CDs. The marginal reserve requirement on certain foreign borrowings by United States banks, primarily Euro-dollars, was reduced from 20 percent to 8 percent. The Federal Reserve also indicated that it plans to phase out the reserve-free base on these foreign liabilities. The reserve-free base will be reduced by 10 percent in each four-week computation period beginning with the one starting July 5. The Board of Governors also proposed an amendment imposing reserve requirements against funds obtained by banks for use in their banking business through the sale of acceptances that are not eligible for discount at the Federal Reserve Banks. For reserve purposes, the new regulation would treat these so-called finance bills as being equivalent to deposits. At present, about $1.1 billion of such bills are outstanding.

At the same time that the Board announced the above series of regulation changes, Chairman Burns sent a letter to about 190 of the largest nonmember banks seeking cooperation in the Federal Reserve's efforts to restrain credit. Accordingly, the letter requested that the nonmember banks voluntarily maintain a marginal reserve of 3 percent on CDs and bank-related commercial paper. A subsequent letter from Chairman Burns to about 100 foreign-owned banking institutions in the United States requested that these institutions also maintain marginal reserves, similar to those required of domestic member banks, against funds obtained from foreign banks and other liabilities. On May 22, Chairman Burns had sent a letter to the member banks, requesting cooperation in helping to curb the growth in bank credit and urging prudence in issuing large-denomination CDs and in borrowing from nondeposit sources.

The monetary aggregates advanced even more strongly in May than they had in April. On the basis of preliminary data for May, it is estimated that M_1 increased at a seasonally adjusted annual rate of about 6½ percent during the three months ended in May and by 7 percent over the twelve months ended then (see Chart II). M_2 is estimated to have grown at annual rates of about 8 percent and 9 percent, respectively, over the three and twelve months ended in May. The growth of the adjusted bank credit proxy slowed somewhat in May from the exceptionally rapid pace of earlier months in the year. Even with this slowing, however, the credit proxy increased at an annual rate of about 15 percent during the three months ended in May and by 12½ percent over the twelve months ended then. The slowing in the growth of the adjusted bank credit proxy occurred as the Treasury reduced the level of its Tax and Loan Ac-

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, MAY 1973

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

Factors	Changes in daily averages— week ended					Net changes
	May 2	May 9	May 16	May 23	May 30	
"Market" factors						
Member bank required reserves	—209	— 56	— 280	+ 433	+ 117	+ 5
Operating transactions (subtotal)	— 570	— 382	+ 14	— 671	+ 534	—1,075
Federal Reserve float	— 654	+ 138	+ 95	— 208	— 334	— 963
Treasury operations*	— 433	— 412	+ 112	+ 323	+ 547	+ 137
Gold and foreign account	— 55	— 19	+ 18	— 29	+ 22	— 63
Currency outside banks	+ 639	— 84	— 316	— 645	+ 380	— 26
Other Federal Reserve liabilities and capital	— 67	— 5	+ 105	— 112	— 82	— 161
Total "market" factors	— 779	— 438	— 266	— 238	+ 651	—1,070
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+ 467	+ 400	+ 535	+ 482	—1,356	+ 528
Outright holdings:						
Treasury securities	+ 929	+ 207	+ 269	+ 181	— 232	+1,354
Bankers' acceptances	+ 1	+ 6	+ 3	— 2	— 2	+ 6
Federal agency obligations	— 6	— 10	—	—	— 14	— 30
Repurchase agreements:						
Treasury securities	— 356	+ 126	+ 196	+ 355	— 971	— 650
Bankers' acceptances	— 29	+ 42	+ 13	— 30	— 51	— 55
Federal agency obligations	— 72	+ 29	+ 54	— 22	— 86	— 97
Member bank borrowings	+ 229	— 391	+ 332	— 128	+ 712	+ 754
Seasonal borrowings†	+ 7	+ 2	+ 5	+ 9	+ 14	+ 37
Other Federal Reserve assets‡	— 20	+ 60	— 140	— 302	+ 83	— 369
Total§	+ 676	+ 69	+ 728	+ 52	— 611	+ 914
Excess reserves‡	— 103	— 369	+ 462	— 186	+ 40	— 156

	Daily average levels					Monthly averages
Member bank:						
Total reserves, including vault cash‡	32,504	32,191	32,933	32,314	32,237	32,436‖
Required reserves	32,271	32,327	32,607	32,174	32,057	32,287‖
Excess reserves§	233	— 136	326	140	180	149‖
Total borrowings	1,875	1,484	1,816	1,688	2,400	1,853‖
Seasonal borrowings§	16	18	23	32	46	27‖
Nonborrowed reserves	30,629	30,707	31,117	30,626	29,837	30,583‖
Net carry-over, excess or deficit (—)#	202	175	9	133	115	127‖

Note: Because of rounding, figures do not necessarily add to totals.

* Includes changes in Treasury currency and cash.

† Included in total member bank borrowings.

‡ Includes assets denominated in foreign currencies.

§ Adjusted to include $172 million of certain reserve deficiencies on which penalties can be waived for a transition period in connection with bank adaptation to Regulation J as amended effective November 9, 1972. The adjustment amounted to $450 million from November 9 through December 27, 1972 and $279 million from December 28, 1972 through March 28, 1973.

‖ Average for five weeks ended May 30.

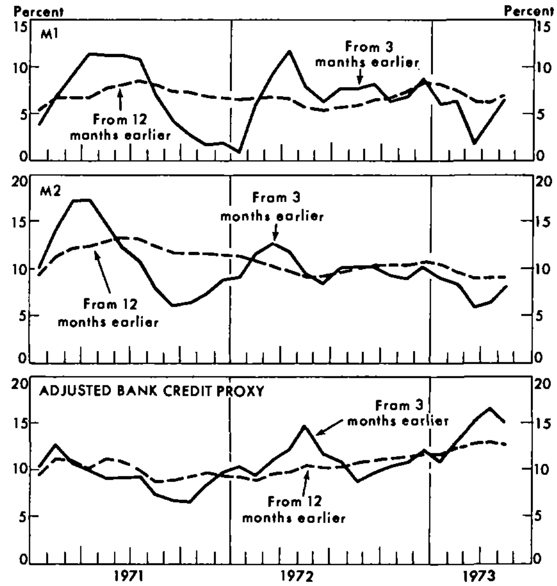
Not reflected in data above.

count balances after the buildup earlier in the year. This reduction resulted because the Treasury has paid down part of the debt and has diverted funds to its accounts with the Federal Reserve Banks. CDs continued to expand rapidly in May, growing at an estimated 60 percent seasonally adjusted annual rate. Still, this is below the explosive 108 percent annual rate of growth posted in the first four months of the year. Reserves available to support private nonbank deposits (RPD) advanced at an estimated 10 percent pace in May, similar to the 10½ percent rate of growth in this series over the first four months of 1973.

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates



Note: Data for May 1973 are preliminary.
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.
Source: Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York.

THE GOVERNMENT SECURITIES MARKET

Treasury bill rates rose sharply during the final two thirds of May, after declining during the first third of the month. The skimpy supply conditions that have prevailed in this market in recent months had sheltered bill rates from some of the upward pressure affecting other market instruments. However, rates began to increase following the announcement of the discount rate increase and other policy changes.

Several specific factors contributed to the early declines in bill rates. The Treasury reduced the number of six-month bills being offered by $100 million a week to about $1.7 billion, beginning with the May 14 auction. Since there was no decrease in the dollar volume of bills maturing, this move meant that the quantity of bills outstanding is being reduced by $100 million a week.

The absence of a short-term "anchor" issue from the Treasury's May refunding package, combined with the substantial paydown on maturing issues, was expected to increase further the demand for bills.[1] In addition, foreign central banks purchased marketable Treasury debt during the statement week ended May 16 as a result of speculative pressure on the dollar following the increases in the price of gold on European markets to levels above $100 per ounce.

Bill rates advanced sharply in the wake of the System's announcements on May 10 of the increase in the discount rate and on May 16 of the changes in regulations dealing with CDs and other bank liabilities. Market participants interpreted these actions as likely to lead to higher short-term interest rates. The higher rates on Federal funds also encouraged market participants to adopt a defensive stance. The Federal Reserve also reduced its holdings of Treasury bills late in May in part to counteract the decline in its holdings of Treasury balances.

The yields established in the weekly auctions reflected the pattern of rates on the outstanding issues. Rates declined about 14 basis points in the May 7 auction on both the three- and six-month bills to 6.136 percent and 6.431 percent, respectively (see Table II). Rates on three-month bills advanced 27 basis points from the week before at the May 21 auction, and rose to 6.694 percent in the final May auction which was advanced to Friday, May 25, because of the Memorial Day holiday weekend. Bill rates continued to climb in the final days of May, with three-month bills trading at 6.92 percent on May 31. In the monthly auction of 52-week bills, held on May 24, an average issuing rate of 6.818 percent was established, 22 basis points higher than the rate set in the auction of similar bills one month earlier.

Prices on most coupon issues rose slightly in early

[1] For details of the May refunding announcement, see this *Review* (May 1973), pages 126-27.

May but fell off thereafter. Prices on intermediate-term securities have been fairly steady since their advances in January and February. Longer term issues had leveled off early in February. While the auction of the new seven-year note on May 1 initially elicited a fairly cautious response, subsequent demand was brisk and gave support to this segment of the market. Prices of outstanding long-term bonds adjusted downward slightly following the 25-year bond auction of May 2. Note and bond prices fell off a bit after the announcement of reserve requirement changes. Over the month, yields on three- to five-year issues changed little while yields on longer term issues increased by an average of 18 basis points.

Several Federal agencies raised new cash during May. The Federal Home Loan Bank System offered on May 9 three bonds of 18-month, 30-month, and 39-month maturities, respectively, each priced to yield 7.05 percent. The $2 billion financing raised $1.6 billion of new cash. These relatively short maturities proved to be very popular, and by the next day all three bonds were trading at a premium. On May 30, the Federal National Mortgage Association raised about $250 million and also refunded maturing issues through an offering of $1.3 billion of three debentures with maturities of thirty-three months, five years, and ten years. They were priced to yield 7⅛ percent, 7.15 percent, and 7.30 percent, respectively. The offerings attracted heavy presale demand and sold out quickly.

Table II

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—May 1973			
	May 7	May 14	May 21	May 25
Three-month	6.136	6.179	6.452	6.694
Six-month	6.431	6.456	6.748	6.864
	Monthly auction dates—March-May 1973			
	March 27	April 24	May 24	
Fifty-two weeks	6.615	6.598	6.818	

* 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

Prices fell in the corporate and municipal bond markets in the latter part of May. On the first two days of the month, two Aa-rated utility bond offerings were aggressively priced to yield 7.48 percent and 7.45 percent, respectively, somewhat below yields on similar issues marketed during the preceding three months. Both sold slowly, and yields rose 4 to 5 basis points in the following week when the bonds were released from syndicate price restrictions. Some softness in prices of outstanding corporate bonds was evident, as investors swapped corporate securities for the new Treasury bonds. Two A-rated utility offerings were marketed on May 16 and on May 22. The first, consisting of $50 million of 25-year debentures, was priced to yield 7.57 percent and sold slowly. The second, a $100 million thirty-year bond issue, yielded 7.72 percent. The higher yield on the thirty-year bond helped sales initially, but further market deterioration limited follow-up orders. On May 30, a $60 million offering of Aa-rated thirty-year bonds yielding 7.64 percent sold out quickly. On May 31, a Bell Telephone subsidiary which has an Aaa rating from Moody's but was recently downgraded to AA by Standard and Poor's offered $200 million of 36-year debentures priced to yield 7.625 percent and $100 million of seven-year notes priced to yield 7.25 percent. The yield on the bond was only about 9 basis points above that offered on another Bell System debenture a month earlier, while the note yielded 18 basis points more than the previous month's offering. Both issues sold slowly, and the price of the debentures fell sharply after syndicate price restrictions were ended on June 4.

New-issue activity in the tax-exempt market picked up moderately, but remained below the volume of the past couple of years. Receptions were mostly mixed, but price adjustments following removal of syndicate price restrictions were generally modest. Rates on outstanding issues advanced gradually during May. The Bond Buyer index of twenty tax-exempt bonds rose from 5.10 percent on May 3 to 5.22 percent on May 31. Dealer inventories rose slightly but remained on the low side. The Blue List of dealers' advertised inventories increased from $633 million to $663 million during May.