The Money and Bond Markets in December

Short-term interest rates edged upward early in December but then drifted generally lower through the remainder of the month. Longer term rates moved within a narrow range and finished the month somewhat higher than at the end of November. Throughout the period, the dominant concerns in the financial markets were the economic implications of the energy shortage and the likely response of monetary policy to the anticipated slower pace of economic activity. Early in the month, increases in the prime lending rates of several major commercial banks and a statement by Federal Reserve Chairman Arthur Burns that "the shortage we have is a shortage of oil, not a shortage of money", caused interest rates to move sharply higher. However, a subsequent reduction in the reserve requirement on large negotiable certificates of deposit (CDs) and a series of Treasury bill purchases by the Federal Reserve were interpreted by the market as presaging a more lenient monetary policy. As a result, short-term rates reversed direction and long-term rates temporarily halted their advance. For the month as a whole, the rates on most maturities of commercial paper were ⅛ percentage point lower to ¼ percentage point higher, while the secondary market yield on CDs fell 11 basis points. During the week ended January 2, the effective rate on Federal funds was 9.87 percent, 22 basis points below the rate for the last week of November (see Chart I).

The yields on Treasury securities were mixed in December. Six-month and 52-week yields declined, while three-month, intermediate-term, and long-term yields rose. Investors appeared to be waiting for some indication of the direction monetary policy would take in 1974. While they apparently expected rates to be falling as a consequence of slower economic activity, buying of securities was constrained by the high Federal funds rate and the high cost of financing dealers' inventories. In the corporate market, a steady supply of new issues contributed to a downward movement in prices. Federal agency securities prices showed little change in a moderately active market. In December, the narrow money supply (M_1)—demand deposits adjusted plus currency outside banks—grew at a moderately rapid pace, although less steeply than in November. M_2, which includes time and savings deposits other than large CDs, also expanded at a more moderate pace. The adjusted bank credit proxy—which consists of daily average member bank deposits subject to reserve requirements plus certain nondeposit liabilities—grew slowly in December. In the past three months, the growth of the credit proxy has fallen well below the average for the earlier months of 1973.

BANK RESERVES AND THE MONEY MARKET

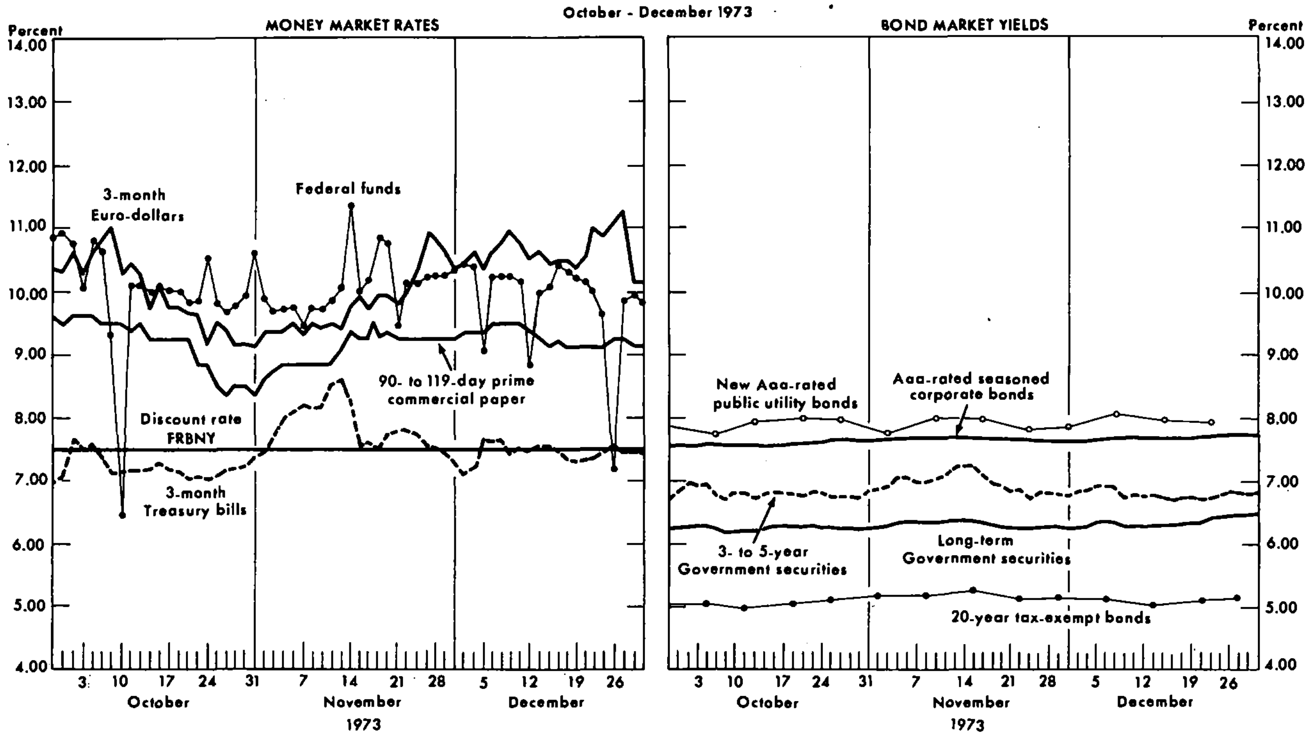
With few exceptions, interest rates on most money market instruments registered small net declines in December. The rate on 120- to 179-day commercial paper fell ⅛ percentage point to 9 percent, while the rate on 30- to 59-day paper rose ¼ percentage point to 9¾ percent. The rates on bankers' acceptances were unchanged. The average effective rate on Federal funds in December was 9.95 percent, 8 basis points below the November average. At the same time, the use of the discount window by member banks declined, and the average level of borrowings fell in December to $1.3 billion (see Table I). This decrease is the fourth successive monthly decline in member borrowings since September.

The secondary market rate on large CDs closed out December slightly below its opening level, while the volume of CDs outstanding increased by a small amount. The Board of Governors of the Federal Reserve System announced on December 7 a reduction in the marginal reserve requirements on large CDs and on bank-related commercial paper and finance bills with maturity of thirty days or more. The change, which lowered the marginal reserve requirement from 11 percent to 8 percent, took effect on deposits in the week beginning December 13. Because of lagged reserve accounting, the level of required reserves was not affected until two weeks later. The Board had imposed a marginal reserve requirement of 8 percent on May 16, 1973, applying it to any increase in CDs, commercial paper, and finance bills above the outstanding level. The

Chart I

SELECTED INTEREST RATES

October - December 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-rated 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.

requirement was raised to 11 percent on September 6 in an effort to restrict the growth of bank credit. The initial requirement was restored in December in recognition of the slower credit growth during October and November. Early in December, several large commercial banks raised their prime lending rate ¼ percentage point to 10 percent. However, the move was not followed by all commercial banks, and during the first full week in January the banks that had raised their prime rates returned them to 9¾ percent.

The latest available data indicate that the monetary aggregates expanded at a more moderate pace in December than they did in November. The seasonally adjusted annual growth rate of M_1 in December was about 5½ percent. This brought the pace of monetary growth for the fourth quarter of 1973 to 6½ percent, compared with about ¼ percent during the third quarter (see Chart II). The increase during the entire year amounted to 5 percent. The data for the monetary aggregates do not reflect the annual bench-mark revisions of nonmember bank deposits. Because deposit data for nonmember banks are available from call reports for only two dates each year (typically June 30 and December 31), deposits at these institutions are estimated initially from data for "country" member banks. The monetary aggregates are usually revised once each year to incorporate data from the latest available call reports from nonmember banks and new seasonal factors.

The broad money supply (M_2) grew at a seasonally adjusted annual rate of about 7½ percent in December, resulting in a fourth-quarter average annual rate of 10 percent. For the year as a whole, M_2 expanded by 8 percent. The adjusted bank credit proxy increased at a 5½ percent rate in December. In the past few months, business firms have shifted to open market instruments as a means of raising funds. Consequently, the growth of the credit proxy fell well below the pace it had set earlier in the year. However, the expansion during the entire twelve months came to 10½ percent. Although the volume of CDs outstanding declined much more slowly in December than in the previous few months, the volume of reserves available to support private deposits (RPD) declined at a slightly faster pace. In December, RPD decreased at about a 2 percent rate, compared with an average decrease of 1¾ percent during the previous two months.

THE GOVERNMENT SECURITIES MARKET

The yield on three-month Treasury bills rose in December, while the six-month and 52-week yields adjusted to lower levels. Throughout the period the market was very sensitive to Federal Reserve actions, as investors sought to gauge the response of monetary policy to the incipient fuel shortage. Early in the month, expectations that monetary policy would follow an easier course were discouraged by the statement of Chairman Burns on December 5 that monetary devices could be of "very limited usefulness" in taking up economic slack caused by an insufficient energy supply. Rates on all maturities of Treasury bills rose quickly. However, the rise in yields did not last, and a somewhat firmer tone developed during the second week of the month. The Board's December 7 announcement of a reduction in the marginal reserve requirement on CDs caught the market by surprise. Despite the small initial impact of the change, the accompanying explanation pointing to the recent slowing in bank credit expansion was interpreted by many market participants as signaling a move toward an easier monetary policy. Bill rates—especially those on six-month and 52-week issues—dropped sharply. Bidding in the regular weekly auction of December 10 was aggressive; rates on three- and six-month bills were set at 7.39 percent and 7.53 percent, respectively (see Table II). Bidding was also active in the 52-week bill auction of December 12. The average issuing rate on the 52-week bill was 6.88 percent, 83 basis points below the rate set in November's monthly auction.

Later in the month, bill purchases by the Federal

Table I

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

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

Factors	Changes in daily averages—week ended				Net changes
	Dec. 5	Dec. 12	Dec. 19	Dec. 26	
"Market" factors					
Member bank required reserves	— 126	+ 1	— 391	— 84	— 600
Operating transactions (subtotal)	— 480	+ 490	— 375	+ 192	— 173
Federal Reserve float	— 821	+ 57	+ 741	+1,664	+1,641
Treasury operations*	— 34	+ 311	— 47	— 591	— 361
Gold and foreign account	+ 211	+ 143	— 100	— 134	+ 120
Currency outside banks	+ 120	— 224	— 792	— 579	—1,475
Other Federal Reserve liabilities and capital	+ 42	+ 203	— 176	— 169	— 100
Total "market" factors	— 606	+ 491	— 766	+ 108	— 773
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 710	— 825	+ 873	+ 609	+1,367
Outright holdings:					
Treasury securities	— 187	— 160	+ 692	+ 490	+ 835
Bankers' acceptances	+ 3	—	+ 9	+ 6	+ 18
Federal agency obligations	+ 15	— 36	+ 24	—	+ 3
Repurchase agreements:					
Treasury securities	+ 713	— 562	+ 91	+ 30	+ 272
Bankers' acceptances	+ 61	— 20	+ 20	+ 87	+ 148
Federal agency obligations	+ 105	— 47	+ 37	— 4	+ 91
Member bank borrowings	+ 189	— 175	+ 187	— 447	— 246
Seasonal borrowings†	— 27	— 12	— 5	— 5	— 49
Other Federal Reserve assets‡	+ 71	+ 20	+ 74	+ 72	+ 237
Total	+ 970	— 980	+1,133	+ 234	+1,357
Excess reserves‡	+ 364	— 489	+ 367	+ 342	+ 584

	Daily average levels				Monthly averages§
Member bank:					
Total reserves, including vault cash‡	34,856	34,360	35,124	35,554	34,975
Required reserves	34,475	34,474	34,865	34,949	34,691
Excess reserves	381	— 108	259	605	284
Total borrowings	1,477	1,302	1,489	1,042	1,328
Seasonal borrowings†	57	45	40	35	44
Nonborrowed reserves	33,379	33,064	33,635	34,512	33,647
Net carry-over, excess or deficit (—)‖	78	277	63	137	136

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.
§ Average for four weeks ended December 26, 1973.
‖ Not reflected in data above.

Reserve for both System and customer accounts were interpreted as further confirmation of a less restrictive monetary policy. Consequently, rates continued to edge lower until the last week of the month. The rates on three- and six-month Treasury bills closed at 7.46 percent and 7.43 percent, respectively, 16 basis points above and 29 basis points below their levels at the end of November. The yield on 52-week bills fell 36 basis points to 6.86 percent.

In the market for Treasury coupon securities, the prices of both intermediate-term and long-term securities declined in December as the prospect for an easing of monetary policy dimmed early in the month. The general tone of the market was further weakened by the report in midmonth that the wholesale price index had risen 1.8 percent in November. However, many participants continued to hold the view that a business slowdown would, of its own weight, ease credit demand and lead to lower interest rates. The optimistic elements in the market were encouraged by the reduction in the marginal reserve requirement on CDs, and market prices moved higher following the Board's announcement of this reduction. For the month as a whole, rates on most three- to five-year issues rose by an average of 5 basis points to 6.82 percent, while rates on longer term issues increased 23 basis points to 6.49 percent.

Price movements in the market for Federal agency securities were similar to those recorded in the Treasury coupon sector. The volume of new issues was not so large as it had been in recent months. Among the more noteworthy new issues was a package offered by the Federal Intermediate Credit Banks (FICB) and the Banks for Cooperatives totaling $1.43 billion. The offering consisted of $462 million of 7.95 percent Banks for Cooperatives bonds that mature July 1, 1974, $561 million of 7.95 percent FICB bonds maturing October 1, 1974, and $406 million of 7.10 percent FICB bonds that will fall due January 3, 1978. All three securities were accorded an excellent reception.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

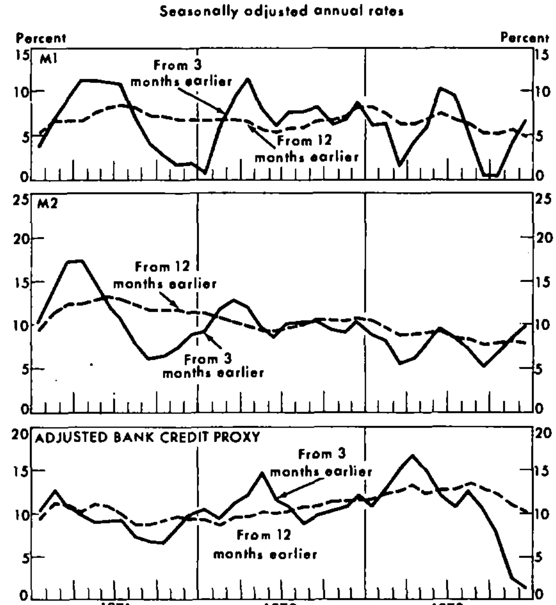
Maturity	Weekly auction dates—December 1973				
	Dec. 4	Dec. 10	Dec. 17	Dec. 21	Dec. 28
Three-month	7.358	7.386	7.366	7.346	7.406
Six-month	7.766	7.530	7.164	7.315	7.371
	Monthly auction dates—October-December 1973				
	Oct. 17	Nov. 14	Dec. 12		
Fifty-two weeks	7.132	7.708	6.881		

* 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 December 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.

OTHER SECURITIES MARKETS

The prices of corporate securities slipped lower in December, while the prices of tax-exempt issues registered small increases. After sagging early in the month, prices of both corporate and municipal issues staged a small rally on the basis of a reported rise in the unemployment rate in November and apparent signs of an easier monetary policy. However, the prospect of a large calendar of new issues in January and subsequent months kept prices below their opening levels.

There were $1.76 billion of new corporate issues in December. Among the more important issues was a $300 million offering by a member of the Bell System. The Aaa-rated debentures were priced to yield 8 percent in thirty years. They sold quickly and were soon trading at a premium. Later in the month, an Aa-rated utility bond was sold at a yield of 8.05 percent. This thirty-year bond got only a fair reception despite its 8⅛ percent coupon, which was the highest rate offered on a straight Aa utility in several months.

The new issue market in tax-exempt securities was moderately active in December, but prices changed very little from their late-November levels. Sales of new issues totaled $2 billion, slightly below the average of the previous few months. The Bond Buyer index of twenty municipal securities, at 5.16 percent in the last week of December, was down 1 basis point from the end of

November. The Blue List of dealers' advertised inventories rose to $1.13 billion.