The Money and Bond Markets in May

After experiencing sharp increases over the past several months, interest rates were mixed in May. Reports that a large commercial bank was experiencing financial difficulties prompted some investors to favor high-quality debt instruments, thereby resulting in enlarged demand for securities of the United States Government. Yields on Treasury coupon securities declined by about 2 to 29 basis points over the month. By the end of the month, the market rate on three-month Treasury bills was down more than 80 basis points from its level at the end of April, while rates on longer term bills fell somewhat more modestly. A persistent scarcity of bills contributed to these declines. In the money market, most rates rose early in the month but subsequently moved slightly lower over the remainder of the period. Commercial banks, in a lagged response to the rise in short-term rates that had occurred earlier, raised their prime lending rate during the month in several ¼ percentage point steps to 11½ percent. In addition, the average effective rate on Federal funds advanced 80 basis points in May to establish a record monthly average level of 11.31 percent.

In contrast to rates in the Government securities market, yields in the corporate and municipal bond markets continued to drift upward in May. Over the month, the Federal Reserve Board's index of yields on newly issued Aaa-rated utility bonds increased 10 basis points to 9.08 percent and The Bond Buyer index of municipal yields rose 26 basis points to 6.08 percent.

During the month, the Board of Governors of the Federal Reserve System announced bench-mark revisions of the money supply measures to reflect data on nonmember bank deposits obtained from the December call reports. Because deposits at such institutions are not available on a current basis, they are estimated initially from data for "country" member banks. The latest revision also incorporates the most recent data on deposits of domestic agencies and branches of foreign banks. In the revision, the growth of the seasonally adjusted narrow money supply (M_1)—private demand deposits adjusted plus currency outside commercial banks—was boosted over that previously reported by 1.4 percentage points in the fourth quarter of 1973 to 8.9 percent at an annual rate and by 0.4 percentage point in the first four months of 1974 to 7.4 percent. Similar upward adjustments were announced for the growth of the broad money supply (M_2), which includes time and savings deposits other than large negotiable certificates of deposit (CDs) at weekly reporting banks. According to preliminary information, the growth of the monetary aggregates slowed appreciably in the first four statement weeks of May. However, taking a somewhat longer run perspective, growth in the aggregates has been rapid thus far this year.

THE MONEY MARKET, BANK RESERVES, AND THE MONETARY AGGREGATES

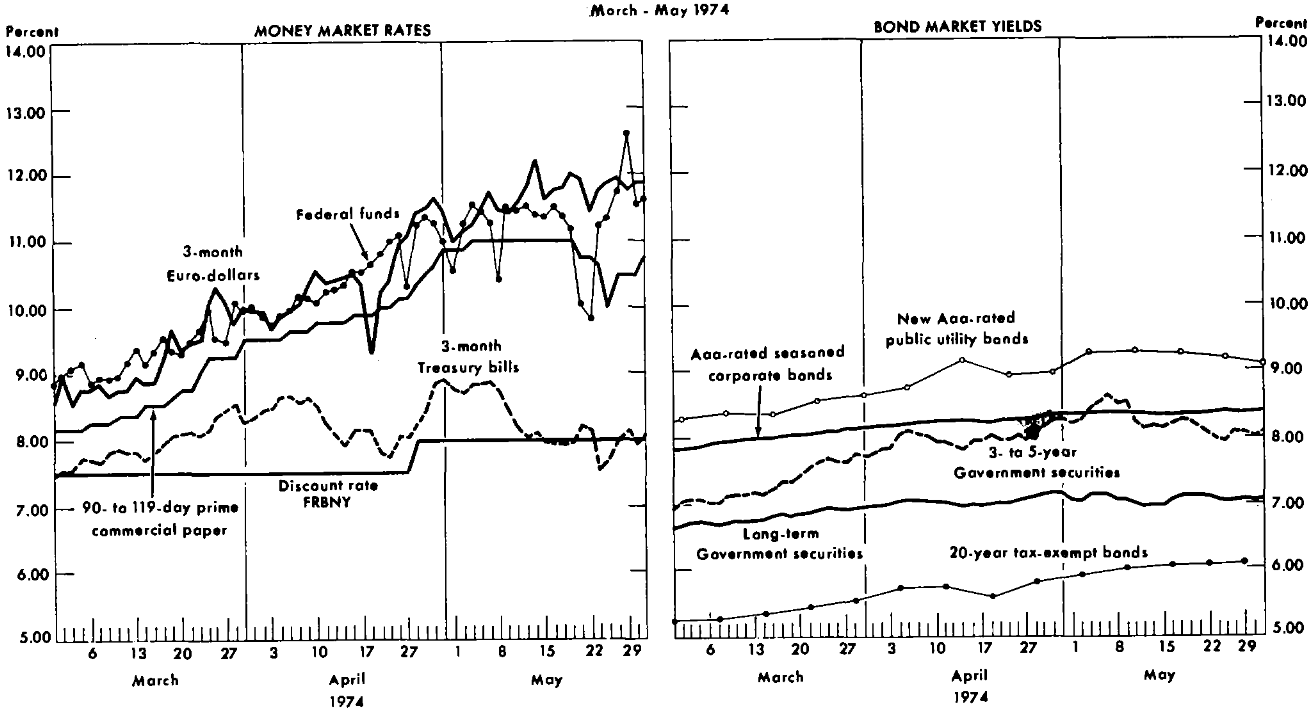
Rates on most money market instruments continued their upward spiral over the first part of May but then retraced some of this advance during the balance of the period (see Chart I). Rates in the commercial paper market were virtually unchanged from their closing levels in April, while bid rates on bankers' acceptances rose ½ percentage point. For the month as a whole, the effective rate on Federal funds averaged 11.31 percent, 80 basis points above April's average and the highest monthly level on record. In the face of persistent strength in the demand for business loans, most major commercial banks raised their prime lending rate in several steps during May to a historically high 11½ percent, up from 10½ percent at the end of April. Member bank borrowings from the Federal Reserve System rose sharply during the month. In part, this increase was attributable to the substantial amount of funds the System provided to the Franklin National Bank. On May 12, in reference to inquiries concerning this bank, George W. Mitchell, Vice-Chairman of the Board of Governors of the Federal Reserve System, indicated that the System stands prepared to advance funds to this bank as needed, within the limits of the collateral that can be supplied. Other banks also increased their use of the discount window, and borrowings averaged $2,489 million for the month (see Table I).

Commercial banks increased their offering rates on large negotiable CDs in the first part of the month to attract sufficient funds to meet the continued heavy demand for busi-

Chart I

SELECTED INTEREST RATES

March - May 1974



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.

ness loans. As the month progressed, investors began to prefer CDs issued by the very largest commercial banks, and these banks sold such instruments in volume. At the same time, CD rates edged down from the peaks established earlier in the month. On a seasonally adjusted basis, CDs grew extraordinarily rapidly in the four statement weeks ended May 22 relative to their average of the preceding four-statement-week period. From the end of 1973, when the growth in business loans resumed its rapid pace, through May 22, the volume of CDs outstanding rose by about \$18.6 billion, compared with an increase in CDs outstanding of \$19.2 billion for all of 1973.

According to preliminary data, the growth of the monetary aggregates slowed in the first four statement weeks in May, following the rapid gains experienced in the preceding several months. However, relative to its four-week-average level in the period ended thirteen weeks earlier, M_1 grew at a seasonally adjusted annual rate of 9.2 percent in the four-week interval ended May 22 (see Chart II). From its four-week average of a year earlier, M_1 grew at a sizable 6.6 percent. The growth in M_2 also slowed over the first four statement weeks in May. However, the time deposit component of M_2 continued to advance at a rapid rate despite an increase in interest rates on competing market instruments relative to rates on consumer-type time deposits which are constrained at ceiling levels. Much of the recent growth in the time deposit component of M_2 may reflect increases in nonnegotiable

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, MAY 1974

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

Factors	Changes in daily averages— week ended					Net changes
	May 1	May 8	May 15	May 22	May 29	
"Market" factors						
Member bank required reserves	− 752	+ 457	− 252	− 25	+ 322	− 250
Operating transactions (subtotal)	− 630	− 413	− 448	− 952	− 199	−2,642
Federal Reserve float	− 582	− 33	+ 79	+ 242	− 451	− 745
Treasury operations*	− 797	− 492	+ 253	− 292	− 171	−1,499
Gold and foreign account	− 74	+ 49	+ 17	− 66	+ 56	− 18
Currency outside banks	+ 932	− 104	− 576	− 729	+ 417	− 60
Other Federal Reserve liabilities and capital	− 109	+ 167	− 221	− 109	− 48	− 320
Total "market" factors	−1,382	+ 44	− 700	− 977	+ 123	−2,892
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+1,106	+ 482	+ 455	+ 87	− 694	+1,436
Outright holdings:						
Treasury securities	+ 475	+ 231	+ 83	− 395	+ 666	+1,060
Bankers' acceptances	+ 8	+ 6	+ 4	− 3	+ 9	+ 24
Federal agency obligations	+ 166	—	—	+ 200	− 4	+ 362
Repurchase agreements:						
Treasury securities	+ 264	+ 37	+ 282	+ 225	− 850	− 42
Bankers' acceptances	+ 56	+ 17	+ 15	+ 37	− 186	− 61
Federal agency obligations	+ 137	+ 191	+ 71	+ 23	− 329	+ 93
Member bank borrowings	+ 216	− 540	+ 360	+1,111	+ 517	+1,664
Seasonal borrowings†	+ 20	+ 8	+ 12	+ 18	+ 2	+ 60
Other Federal Reserve assets‡	+ 98	+ 50	− 83	− 369	+ 21	− 283
Total	+1,420	− 8	+ 732	+ 829	− 156	+2,817
Excess reserves‡	+ 38	+ 36	+ 32	− 148	− 33	− 75

	Daily average levels					Monthly averages§
Member bank:						
Total reserves, including vault cash‡	36,845	36,424	36,708	36,585	36,230	36,558
Required reserves	36,668	36,211	36,463	36,488	36,166	36,399
Excess reserves	177	213	245	97	64	159
Total borrowings	2,157	1,617	1,977	3,088	3,605	2,489
Seasonal borrowings	74	82	94	112	114	95
Nonborrowed reserves†	34,688	34,807	34,731	33,497	32,625	34,070
Net carry-over, excess or deficit (—)‖	118	100	101	134	105	112

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 five weeks ended May 29, 1974.
‖ Not reflected in data above.

large CDs at weekly reporting banks and negotiable CDs at nonweekly reporting banks. Like negotiable large CDs at weekly reporting banks, such deposits are exempt from Regulation Q ceilings. The adjusted bank credit proxy continued to advance rapidly in May. Over the first four statement weeks of the month, the proxy rose at a seasonally adjusted annual rate of 18 percent, in comparison with a 32 percent annual rate of increase recorded over the four previous weeks.

THE GOVERNMENT SECURITIES MARKET

Yields on Treasury securities fluctuated widely during May but, by the close of the month, most yields were below the levels that had prevailed at the end of April. In the first half of the month the market was dominated by the Treasury's refunding operation. The terms of the refunding were viewed as attractive, and the refunding attracted substantial demand, especially from small investors. The successful marketing of the new Treasury issues, together with the very good response to a large Federal Home Loan Bank (FHLB) offering, prompted a rally in the Government securities market. The market benefited as the month progressed from increased investor preference for high-quality debt instruments. The rally subsequently lost some momentum, and rates edged up after Chairman Burns reaffirmed the Federal Reserve's resolve to resist excessive expansion in money and bank credit.

Pressures on money market rates were a source of concern to the Treasury bill market over much of the month. Bidding was restrained in the monthly auction of 52-week bills on May 2, and a record average issuing rate of 8.42 percent was established, 54 basis points above the issuing rate in the previous such auction (see Table II). Rates on the three- and six-month bills in the first regular weekly auction of the month also advanced to record-high levels. Subsequently, with the conclusion of the Treasury refunding operation, investors displayed renewed interest in bills. This demand, together with Federal Reserve purchases for both the System and foreign accounts, pressed against very thin dealer inventories, and rates moved sharply lower through the middle of the month. Another factor favorably affecting the bill market was the anticipation that some investors would shift part of their portfolios into safer Treasury securities in view of the liquidity problems which had come to light. Some of this optimism was tempered, however, by underlying concern over pressures on interest rates. Hence, a cautious atmosphere persisted. The Treasury's announcement that it planned to raise some $800 million in new cash through an auction on May 30 of a strip of bills was greeted favorably, since the financing was smaller than generally expected. The offering consisted of $100 million of bills maturing each week from September 19 through November 7, 1974; the auction resulted in an average issuing rate of 8.28 percent for the strip of bills. For the month as a whole, the market yield on the three- and six-month bills declined 82 and 50 basis points, respectively.

Yields on Treasury coupon securities followed the pattern of fluctuations in bill rates during the month. Investor activity diminished considerably prior to the refunding, as the rise in bill rates and indications that the heavy demand for loans at commercial banks was continuing unabated engendered a cautious atmosphere. Dealers were also apprehensive of taking on new issues prior to the refinancing because of the very high carrying costs relative to available yields. However, the strong technical position of the market and the attractive terms of the refunding provided some support.

On May 7, the Treasury auctioned $1.75 billion of 4¼-year 8¾ percent notes. Interest in this issue proved greater than expected, primarily because of the large volume of noncompetitive tenders that were attracted to the record-high coupon rate, and the average issuing rate was set at 8.73 percent. Interest in the 25-month 8¾ percent note and in the 25-year 8½ percent bond offered the following day was substantial. The issuing rate for the note was 8.73 percent, and the yield on the bond was set at 8.23 percent. About 40 percent of the entire refunding was awarded to noncompetitive tenders. Demand soon emerged from dealers who had been unsuccessful in obtaining these issues in the auctions. Thus, both the new issues and older outstanding issues of comparable maturity benefited in subsequent trading. As the month progressed, investors seeking high-quality investments turned to the Treasury market, and yields on most issues continued to move lower. Yields on intermediate-term issues closed the month down about 2 to 29 basis points, while yields on issues due in ten years or more ranged from 3 to 22 basis points lower.

Yields on Federal agency securities moved in tandem with yields in the Treasury coupon market, as a cautious atmosphere prevailed over most of the month. Evidence of the withdrawal of funds from thrift institutions mounted, giving rise to expectations of increased supplies of issues from the housing agencies. On May 10, the FHLBs sold $700 million of eighteen-month 9.10 percent bonds, $600 million of 3¼-year 8.80 percent bonds, and $400 million of five-year and $300 million of ten-year 8.75 percent bonds. While $1 billion of this $2 billion package

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

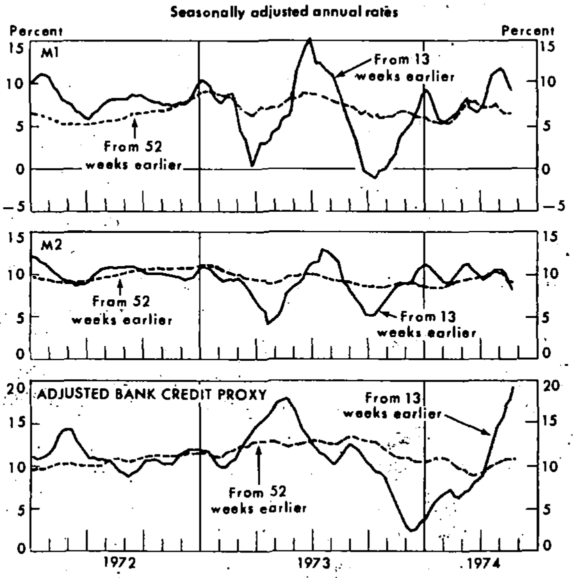
Maturity	Weekly auction dates—May 1974			
	May 6	May 13	May 20	May 24
Three-month	9.030	8.023	8.197	7.983
Six-month	9.006	8.031	8.440	8.205
	Monthly auction dates—March-May 1974			
	April 3	May 2	May 29	
Fifty-two weeks	7.886	8.421	8.248	

* 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: Growth rates are computed on the basis of four-week averages of daily figures for periods ended in the statement week plotted, 13 weeks earlier, and 52 weeks earlier. The latest statement week plotted is May 22, 1974.

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.

was new money, the undertaking proved extremely successful, and the securities advanced to sharp premiums in subsequent trading. This sparked the agency market, and on May 16 the Banks for Cooperatives and the Federal Intermediate Credit Banks were able to sell quickly $351 million of six-month 8.90 percent bonds and $796 million of nine-month 9 percent bonds, respectively. Late in the month, the Federal National Mortgage Association sold three issues totaling $1.5 billion, $750 million of which was new money. The offering consisted of $500 million of thirty-month 8.45 percent debentures, $650 million of 3¾-year 8.45 percent debentures, and $350 million of six-year 8.50 percent debentures. The issues received good support in initial trading.

THE OTHER SECURITIES MARKETS

Concern over inflation and the escalation of short-term rates remained a dominant influence in the corporate and municipal bond markets, and yields rose over the month on balance. Early in the month, both markets were pressured by heavy supplies of new issues. Thereafter, prices of corporate securities fluctuated widely. Higher yields and hopes for an eventual downturn in rates caused some postponements and scaling-down of announced offerings. This alleviated some of the supply pressures from the corporate sector. However, concern over deposit outflows at mutual savings banks, which could cause those institutions to refrain from purchasing corporate issues, coupled with investor preoccupation with disturbing news of the financial condition of some electric utility companies dampened the market over much of the month. Indeed, the disparity in yields between industrial and utility bonds widened to historically broad dimensions.

The tax-exempt market exhibited strains as a result of the huge volume of new issues sold thus far this year. In the first four months of 1974, nearly $8.7 billion of tax-exempt securities was marketed, up 18 percent from the first four months of 1973. Volume remained heavy in May, and the market was further depressed by the lack of commercial bank interest in the new offerings. The Bond Buyer index of twenty municipal bond yields rose to 6.08 percent on May 30, the highest level since August 1971.

As the month began, one of the few Aaa-rated manufacturing corporations marketed $50 million of 25-year debentures priced to yield 8.52 percent. The issue was the company's first bond financing in the United States, and it was received enthusiastically. About a week later, two large industrial offerings generally sold well on a negotiated basis. However, around the same time, offerings of two utility companies located in large cities experienced only moderate receptions. Specifically, $35 million of A-rated thirty-year debentures was priced to yield 9.75 percent, about 7 basis points higher than similarly rated outstanding issues, and $25 million of A-rated bonds of similar maturity was priced to return 9.68 percent. The somewhat cautious investor response to these issues was generally attributed to ratings reductions for several large urban utilities. The atmosphere of investor sensitivity to the financial position of urban electric utilities persisted, and in the next week $100 million of A-rated thirty-year utility debentures attracted only limited interest when priced to yield 9.95 percent. These bonds had recently been downgraded from Aa. An A-rated nonurban utility issue offered the next day sold well, even though priced at a somewhat lower yield. Later in the month, as additional postponements materialized and relieved some of the supply pressures from the market, the American Telephone and Telegraph Company marketed $500 million of debentures priced to yield 8.80 percent in 2005. This is the highest return ever offered by the company on its long-term debt instruments. The issue sold out quickly, but it failed to stimulate the market for older outstanding issues. Two negotiated corporate issues, which were priced rather generously, encountered good receptions toward the end of the month.

In the tax-exempt market, the major long-term issues encountered mixed receptions during the month. Early in May, $125 million of highly regarded Aaa-rated bonds sold quickly when priced to yield from 5 percent in 1975 to 5.50 percent in 1989. Several days later, $146 million of Aaa-rated securities was reoffered to yield 5.30 percent in 1982. The return was 20 basis points higher than that on the comparable maturity of the previous Aaa-rated offering, and the issue sold out. Later in the month, an aggressively priced two-part offering—consisting of $25.2 million of Aa-rated bonds scaled to yield from 5.25 percent in 1980 to 6.10 percent in 1999 and $24.8 million of bonds priced to yield 6.25 percent in 2014—met some investor resistance. Shortly thereafter, a negotiated placement of $38 million of Aaa-rated revenue bonds priced to yield 5.92 percent in 2001 sold quickly. However, two lower rated competitive offerings did not fare as well. This response was indicative of the trend toward negotiated issues, which typically win better receptions in periods of tight money. Later in the month, $40 million of A-rated revenue bonds was offered on a competitive basis. The bonds were priced to return from 5.50 percent in 1975 to 7.10 percent in 2004. Investor interest was restrained despite the relatively generous yields. The Blue List of dealers' advertised inventories rose $142 million to $616 million by the end of the month.