The Money and Bond Markets in October

Interest rates in the money and bond markets declined sharply during October. The broad-based rally was precipitated by substantially easier conditions in the Federal funds market which emerged early in the month. Besides the lower trading range for Federal funds, market sentiment was affected favorably by a reduction in reserve requirements on longer term time deposits. Also adding to the improved tone of the markets were continued slow growth in the monetary aggregates and indications that the remaining Treasury debt financing for the year would be easily manageable.

Virtually all sectors of the money and capital markets participated in the rally, including the market for high-grade state and local government obligations. The demand for lesser quality municipal securities, however, continued to be adversely affected by New York City's fiscal crisis. The city narrowly escaped default at midmonth, but considerable apprehension remained over whether default could be avoided by early December or perhaps even in mid-November. At the end of October, amidst Congressional debate over providing Federal aid or loan guarantees to the city, President Ford announced his intention to veto Congressional legislation that would aid New York City prior to a default. In response to his announcement, large negotiable certificates of deposit of commercial banks (CDs) and high-quality municipal securities gave up some of the gains posted earlier in the month and yields on Treasury bills experienced additional moderate declines.

According to preliminary data, the narrow money stock (M_1) declined in October, following modest gains in the previous three months. Growth of the more broadly defined money stock (M_2) was sluggish, although the expansion of consumer-type time and savings deposits accelerated slightly. The bank credit proxy experienced moderate growth in October for the second consecutive month, with a substantial increase in the average level of large negotiable CDs outstanding.

THE MONEY MARKET AND THE MONETARY AGGREGATES

Interest rates on Federal funds and other short-term financial instruments moved sharply lower in October (see Chart I), while member bank reserve positions eased somewhat (see Table I). The effective rate on Federal funds averaged 5.82 percent during the month, down 42 basis points from September's average. Rates on 90- to 119-day dealer-placed commercial paper fell by about 1 percentage point to close the month at 5.93 percent, and rates on ninety-day bankers' acceptances declined 1 percentage point to 5.8 percent. Large negotiable CDs maturing in ninety days traded in the secondary market at 6.16 percent at the end of the month. This rate was 87 basis points below the rate at the end of September though slightly above the rate in the period immediately preceding the President's announcement about aid to New York City.

Business demand for short-term credit continued weak in October. Commercial and industrial loans at large commercial banks, after adjustment for normal seasonal variation, grew at a moderate rate during the month. In spite of this growth, the volume of loans remained almost \$10 billion or about 7 percent below the level of one year earlier. Following declines in other market rates and reflecting the continued sluggishness of loan demand, most money center banks lowered their prime lending rate by ¼ percentage point to 7¾ percent. A further move to 7½ percent was initiated as the month ended.

The latest available data indicate that the growth in the monetary aggregates has continued to be unusually sluggish. Indeed, during the four-week period ended October 29, seasonally adjusted M_1—private demand deposits adjusted plus currency outside commercial banks—declined by 3.1 percent at an annual rate from its average level during the four previous statement weeks. This brought the annual growth rate in M_1 over the past thirteen weeks to less than

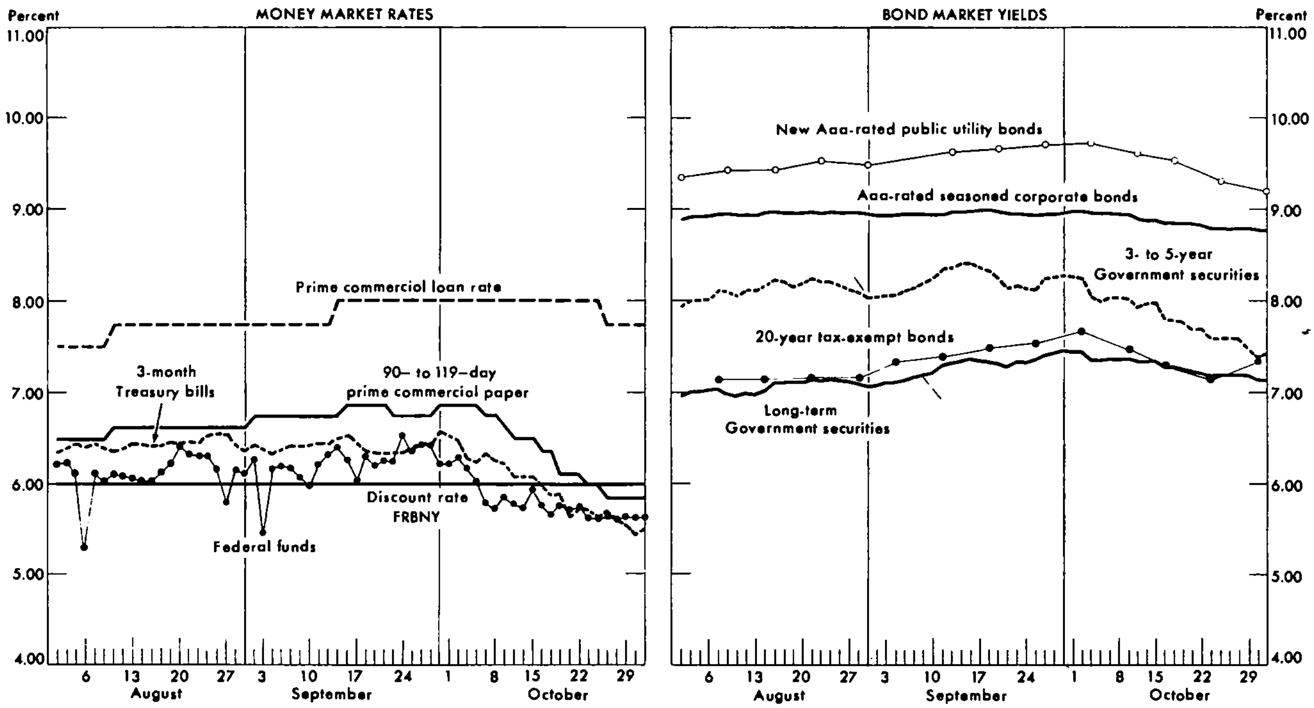
1 percent (see Chart II). Because of a moderate expansion in consumer-type time and savings deposits at commercial banks in October, M_2—M_1 plus time deposits other than large negotiable CDs—posted a modest gain. During the first four statement weeks of the month, M_2 averaged 4 percent at an annual rate above its average during the four statement weeks ended September 24 and 4.6 percent above its average during the four weeks ended thirteen weeks earlier. The adjusted bank credit proxy—total member bank deposits subject to reserve requirements plus certain nondeposit sources of funds—also experienced modest growth in October. The proxy advanced 4.6 percent at an annual rate in the first four statement weeks of the month from its average level over the four previous statement weeks.

On October 15, the Federal Reserve announced a reduction in reserve requirements on member bank time deposits with maturities of four years or more from 3 percent to 1 percent. The new reserve requirement is subject to the condition that the average of reserves on time and savings deposits at any individual bank must not be less than 3 percent, the minimum specified by law. The reserve ratio applies to deposits in the week beginning October 16 and will affect required reserves in the statement week beginning October 30. About $550 million of reserves is expected to be released by this action.

Chart I

SELECTED INTEREST RATES

August-October 1975



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Prime commercial loan rate at most major banks; 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.

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, OCTOBER 1975

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

Factors	Changes in daily averages—week ended					Net changes
	Oct. 1	Oct. 8	Oct. 15	Oct. 22	Oct. 29	
"Market" factors						
Member bank required reserves	— 402	+ 646	— 67	— 167	+ 133	+ 143
Operating transactions (subtotal)	—2,244	+1,807	+2,261	—1,239	—2,245	—1,660
Federal Reserve float	— 405	+ 95	+ 365	+ 79	— 349	— 215
Treasury operations*	—2,378	+1,588	+2,788	— 470	—2,567	—1,034
Gold and foreign account	+ 8	+ 42	— 105	+ 95	— 20	+ 20
Currency outside banks	+ 665	— 417	— 698	— 773	+ 851	— 367
Other Federal Reserve liabilities and capital	— 140	+ 499	— 94	— 169	— 160	— 64
Total "market" factors	—2,646	+2,458	+2,194	—1,406	—2,112	—1,517
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+2,798	—2,764	—1,984	+ 935	+2,418	+1,453
Outright holdings:						
Treasury securities	+ 826	— 201	— 610	+ 167	+1,484	+1,666
Bankers' acceptances	+ 16	+ 12	— 5	+ 2	+ 21	+ 46
Federal agency obligations	+ 113	+ 281	—	—	+ 284	+ 678
Repurchase agreements:						
Treasury securities	+1,618	—2,505	—1,069	+ 689	+ 569	— 698
Bankers' acceptances	+ 120	— 145	— 150	+ 41	+ 44	— 90
Federal agency obligations	+ 105	— 206	— 100	+ 36	+ 16	— 149
Member bank borrowings	+ 186	— 348	— 65	+ 60	— 138	— 300
Seasonal borrowings†	+ 10	—	— 8	— 8	— 2	— 8
Other Federal Reserve assets‡	+ 88	+ 203	+ 104	+ 126	+ 88	+ 604
Total	+3,067	—2,904	—1,895	+1,121	+2,369	+1,758
Excess reserves‡	+ 421	— 451	+ 299	— 285	+ 257	+ 241

	Daily average levels					Monthly averages§
Member bank:						
Total reserves, including vault cash‡	35,454	34,357	34,723	34,605	34,729	34,774
Required reserves	34,988	34,342	34,409	34,576	34,443	34,552
Excess reserves	466	15	314	29	286	222
Total borrowings	581	238	173	233	95	264
Seasonal borrowings†	74	74	66	68	61	68
Nonborrowed reserves	34,873	34,119	34,550	34.372	34,634	34,510
Net carry-over, excess or deficit (—)‖	7	196	82	106	8	69

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 October 29, 1975.
‖ Not reflected in data above.

THE GOVERNMENT SECURITIES MARKET

Yields on all maturities of Government obligations declined dramatically during October in direct response to an apparent easing in the Federal Reserve's stance with respect to interest rates. With an increased availability of Federal funds, inventory financing costs for dealers declined and bill rates adjusted sharply downward. Continued slow growth in the monetary aggregates was viewed as providing additional latitude for the Federal Reserve in pursuing its longer range targets, and some market participants interpreted the reduction in reserve requirements as a further sign of easing. Against this background, prices on coupon-bearing Treasury obligations were bid up substantially. Demand for Treasury issues was augmented by increased investor preferences for high-quality securities and by moderate financing needs of businesses.

On October 22, the Treasury announced its borrowing needs for the remainder of 1975. The Treasury indicated that it expected to raise between $8 billion and $11 billion of additional cash before the year-end, with $1.1 billion obtained in auctions of notes and bonds late in October. Only $500 million to $1.5 billion of the remainder would be financed by the sale of additional coupon issues later in the quarter, with the rest to be raised as additional amounts in Treasury bill auctions. Despite the substantial supply of new Treasury bills forthcoming, bill rates, which had declined throughout the month, continued their decline as a result of generally optimistic market sentiment. At the end of the month, the President's announcement about New York City apparently led buyers of CDs and municipal securities to place relatively more of their funds in Treasury bills and other high-quality assets, and this may have enlarged the decline in bill rates. Moreover, the Treasury did not offer a short-term issue in the refunding of the November 15 issues on October 29 and, with rates already on a downward trend, many holders of the November 15 issues may have reinvested in short-term securities in advance.

The average yield at the monthly auction of 52-week bills on October 15 was 6.60 percent, 74 basis points less than the average yield at the corresponding auction in September (see Table II). At the weekly auction on October 24, the average yields on three- and six-month bills were 5.69 and 5.97 percent, down 86 and 101 basis points respectively from the last auction in September. Over the month as a whole, yields on most bills fell 95 to 160 basis points.

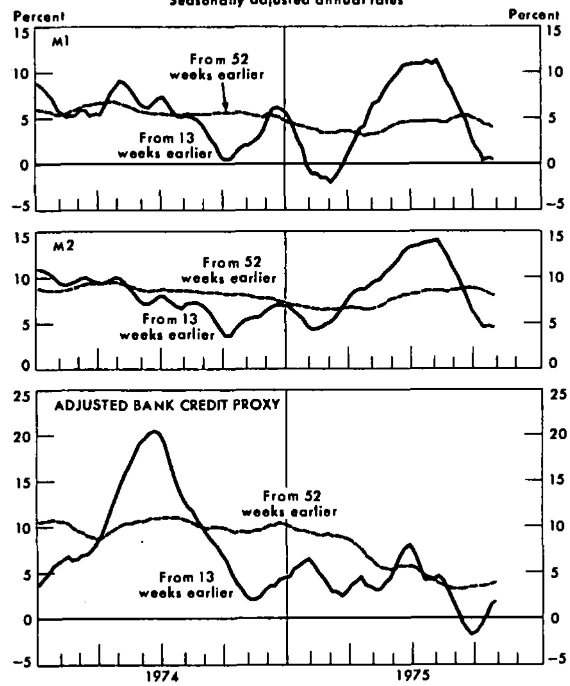
Yields on Treasury coupon securities, reflecting the improvement in market conditions, fell sharply during October. Early in the month, $2.5 billion of 38-month notes was auctioned with an average yield of 8.14 percent. At midmonth, $3 billion of two-year notes was auctioned with an average yield of 7.55 percent. This was 89 basis points lower than the yield at an auction of $3 billion of two-year notes on September 16. A $2.5 billion auction of seven-year notes on October 29 resulted in a yield of 7.92 percent, while on the following day $1 billion of 25-year bonds was auctioned to return 8.25 percent. Over the month as a whole, the index of yields on intermediate-term Government securities fell 85 basis points to 7.43 percent. The yield on the 8½ percent Treasury bond of 1994-99 fell to 8.18 percent at the end of October, down 46 basis points from its level at the end of September.

In the major agency financing of the month, the Federal Land Banks issued $650 million of 42-month bonds with a yield of 8.55 percent and $435 million of ten-year bonds with a yield of 8.8 percent. The issue was very well received. Over the month, yields on agency securities dropped in concert with yields on Treasury issues, and prices on the Federal Land Bank bonds moved to substantial premiums. At the end of the month, yields on short-term agency securities declined further in response to the President's announcement.

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 lastest statement week plotted is October 29, 1975.

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.

OTHER SECURITIES MARKETS

The tone of the corporate bond market improved considerably during October, primarily reflecting the indications of some easing in monetary policy. With few new financings and with the upcoming calendar of bond flotations light relative to the first half of 1975, yields declined steadily over the month. This pattern was reflected in three recently marketed Aaa-rated telephone issues. At the end of October, a $100 million financing of 37-year debentures was priced to yield 9.06 percent. This yield was appreciably below those of two earlier issues, a 9.60 percent yield offered on a $200 million issue of 33-year debentures at the beginning of October and a 9.70 percent yield on $125 million of forty-year bonds in September. At midmonth, a $300 million issue of Aaa-rated industrial debentures due in twenty-five years was priced to yield 8.90 percent and was sold quickly. Several Aa- and A-rated securities also sold well, with yields 50 to 75 basis points below those of comparably rated issues brought to market one month earlier.

In the market for tax-exempt securities, high-quality issues followed the general move toward lower yields while some lower grade securities responded directly to developments surrounding the effort of New York City to avoid default. On October 17, a default by the city was averted only after a last-minute agreement by a union of municipal employees to purchase $150 million of Municipal Assistance Corporation obligations with pension funds. Later in the month, attention centered on Washington, where Congressional proposals for Federal assistance for the city met mixed reviews. At the end of the month, President Ford announced that he would veto any Congressional proposal that would provide Federal aid to the city to avert a default. As an alternative, the President proposed legislation modifying Federal bankruptcy laws to give the courts sufficient authority, if necessary, to preside over an orderly reorganization of the city's financial affairs.

Significant concern also emerged over New York State's extensive involvement in the city's financial problems.

Amidst these developments, yields on the general obligation bonds of the state traded in the secondary market several percentage points above yields on comparably rated obligations of other tax-exempt borrowers. In addition, the ratings of a number of the issues of New York State agencies were lowered by the major investor services, and these agencies became unable to market additional securities. In other evidence of investor concern for quality, the Massachusetts Housing Finance Agency was required to reduce the size of a planned $31.1 million issue of bonds to $12.4 million. In a negotiated underwriting of these bonds, which carry only the state's moral obligation, $1.5 million of the issue was priced to yield from 6 percent in 1978 to 8.50 percent in 1995 and the remaining $10.9 million was priced to return 9 percent in thirty-seven years.

Following the downward movement in yields for government and corporate debt, returns on Aaa-rated issues of state and local governments moved sharply lower over the month. This improvement is reflected in the terms on the month's two major Aaa-rated tax-exempt issues. On October 1, the State of Oregon marketed $125 million of bonds, with yields ranging from 5.25 percent on the 1981 issues to 6.70 percent on the 1993 issues; these are some of the highest yields ever paid on tax-exempt obligations with an Aaa rating. Three weeks later, the State of Maryland sold $85.9 million in bonds, with yields ranging from 4.20 percent in 1978 to 5.70 percent in 1990 or about 1 percentage point less than the yields on the Oregon securities. After the President's announcement, prices on Aaa-rated municipal securities gave up about one third of their previous gains for October. The Bond Buyer index of twenty bond yields on twenty-year tax-exempt bonds fell to 7.36 percent on October 29 from its record level of 7.67 percent on October 1. The Blue List of dealers' advertised inventories rose by $49 million and closed the month at $684 million.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—October 1975			
	Oct. 6	Oct. 10	Oct. 20	Oct. 24
Three-month	6.239	6.045	5.887	5.685
Six-month	6.571	6.243	6.156	5.974
	Monthly auction dates—August-October 1975			
	Aug. 20	Sept. 17	Oct. 15	
Fifty-two weeks	7.331	7.338	6.601	

* 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.