The Money and Bond Markets in August

Interest rates on short-term instruments continued to climb during much of August in response to the momentum of an expanding economy and expectations that monetary policy would exert prolonged restraint. The Federal Reserve provided nonborrowed reserves sparingly, and commercial banks competed aggressively for funds. Federal funds traded at 10½ percent or above over much of the month, and banks raised offering rates on large-denomination certificates of deposit (CDs). The Federal Reserve discount rate was increased by ½ percentage point to a record 7½ percent about midmonth, while member bank borrowings remained heavy throughout the period. Commercial banks boosted the prime lending rate charged to large business borrowers in four ¼ percentage point steps over the month, with the rate reaching 9¾ percent by the month end. Rates on most maturities of commercial paper increased by ½ to 1 percentage point during the period.

The market for Treasury securities experienced wide fluctuations during the month. Treasury bill rates increased considerably during the first half of August but reversed course later in the month. Prices of Treasury coupon securities rose sharply, although unevenly, over much of the period, recovering from the precipitous decline of late July. The Treasury's August 24 auction of $2 billion of 8⅜ percent 25-month notes attracted substantial interest and resulted in an average issuing yield of 7.94 percent. Prices of Federal agency securities also improved in August despite a continued heavy calendar of new issues. New issue activity in the corporate and municipal bond markets was generally light, while yields on older outstanding issues declined slightly on balance.

The growth of M_1—defined as demand deposits adjusted plus currency outside banks—slowed considerably during August. However, M_2, which also includes time and savings deposits other than large CDs, expanded more rapidly in August than it had in July. Growth of consumer time and savings deposits at commercial banks was strong in August, perhaps as a result of the July increase in interest rates payable on such deposits. The gain in other time deposits together with the sustained growth of large-denomination CDs contributed to the rapid expansion of the adjusted bank credit proxy in August, bringing its estimated rate of growth above those recorded in the previous four months.

BANK RESERVES AND THE MONEY MARKET

The money market remained firm throughout August, as the Federal Reserve maintained pressure on bank reserve positions. The effective rate on Federal funds averaged 10.79 percent in the statement week ended August 29, 22 basis points above the average of the August 1 statement week. A sizable decrease in Treasury balances at the Reserve Banks led to some temporary easing in the Federal funds rate around midmonth; indeed, on August 15 the Treasury borrowed $350 million from the Federal Reserve to avoid an overdraft. In an effort to slow the growth of the money and credit aggregates, the monetary authorities restrained the growth of nonborrowed reserves during the month. However, faced with the restrictive stance of monetary policy, commercial banks continued their massive borrowing from the Federal Reserve. Borrowings from the discount window averaged $2.14 billion in August (see Table I), compared with $1.97 billion of borrowed reserves in July and a monthly average of $1.66 billion over the first six months of this year.

Effective August 14, the Board of Governors of the Federal Reserve System approved a ½ percentage point increase in the discount rate at ten Reserve Banks. Similar increases in the discount rate at the two remaining Reserve Banks were approved shortly thereafter. This move, the seventh increase in the discount rate this year, brought the rate to 7½ percent, the highest in the history of the Federal Reserve System. Persistent rises in short-term market rates of interest and ongoing concern with inflation and with the excessive growth of the monetary aggregates led to the successive increases from the 4½ percent rate

Table I

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

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

Factors	Changes in daily averages— week ended					Net changes
	Aug. 1	Aug. 8	Aug. 15	Aug. 22	Aug. 29	
"Market" factors						
Member bank required reserves	+ 241	+ 171	— 129	— 48	— 115	+ 120
Operating transactions (subtotal)	— 499	+ 492	+1,358	— 307	— 662	+ 382
Federal Reserve float	—1,030	+ 412	+ 178	—201	— 613	—1,254
Treasury operations*	+ 246	+ 149	+1,350	+ 491	—717	+1,519
Gold and foreign account	— 2	+ 132	— 39	— 34	+ 62	+ 119
Currency outside banks	+ 449	— 147	— 329	— 436	+ 604	+ 141
Other Federal Reserve liabilities and capital	— 161	— 54	+ 198	— 128	—	— 145
Total "market" factors	— 258	+ 663	+1,229	— 355	— 777	+ 502
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+ 674	—1,019	— 931	+ 394	+ 487	— 395
Outright holdings:						
Treasury securities	+ 528	— 486	— 977	+ 190	+ 417	— 328
Bankers' acceptances	+ 1	—	— 4	— 4	+ 3	— 4
Special certificates	—	—	+ 50	— 50	—	—
Federal agency obligations	+ 24	— 3	—	—	— 7	+ 14
Repurchase agreements:						
Treasury securities	+ 126	— 440	—	+ 230	+ 12	— 72
Bankers' acceptances	+ 27	— 46	—	+ 19	+ 13	+ 13
Federal agency obligations	— 32	— 44	—	+ 9	+ 49	— 18
Member bank borrowings	+ 14	— 89	— 90	+ 219	+ 423	+ 477
Seasonal borrowings†	+ 13	+ 17	— 10	+ 15	+ 22	+ 57
Other Federal Reserve assets‡	+ 34	+ 20	+ 4	— 510	— 23	— 475
Total§	+ 723	—1,088	—1,017	+ 103	+ 888	— 391
Excess reserves‡	+ 465	— 425	+ 212	— 252	+ 111	+ 111

	Daily average levels					Monthly averages
Member bank:						
Total reserves, including vault cash‡	34,051	33,455	33,796	33,592	33,818	33,742‖
Required reserves	33,552	33,381	33,510	33,558	33,673	33,535‖
Excess reserves§	499	74	286	34	145	207‖
Total borrowings	2,095	2,006	1,916	2,135	2,558	2,142‖
Seasonal borrowings†	141	158	148	163	185	159‖
Nonborrowed reserves	31,956	31,449	31,880	31,457	31,260	31,600‖
Net carry-over, excess or deficit (—)#	32	385	72	109	49	129‖

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 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, $279 million from December 28, 1972 through March 28, 1973, and $172 million from March 29 through June 27, 1973.
‖ Average for five weeks ended August 29.
Not reflected in data above.

prevailing at the beginning of this year.

Other short-term interest rates advanced further in August (see Chart I). With continued expansion in economic activity, the demand for credit remained strong, and major commercial banks sought additional funds through the sale of large CDs. Competitive bidding for these deposits raised rates to new highs. With the cost of funds rising sharply and demand for loans still strong, banks increased their prime lending rate for large business borrowers by 1 percentage point over the month in four ¼-point steps. These hikes brought the prime rate to 9¾ percent, a historic high. During the 1969-70 period of high interest rates, the prime rate peaked in June 1969 at 8½ percent and remained at that plateau for nearly ten months. Commercial paper rates continued their upward spiral in August. The rate on 90- to 119-day paper advanced ⅝ percentage point over the month and closed at 10½ percent. Thus, despite the steady advance in the prime rate, bank loans remained less costly than borrowing in the commercial paper market, although the difference is probably not so large as the divergence in rates suggests because of compensating balance requirements and other costs imposed by commercial banks. In addition, many bank loans are presently being made on a variable rate basis, so that over the term of the loan the cost of funds will fluctuate with changes in the prime rate. Rates on bankers' acceptances increased in concert with other market rates by ½ percentage point over the month.

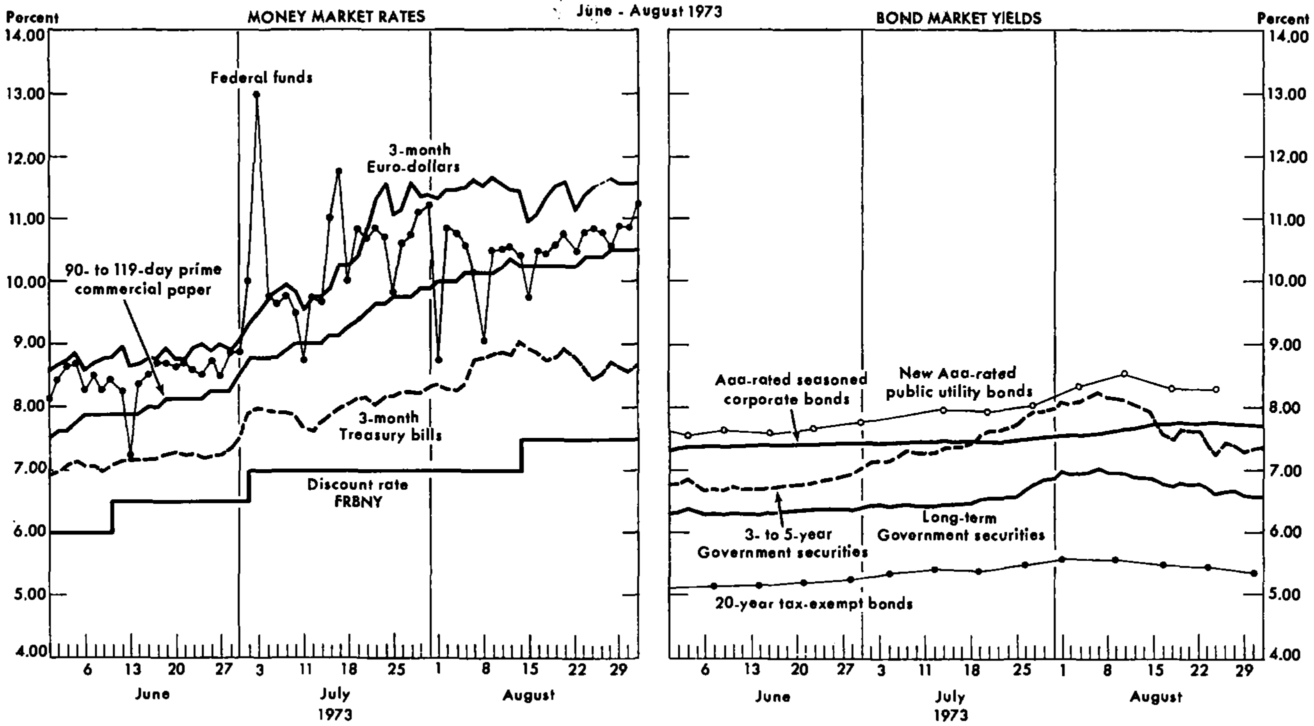
Preliminary estimates indicate that the advance of M_1 slowed considerably during August. With this moderation, the growth of M_1 over the three months ended in August comes to a bit below 6 percent at a seasonally adjusted annual rate (see Chart II). Over the past twelve months, M_1 has expanded by 6¼ percent. On the other hand, the growth of M_2 accelerated in August in the wake of the July changes in interest rate ceilings on consumer time and savings deposits and the abandonment of ceiling restrictions on deposits of maturities of four years or more. Time deposits other than large CDs grew significantly in August. The growth of these time and savings deposits had been on a declining trend over the past year. Over the three months ended in August, M_2 increased at an annual rate of about 7½ percent.

The adjusted bank credit proxy—which consists of daily average member bank deposits subject to reserve requirements and certain nondeposit liabilities—advanced substantially in August, bringing the growth over the past three months to approximately a 12½ percent annual rate. Much of the growth in the proxy can be attributed to the rise in time deposits. Large CD growth remained strong, increasing at about the same rate as in July. This gain, cou-

Chart I

SELECTED INTEREST RATES

June - August 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.

pled with the expansion of other time deposits and some increase in interbank deposits, resulted in the rapid expansion of the credit proxy. The rate of growth of reserves available to support private nonbank deposits (RPD) diminished considerably in August.

THE GOVERNMENT SECURITIES MARKET

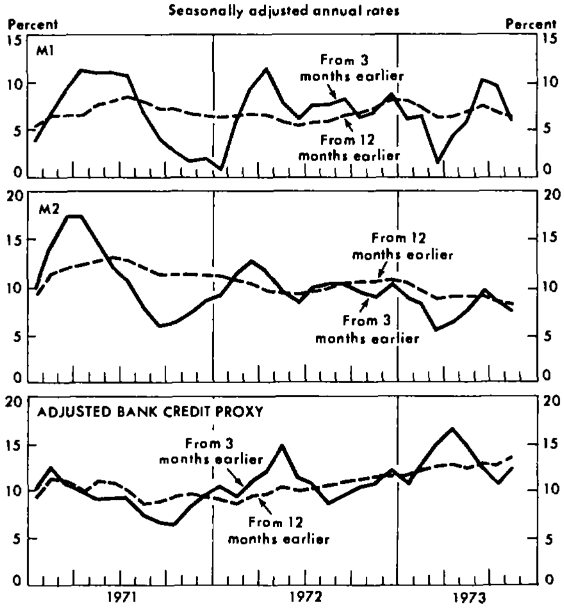
Treasury bill rates continued to advance over the first half of August, as expectations were widespread that monetary policy would foster an extended period of restraint. The final phase of the August refunding was conducted in this atmosphere, and the $2 billion of 35-day tax anticipation bills was auctioned on August 8 at a record average yield of 9.802 percent.* An announcement by the Federal Home Loan Bank (FHLB) Board that it would market a large block of short-term securities contributed to the upward pressure on bill rates through the first two weeks of the month. In the weekly auction on August 13, the average issuing rates for the three-month and six-month bills climbed 49 and 29 basis points, re-

* For details of the August refunding announcement, see this *Review* (August 1973), pages 200-201.

spectively, above the rates set at the previous auction.

The bill market rallied shortly after midmonth and sizable rate declines ensued, particularly on issues maturing beyond four months. Improved investor demand sustained the declines over much of the remainder of the month. Rates on the three- and six-month bills were below their mid-August levels in the August 31 auction (see Table II) but were 46 basis points and 26 basis points, respectively, above the rates set in the final auction in July. The volume of noncompetitive tenders awarded at the weekly bill auctions in August averaged about 13.5 percent of the total accepted. In comparison, noncompetitive tenders accounted for less than half of this percentage on average in the auctions held during the first three months of the year. The yield on 52-week bills in the monthly auction held August 22 was 8.39 percent, about unchanged from the rate established at the previous month's auction. These rates have surpassed the peaks established in 1969-70 by a wide margin. In that period, for example, the highest yield set in a monthly auction of 52-week bills was the 7.592 percent recorded in November 1969.

Chart II
CHANGES IN MONETARY AND CREDIT AGGREGATES
Seasonally adjusted annual rates



Note: Data for August 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 Treasury coupon securities fluctuated widely during August but rose on balance from the post-financing lows recorded early in the month. Remarks made by Federal Reserve Board Chairman Burns suggesting that monetary policy might become more restrictive if the growth of the monetary aggregates failed to recede led to some initial erosion in prices of intermediate-term issues. However, prices of longer term securities benefited from the limited amount of the Treasury's new 7½ percent twenty-year bonds awarded to the public in the August refunding, and the ensuing rally spread to intermediate-term issues before midmonth. While the initial price improvement stemmed largely from the favorable technical position of the market, the rally was extended as participants took encouragement from the stability exhibited by the Federal funds rate during the middle of the month and from news of improvement in the United States balance of payments in the second quarter. Over the month, yields on most three- to five-year issues declined by an average of 64 basis points, while yields on longer term issues generally fell by about 25 basis points. Although short-term rates have risen well above their peaks of 1969-70, yields on Treasury coupon securities have remained considerably below their 1970 highs.

On August 20, the Treasury announced that it would auction $2 billion of 25-month notes on August 24. This new offering was intended to raise funds to cover a low period in the Treasury's cash balance in early September and to replace, in part, some redemptions of special nonmarketable securities held by foreign monetary authorities. The Treasury deferred setting a coupon rate for the note until August 22 in view of the sharp gyrations that had been experienced in the bond market. In the event, the Treasury placed an 8⅜ percent coupon on the note, and bidding for the issue proved to be quite aggressive. The new note was issued at an average rate of 7.94 percent.

Prices of Federal agency securities rose during August. New issue activity remained substantial, but the market benefited to some extent from the good overall technical position of the capital markets. Most new issues were afforded favorable receptions by investors. Early in the month, the FHLB system offered a package of short-term securities consisting of $700 million of six-month 9¾ percent notes, $800 million of one-year 9⅝ percent bonds, and $300 million of thirty-month 8¾ percent bonds. This offering sold well as a considerable amount of investor interest developed. Around midmonth, the Export-Import Bank offered $300 million of five-year securities priced to yield 8.35 percent. This issue sold out quickly. Shortly

Table II

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—August 1973				
	Aug. 6	Aug. 13	Aug. 20	Aug. 27	Aug. 31
Three-month	8.486	8.976	8.910	8.668	8.778
Six-month	8.650	8.943	8.856	8.577	8.735

Maturities	Monthly auction dates—June-August 1973		
	June 26	July 24	Aug. 22
Fifty-two weeks	7.235	8.393	8.388

* 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.

thereafter, $660.5 million of the Federal Intermediate Credit Banks' nine-month bonds encountered good demand when priced to yield 9.75 percent. Subsequently, the issue was trading well above par. On August 29, the Federal National Mortgage Association encountered excellent interest for its $1 billion issue. The offering consisted of $300 million of 27-month 8¼ percent debentures, $400 million of four-year bonds, and $300 million of 69-month debentures, with both longer term securities yielding 7.85 percent.

OTHER SECURITIES MARKETS

Prices of corporate and municipal bonds also experienced sharp price fluctuations in August. In the corporate sector, dealer positions were minimal and the supply of new issues was modest. However, continuing concern over inflation and the persistent rise in short-term interest rates combined to limit investor demand. As a result, prices of corporate securities fluctuated rather widely in response to largely professional trading. Prices of outstanding corporate bonds rose before midmonth in concert with the rally in the market for United States Government securities. However, some of these gains were dissipated later in the period. On August 7, $100 million of a thirty-year A-rated power company issue was priced to yield 8.80 percent. Interest in these bonds improved after $50 million of Aa-rated thirty-year utility company debentures, priced to return 8.50 percent, received a good response the next day. The next week, two other power company issues yielding several basis points less than comparable issues marketed earlier in the month received favorable receptions after slow initial sales. The month's major corporate offering, $300 million of Aaa-rated Bell System bonds, was marketed August 21. The 39-year bonds, priced to yield 8.20 percent in a negotiated underwriting, sold quickly; however, an appreciable quantity of these bonds reportedly went to professionals or to investors who swapped them for other utility issues.

Prices of tax-exempt securities moved somewhat higher in August. On August 8, $100 million of Aaa-rated bonds received good interest when priced to yield from 5 percent in 1974 to 5.80 percent in 1998. About the same time, a $50 million Aa-rated issue received considerable support when scaled to return from 5.30 percent in 1974 down to 5.00 percent in 1977-81 and up to 5.75 percent in 1992. This distribution of yields basically represented the prevailing term structure of interest rates for outstanding tax-exempt securities, and the offering was well received. Two small tax-exempt issues marketed around midmonth encountered moderate interest, while several issues offered near the end of August were sold quickly at yields below those available on comparable issues marketed earlier in the month. The Bond Buyer index of twenty tax-exempt bond yields fell from 5.48 percent on July 26 to 5.34 percent on August 30. The Blue List of dealers' advertised inventories fell $99 million over the month to $485 million.