The Money and Bond Markets in July

Interest rates increased markedly during July, with yields on short-term instruments rising to record levels. Rates rose dramatically early in the month in the wake of Federal Reserve actions boosting the discount rate to 7 percent and raising reserve requirements on most demand deposits at member banks. While rates leveled off temporarily before midmonth in response to improvement in the international position of the dollar, they soon resumed an advance which persisted over the remainder of the period. The announcement, on July 18, of Phase Four of the economic controls program had little impact, as participants were convinced that the Federal Reserve would maintain its restrictive stance. Treasury bill rates climbed substantially over the month as a whole. Yields on Government coupon securities moved up as concern over inflation and pressures in the money market continued. As evidence of the Federal Reserve's restrictive stance mounted, market participants backed away late in the month from the Treasury's offering of $2 billion of notes due in 1977 and $500 million of twenty-year bonds. Prices dropped sharply, and public interest proved quite limited in the longer issue. Yields on corporate and tax-exempt bonds increased dramatically in July, particularly late in the month.

In response to the rapid rise in short-term interest rates and the potential danger of disintermediation, the Board of Governors of the Federal Reserve System, together with the Federal Home Loan Bank (FHLB) Board and the Federal Deposit Insurance Corporation (FDIC), on July 5 raised the ceilings on interest rates member banks and thrift institutions may pay on passbook savings and other consumer-type time deposits (see Table I). In a further effort to allow these institutions to be more competitive, a new category of consumer time deposit was established. This deposit is not subject to an interest rate ceiling; however, the deposit must have a minimum maturity of four years and have a minimum denomination of $1,000.

The growth of both M_1—defined as demand deposits adjusted plus currency outside banks—and M_2, which also includes time and savings deposits other than large certificates of deposit (CDs), slowed during July, but growth in recent months was still greater than desired. The growth of the adjusted bank credit proxy was at a more moderate rate in July than that during the past few months, largely as a result of a sharp decline in Treasury deposits at member banks. Large-denomination CDs outstanding increased substantially again in the month.

BANK RESERVES AND THE MONEY MARKET

Pressure in the money market increased considerably during July, as the Federal Reserve sought to restrict the growth in money and credit. The average effective rate on Federal funds rose from 8.59 percent in the June 27 statement week to 10.57 percent in the statement week ended August 1.[1] Average required reserves rose $1.2 billion above June levels, in part because of the increase in reserve requirements on member bank demand deposits which became effective in mid-July. The monetary authorities provided nonborrowed reserves reluctantly in reaction to this expanded demand for reserves. Consequently, member banks bid aggressively for Federal funds and stepped up their borrowings from the Federal Reserve Banks as well. Borrowings from the discount window averaged $1.97 billion in July (see Table II), compared with $1.79 billion borrowed in June. With the spread between the cost of Federal funds and Euro-dollars narrowing, banks also began to utilize the Euro-dollar market to a greater extent.

Other short-term interest rates also rose significantly in July (see Chart I). In attempting to attract additional funds, large banks have raised offering rates on short-term CDs considerably. These rates have risen to such an extent that some smaller banks are now investing in the CDs

[1] Beginning July 19, 1973 the daily effective Federal funds rate is calculated as a "weighted average", reflecting the volume of activity at each rate at which transactions occur. Previously, the effective rate was defined as the most representative rate for the day, usually the rate at which most transactions through Federal funds brokers occurred.

of large city banks, particularly in New York. The small banks are using large CDs as an alternative investment to supplying funds in the overnight market, and are thereby extending the maturity of their liquid assets. With the cost of funds rising sharply, commercial banks raised their prime lending rate for large business borrowers by 1 percentage point over the month in a series of ¼ percentage point steps. The prime rate reached a level of 8¾ percent at virtually all major banks by the month end. This represented the highest rate banks have charged their prime business customers since the practice of a publicized prime rate became common about forty years ago. Rates on commercial paper climbed steadily throughout the month. The rate on 90- to 119-day commercial paper advanced 1⅜ percentage points over the month and closed at 9⅞ percent. Over the past three months, the rate on such paper has risen a total of 2¾ percentage points. Thus, despite persistent increases in the commercial bank prime rate, bank loans have continued to be attractive in relation to borrowing in the commercial paper market. Rates quoted by dealers in bankers' acceptances increased by 1¼ percentage points over the month.

In response to the pronounced increases in market interest rates in recent months, the authorities regulating depository institutions raised in July the interest rate ceilings that banks and thrift institutions may pay on passbook savings and other consumer time deposits. Specifically, on July 5 the Board of Governors of the Federal Reserve System raised the interest rate ceilings that member banks may pay on passbook savings accounts by ½ percentage point and on other time deposits of less than $100,000 by ¼ to ¾ percentage point. The new schedule of ceilings was made effective as of July 1 and applies to both single- and multiple-maturity deposits. Interest rate ceilings on consumer-type time deposits were last increased on January 21, 1970. Additionally, member banks were authorized to offer four-year time deposits with a minimum denomination of $1,000 without any interest rate restriction. Subsequently, the amount of such deposits that a bank may issue was limited to 5 percent of its total time and savings deposits. Penalty provisions for payment of time deposits prior to maturity were also modified.[2] The FDIC and the FHLB Board announced on the same day similar changes in interest rate ceilings for the institutions under their jurisdiction, with the exception that ceilings on passbook accounts at thrift institutions were raised by only ¼ percentage point. These increases in interest rate ceilings were taken both to enable the financial institutions to compete more effectively for consumer deposits and to provide consumers with a higher return in an environment where many interest rates have risen substantially.

Many banks and thrift institutions rapidly adjusted their rates to the new ceilings and introduced deposits of varying maturity, minimum balance, and interest rate to fill the "no ceiling" four-year deposit category. The most common rate offered on the new four-year certificates was 7 percent. With the increase in deposit ceilings, some

Table I

NEW INTEREST RATE CEILINGS ON SAVINGS DEPOSITS AND TIME DEPOSITS IN DENOMINATONS OF LESS THAN $100,000

In percent per annum

Institution and instrument	New maximum	Previous maximum
FDIC-insured commercial banks		
Passbook savings	5.00	4.50
Time deposits maturing in:		
90 days to 1 year	5.50	5.00
1 year to 2½ years	6.00	5.50*
2½ years and over	6.50	5.75
4 years and over (minimum denomination of $1,000)	no ceiling	5.75
FDIC-insured mutual savings banks		
Passbook savings	5.25	5.00
Time deposits maturing in:		
90 days to 1 year	5.75	5.25
1 year to 2½ years	6.50	5.75†
2½ years and over	6.75	6.00
4 years and over (minimum denomination of $1,000)	no ceiling	6.00
FHLB member savings and loan associations		
Passbook savings	5.25	5.00
Time deposits maturing in:		
90 days to 1 year	5.75	5.25
1 year to 2½ years	6.50‡	5.75†
2½ years and over	6.75‡	6.00
4 years and over (minimum denomination of $1,000)	no ceiling	6.00

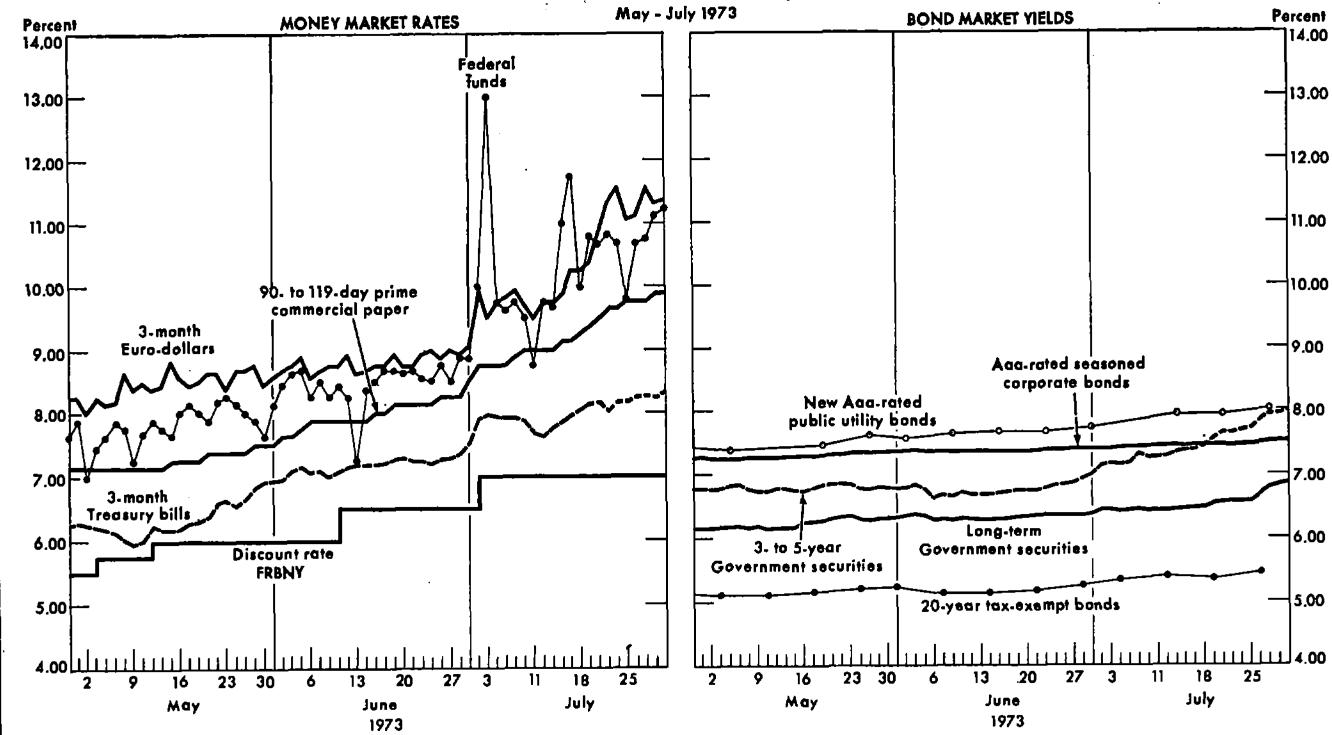
* 5.50 percent for one to two years; 5.75 percent for two years or more.
† 5.75 percent for one to two years; 6.00 percent for two years or more.
‡ Subject to varying minimum denomination requirements.
Sources: Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Federal Home Loan Bank Board.

[2] Under the new rule, a bank may pay a time deposit at any time before maturity but only at the passbook rate for the period held, less three months interest.

Chart I

SELECTED INTEREST RATES

May - July 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.

states were induced to raise their ceilings on mortgage interest rates so that thrift institutions could meet, profitably, the demand for mortgage funds.

The monetary aggregates continued to grow at a rapid pace in July. Preliminary estimates indicate that M_1 advanced at a seasonally adjusted annual rate of about 5¾ percent in that month, bringing the growth over the past three months to 9¾ percent at an annual rate (see Chart II). Over the twelve months ended in July, M_1 has increased by 6¾ percent. The growth of time deposits other than large negotiable CDs has been moderating steadily throughout the year. The combined effect of the growth of these time deposits and M_1 resulted in an expansion of the broad money supply (M_2) at an annual rate of 5¾ percent in July. This is a somewhat slower pace than the growth experienced over the twelve months ended in July.

The adjusted bank credit proxy—which consists of daily average member bank deposits subject to reserve requirements and certain nondeposit liabilities—expanded at an estimated 9 percent seasonally adjusted annual rate in July. This is a somewhat slower pace than the 13.8 percent rate of advance experienced during the first half of the year. Much of the slowing in growth of the proxy can be attributed to the decline in Government deposits during July. The growth in large CDs remained strong. CDs increased at a rate of 46.5 percent in July by comparison with the explosive 87 percent annual rate of gain posted

Table II

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

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

Factors	Changes in daily averages—week ended				Net changes
	July 4	July 11	July 18	July 25	
"Market" factors					
Member bank required reserves	— 687	+ 159	— 744	— 521	—1,793
Operating transactions (subtotal)	—1,470	+ 709	+ 831	— 264	— 194
Federal Reserve float	— 485	+1,534	+ 129	— 528	+ 650
Treasury operations*	— 533	— 357	+ 776	+ 72	— 42
Gold and foreign account	— 31	+ 24	+ 3	— 124	— 128
Currency outside banks	— 253	— 381	— 239	+ 326	— 547
Other Federal Reserve liabilities and capital	— 107	— 111	+ 162	— 11	— 127
Total "market" factors	—2,157	+ 868	+ 87	— 785	—1,987
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+1,937	— 793	+ 250	— 22	+1,372
Outright holdings:					
Treasury securities	+ 732	+ 86	+ 171	— 112	+ 877
Bankers' acceptances	— 2	— 4	— 6	— 5	— 17
Federal agency obligations	—	—	—	+ 144	+ 144
Repurchase agreements:					
Treasury securities	+ 989	— 765	+ 92	— 25	+ 291
Bankers' acceptances	+ 52	— 33	— 6	+ 4	+ 17
Federal agency obligations	+ 166	— 77	— 1	— 28	+ 60
Member bank borrowings	+ 552	— 721	+ 42	+ 358	+ 231
Seasonal borrowings†	+ 18	+ 6	—	+ 11	+ 35
Other Federal Reserve assets‡	+ 97	— 8	+ 87	+ 61	+ 237
Total§	+2,526	—1,522	+ 379	+ 396	+1,779
Excess reserves‡	+ 369	— 654	+ 466	— 389	— 208

	Daily average levels				Monthly averages
Member bank:					
Total reserves, including vault cash‡	33,280	32,467	33,677	33,809	33,308‖
Required reserves	32,687	32,528	33,272	33,793	33,070‖
Excess reserves§	593	— 61	405	16	238‖
Total borrowings	2,401	1,680	1,722	2,080	1,971‖
Seasonal borrowings†	111	117	117	128	118‖
Nonborrowed reserves	30,879	30,787	31,955	31,729	31,337‖
Net carry-over, excess or deficit (—)#	100	216	17	227	140‖

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 $112 million of certain reserves 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, $279 million from December 28, 1972 through March 28, 1973, $172 million from March 29 through June 27, 1973.

‖ Average for four weeks ended July 25.

Not reflected in data above.

over the first six months of the year. Reserves available to support private nonbank deposits grew at an annual rate of 16.5 percent in July.

THE GOVERNMENT SECURITIES MARKET

Treasury bill rates rose sharply in July, largely in response to the increasingly restrictive stance of monetary policy. Bill rates moved dramatically higher early in the month in the wake of the increase in the discount rate and the rise in member bank reserve requirements announced in late June. In the weekly bill auction on July 2, the average issuing rates on both the three- and six-month bills were more than 70 basis points above the rates set at the previous auction. The issuing rate for the three-month bill advanced somewhat further over the rest of the month (see Table III) and finished 109 basis points above the rate set in the final auction in June. Similarly, the rate for the six-month bill at the July 30 auction was 118 basis points above its month-earlier level. The yield on 52-week bills in the July 24 auction was 8.393 percent, 116 basis points above the month-earlier level.

Bill rates steadied briefly in the second week of July, as some temporary improvement in the dollar in the foreign exchange markets bolstered investor demand. On July 10, the Federal Reserve announced increases in most of the reciprocal currency arrangements, or swap lines, that it maintains with fourteen foreign central banks and the Bank for International Settlements, and market participants were encouraged by this step. However, rates soon resumed their climb. The upward momentum of rates was little affected by the disclosure, on July 18, of Phase Four of the Administration's price controls program. It was expected that monetary policy would remain firm in any event. Against this background, bill rates advanced substantially over the remainder of the period to record levels.

The market for Treasury coupon securities was influenced by many of the same factors which affected the bill market. Prices were buoyed temporarily by developments in the foreign exchange markets but declined over much of the month. Yields on three- to five-year issues rose by an average of 99 basis points over the month as a whole, while yields on longer term issues increased by about 46 basis points.

On July 25, the Treasury disclosed the terms for refunding $4.7 billion of publicly held notes and bonds due to mature August 15. The Treasury announced that it would auction $2 billion of four-year 7¾ percent notes, $500 million of 7½ percent twenty-year bonds callable in fifteen years, and $2 billion of 35-day tax anticipation bills. For the bond auction, the Treasury employed the technique, which was used in the two preceding bond sales, of awarding all of the bonds at the price of the lowest accepted bid.

Following the announcement of the refinancing, rates on short-term Treasury bills adjusted upward while the prices of intermediate- and long-term Government securities declined quite sharply. The price declines in the intermediate area were the largest on record. In the rapidly deteriorating market atmosphere, participants became increasingly cautious as the auctions approached, and the new notes and bonds met only limited demand. On July 31, the 7¾ percent notes were sold at an average issuing yield of 8.03 percent, considerably higher than had been anticipated when the refunding package was announced. The 7½ percent bonds, auctioned August 1, were issued at an average yield of 8 percent. The public subscribed to only $260 million of the bonds.

Table III

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

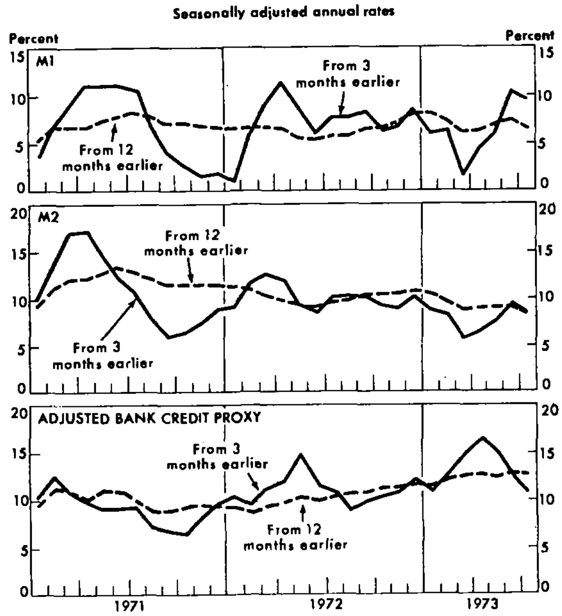
Maturities	Weekly auction dates—July 1973				
	July 2	July 9	July 16	July 23	July 30
Three-month	7.987	7.991	7.967	8.114	8.320
Six-month	8.011	8.019	8.023	8.272	8.476
	Monthly auction dates—May-July 1973				
	May 24	June 26	July 24		
Fifty-two weeks	6.818	7.235	8.393		

* 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.

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates



Note: *Data for July 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.

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

Prices of Federal agency securities declined during July amid continued heavy new-issue activity. Early in the month the Federal Land Banks offered three issues totaling $1.1 billion. These securities, priced to yield from 7.50 percent to 7.65 percent, received a mediocre reception. On July 12, the FHLB Board priced $500 million of 25-month bonds at 7.875 percent and $500 million of 37-month bonds at 7.80 percent. This offering failed to attract much investor interest. Other agency issues marketed later in the month similarly received unenthusiastic receptions.

OTHER SECURITIES MARKETS

Rising money market rates and continued pessimism about inflation exerted downward pressure on prices of corporate and municipal bonds during July. Despite light dealer positions, prices of older corporate issues moved lower over the month as investors remained cautious about committing funds to long-term securities amid expectations of further increases in short-term rates. New financing activity in the corporate sector was modest. On July 12, $125 million of twenty-year Aa-rated debentures was offered to yield 7.875 percent. This issue initially received a good reception, but sales subsequently encountered some resistance. Several relatively small utility bond issues offered during the month also sold slowly. During the final week of July, several utility issues were offered at the highest yields in over two years. Despite these attractive returns, investor interest was generally unenthusiastic. One $75 million Aa-rated power company issue, priced to yield 8.50 percent in 2003, received lackluster support even though this return was 25 basis points above that of a similarly rated utility offering in the previous week.

Prices of tax-exempt bonds generally moved lower during July. On July 2, $86 million of Aa-rated bonds received a good reception when priced to yield from 4.40 percent in 1974 to 5.25 percent in 1997, about 10 basis points more than yields available on similar outstanding securities. The municipal calendar increased later in the month, but legal technicalities forced the postponement of one issue and this aided sales of the others, as municipal bond dealers were able to reduce their inventories. On July 10, $150 million of A-1 rated bonds was priced to return from 4.40 percent in 1974 to 5.90 percent in 2003. Despite the generous yields, there was only moderate interest in this issue. Several smaller tax-exempt issues marketed later in July met good demand. The fourth week of July was dominated by the offering of $331 million of New York City A/BB-rated (Moody's/Standard and Poor's) bonds priced to yield 5.98 percent. This offering received strong support. The Bond Buyer index of twenty tax-exempt bond yields climbed from 5.25 percent on June 28 to 5.48 percent on July 26. The Blue List of dealers' advertised inventories fell $111 million to $584 million over the month.