The Money and Bond Markets in December

Interest rates rose at the beginning of December, but declines later in the month more than offset earlier increases. Upward pressure on rates emerged early in December, when market participants became concerned that the Federal Reserve might tighten money market conditions if November's rapid growth of the monetary aggregates continued. At the same time, a large volume of new corporate and United States Government issues also contributed to these increases. Adding to supplies, several New York City pension funds sold corporate and agency securities in the secondary markets to raise money to invest in Municipal Assistance Corporation (MAC) bonds. The markets rallied around the middle of December when reports of weakness in the growth of the monetary aggregates, coupled with private forecasts that new corporate borrowing would be lower in 1976, fostered the belief that interest rates could well decline in the near term. As a result, yields on corporate and Treasury issues fell over the balance of December, closing the month below their end-of-November levels.

Yields on highly rated tax-exempt issues also moved downward on balance in December, but yields on lower rated issues continued to advance. Investors remained concerned about the financial backing of issues offered by municipalities and continued to show unusually strong preference for safer, highly rated issues. A New York State court upheld the deferral of principal and reduction of interest payments to holders of certain New York City notes. This decision is to be appealed, but it cleared the way by December 29 for an exchange of these notes for MAC bonds. In other developments, a package of business and bank taxes designed to help balance the state budget was passed by the New York State legislature and enacted into law.

According to preliminary estimates, the narrowly defined money stock (M_1) fell in December after advancing rapidly in November. Growth of the more broadly defined money stock (M_2) was modest, since consumer-type time and savings deposits expanded moderately. The bank credit proxy also grew at a modest pace.

THE MONEY MARKET AND THE MONETARY AGGREGATES

Interest rates on most money market instruments declined in December after rising in the early part of the month (see Chart I). The rate on 90- to 119-day dealer-placed commercial paper dropped about ⅛ percentage point to 5.63 percent. Rates on bankers' acceptances fell ¼ percentage point over the month, while the average yield in the secondary market on ninety-day large negotiable certificates of deposit (CDs) declined ½ percentage point to 5.68 percent. In comparison, the effective rate on Federal funds was relatively stable during the month and averaged 5.20 percent, compared with a 5.22 percent average in November. Federal funds continued to trade at rates substantially below the discount rate, and thus member bank borrowings from the discount window remained modest, although borrowings rose on Christmas eve in response to settlement day pressures (see Table I).

The demand for bank loans by businesses remained weak in December. Commercial and industrial loans at large commercial banks rose by $1.1 billion in the four statement weeks ended December 31. A portion of this, however, reflected a rise in holdings of bankers' acceptances. Business loans excluding bankers' acceptances increased by $0.5 billion. Over comparable periods in the preceding two years, these loans excluding bankers' acceptances showed an average increase of $2 billion. At the beginning of the month, a number of large banks lowered their prime lending rates ¼ percentage point to 7¼ percent after a few money center banks had reduced their prime rates to this level at the end of November. Following midmonth, one large bank that had been quoting 7 percent raised its prime rate ¼ percentage point to the prevailing 7¼ percent. The volume of nonfinancial commercial paper outstanding fell by $1.4 billion in the four weeks ended December 31. Year-end declines are normal in this series, which showed an average decrease of $471 million over the similar period in the preceding two years.

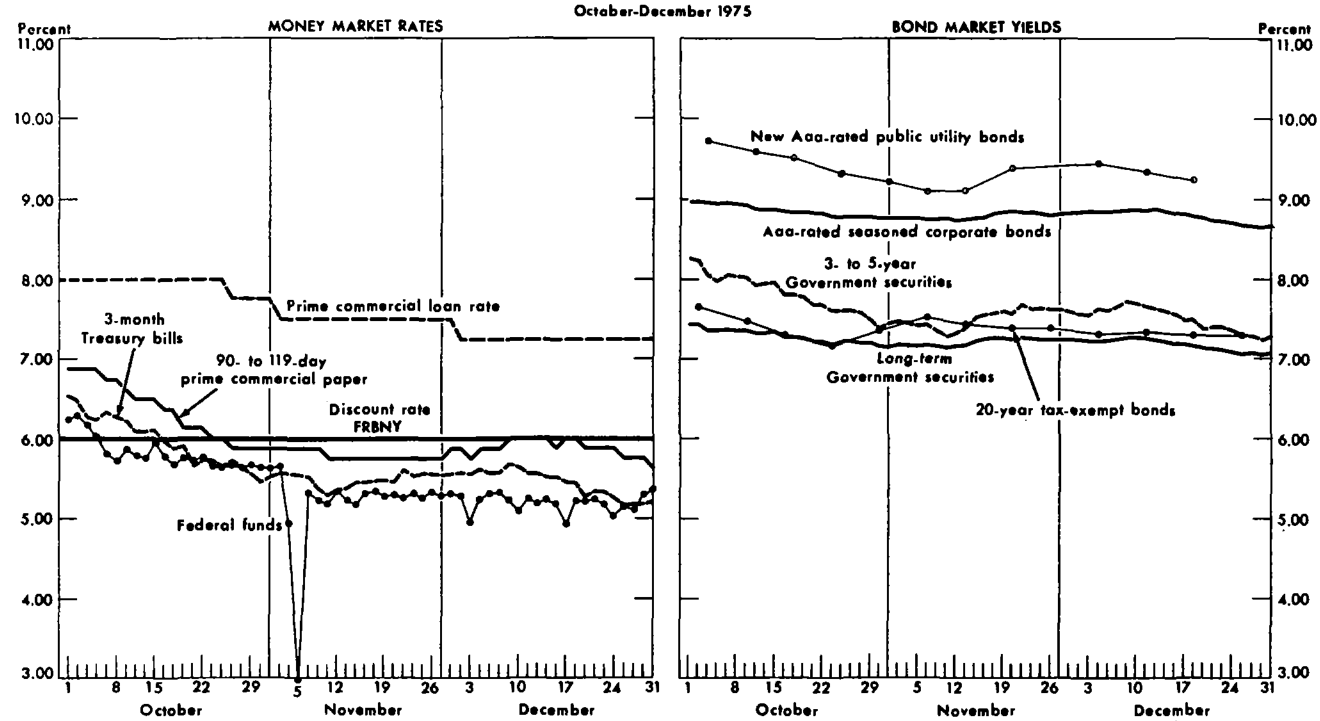
Preliminary data suggest that M_1 declined in December, while the broader monetary aggregates advanced at a modest pace. M_1—private demand deposits adjusted plus currency outside commercial banks—fell at an annual rate of 3.2 percent in December, after rising by 12.2 percent in the previous month. This brought the growth in M_1 in the four-week period ended December 31 from its average level in the four weeks ended thirteen weeks earlier to 1.6 percent at an annual rate (see Chart II). Consumer-type time and savings deposits at commercial banks grew at a moderate rate in December. Consequently, M_2—M_1 plus time deposits other than large negotiable CDs—registered a modest gain of 3.2 percent. The average level of CDs also rose moderately in December, and the adjusted bank credit proxy—total member bank deposits subject to reserve requirements plus certain nondeposit sources of funds—increased at a 4.2 percent annual rate.

On December 24, the Board of Governors of the Federal Reserve System announced a reduction from 3 percent to 2.5 percent of reserve requirements on time deposits maturing in 180 days to four years. The new reserve requirement ratio is subject to the condition that in no case may the average of reserves on the total of time and savings deposits at any member bank be less than 3 percent, the minimum level specified by law. The action, which initially affected required reserves of member banks in the week that began January 8, 1976, lowered required reserves by

Chart I

SELECTED INTEREST RATES

October-December 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.

about $340 million. In commenting on its move, the Board noted that the decision was in line with previous actions encouraging member banks to lengthen the structure of their time deposit liabilities. Since the last half of 1974, reserve requirements on time deposits have been changed on two previous occasions. These changes involved an increase in reserve requirements on time deposits with a maturity of less than six months and a reduction of reserve requirements on time deposits of various maturities of six months or longer.

THE GOVERNMENT SECURITIES MARKET

Yields on United States Government securities moved upward early in December, but subsequent declines more than offset earlier increases. At the beginning of the month, demand by investors was restrained, as they awaited announcements regarding the Treasury's borrowing plans and noted the sizable volume of planned corporate financing. On December 9, the Treasury announced that $3 billion of new cash would be raised through coupon-bearing obligations during December. This financing involved an auction of $2.5 billion of two-year notes on December 16—to replace $1.5 billion of publicly held maturing notes and to raise $1 billion in new cash—and an auction of $2 billion of four-year notes on December 22. The offerings were larger than some participants had expected, and yields edged upward in the wake of the announcement. Toward midmonth, sentiment was buoyed by private forecasts that interest rates would decline early in 1976. Market participants were also encouraged by a large unexpected drop in M_1. Yields of securities throughout the maturity spectrum adjusted downward, retracing earlier rises and ending the month generally 5 to 55 basis points lower.

Rates on Treasury coupon issues inched upward through mid-December, as dealers reduced their inventories of securities in preparation for the auctions of two- and four-year notes. Response to the $2.5 billion of two-year notes sold at midmonth was favorable, with tenders from the public totaling $4.3 billion. The notes were offered at an average yield of 7.28 percent, 27 basis points below the yield on a similar issue auctioned in mid-October. Demand by investors strengthened in mid-December and, reflecting this, the average issuing yield on the four-year notes was 7.50 percent. Over the month as a whole, the index of yields on intermediate-term Government securities fell 34 basis points to 7.28 percent. The index of long-term bond yields declined 19 basis points to 7.05 percent.

Movements in the yields of Treasury bills paralleled

Table I

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

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

Factors	Changes in daily averages—week ended					Net changes
	Dec. 3	Dec. 10	Dec. 17	Dec. 24	Dec. 31	
"Market" factors						
Member bank required reserves	— 19	+ 267	— 631	+ 298	— 591	— 670
Operating transactions (subtotal)	+1,044	+1,936	— 423	—3,899	+ 195	—1,147
Federal Reserve float	+ 398	— 344	+ 275	+ 536	+1,516	+2,381
Treasury operations*	+ 901	+2,264	— 72	—3,603	—1,240	—1,750
Gold and foreign account	— 28	+ 62	— 1	— 10	— 39	— 16
Currency outside banks	— 71	— 256	— 452	— 740	+ 99	—1,420
Other Federal Reserve liabilities and capital	— 155	+ 209	— 172	— 82	— 141	— 341
Total "market" factors	+1,025	+2,203	—1,054	—3,601	— 396	—1,823
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	—1,064	—2,536	+1,049	+3,643	+ 453	+1,545
Outright holdings:						
Treasury securities	— 105	—1,878	+1,616	+1,955	+ 398	+1,980
Bankers' acceptances	— 5	+ 2	+ 4	+ 3	+ 5	+ 9
Federal agency obligations	—	—	—	—	—	—
Repurchase agreements:						
Treasury securities	— 888	— 488	— 472	+1,446	— 77	— 479
Bankers' acceptances	— 28	— 108	— 49	+ 131	+ 114	+ 60
Federal agency obligations	— 38	— 64	— 50	+ 108	+ 13	— 31
Member bank borrowings	— 7	— 37	+ 15	+ 175	+ 37	+ 183
Seasonal borrowings†	— 4	— 7	— 1	— 2	—	— 14
Other Federal Reserve assets‡	+ 163	+ 207	+ 71	— 204	+ 115	+ 352
Total	— 908	—2,366	+1,135	+3,614	+ 606	+2,081
Excess reserves‡	+ 117	— 163	+ 81	+ 13	+ 210	+ 258

	Daily average levels					Monthly averages§
Member bank:						
Total reserves, including vault cash‡	34,860	34,480	35,142	34,857	35,658	34,989
Required reserves	34,531	34,264	34,895	34,597	35,188	34,695
Excess reserves	329	166	247	260	470	294
Total borrowings	67	30	45	220	257	124
Seasonal borrowings†	22	15	14	12	12	15
Nonborrowed reserves	34,793	34,400	35,097	34,637	35,401	34,866
Net carry-over, excess or deficit (—)‖	117	195	140	148	119	144

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 December 31, 1975.
‖ Not reflected in data above.

those of coupon obligations. In the second weekly bill auction held on December 8, the average issuing rate for three-month bills was set at 5.63 percent, about 10 basis points above the rate established in the last weekly auction in November. The shift to more optimistic market sentiment just before midmonth increased investor demand, and rates moved downward. At the weekly auction on December 29, the average yields on three- and six-month bills were 5.21 percent and 5.51 percent (see Table II), down 31 and 43 basis points, respectively, from the last auction in November. Over the month as a whole, yields on most bills fell 32 to 55 basis points.

Yields on Federal Government agency securities responded in a similar manner to many of the factors which affected the market for Treasury obligations during December. Prices on Federal agency issues declined modestly in the first half of the month as the volume of borrowing rose. On December 11, the Government National Mortgage Association (GNMA) offered $200 million of thirty-year modified pass-through securities, of which $69 million was for new cash. These issues are backed by pools of Federal Housing Administration-insured or Veterans Administration-guaranteed mortgages. The principal and interest collected on the mortgages are transmitted to the holders of pass-through securities, and GNMA guarantees that these payments ultimately will be made. In modified pass-through securities, GNMA insures that these transmittals are made on normal payment dates, even when actual collections are late. The two-part offering consisted of $131 million and $69 million of securities bearing coupons of 7¼ percent and 7½ percent, respectively. Both of these securities were priced to yield 8.70 percent, about 27 basis points above the yield on a similar offering sold in mid-November. Initial sales were slow, but market conditions improved during the week as demand strengthened and remaining issues were sold. On December 18, the Federal Intermediate Credit Banks, in a two-part offering, successfully sold $1,330 million of bonds, redeeming $10 million more of securities than was offered. Rates of return on this two-part financing were 6.55 percent on $898 million of nine-month bonds and 7.90 percent on $432 million of five-year bonds. At the same time, the Banks for Cooperatives successfully sold $589 million of 6.25 percent six-month bonds, of which $155 million was for new cash.

OTHER SECURITIES MARKETS

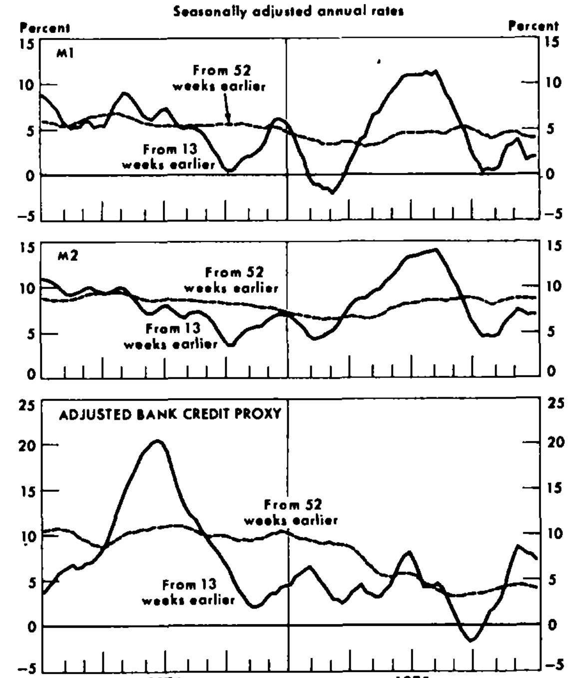
A large volume of borrowing weighed heavily on the market for corporate securities in the first half of December. A number of large issues were offered by industrial firms and utility companies and, in addition, five New York City employee pension funds sold in the secondary market corporate and agency securities with face values of about $340 million. Around $280 million was raised to help meet the city's cash needs until Federal loans became available. Prices in the secondary market moved downward, and a number of offerings were postponed. However, at midmonth, investor demand was bolstered by the same factors that were supporting the Treasury market and by private forecasts of lower corporate bond flotations in 1976 than in 1975. Bond prices moved upward, offsetting earlier declines, while underwriting and trading activity tapered as is typical near the end of the year.

Rate movements on corporate securities were reflected

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 December 31, 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.

by the yields on several major issues sold during December. Early in the month a credit company offered $225 million of notes and bonds, rated Aa by Moody's and A by Standard & Poor's. The 26-year bonds were priced to yield 9.82 percent, about ¾ percentage point above the yields on comparably rated industrial issues sold in mid-November. The major offering of the month was an Aaa-rated $750 million three-part issue of an international organization, which consisted of equal dollar amounts of five-year notes, ten-year notes, and 25-year bonds. The bonds were priced to yield 9.35 percent, slightly above the rate on a similar issue offered by a foreign government in mid-November, and were favorably received. A number of issues, including a $150 million Aa-rated offering by a finance company, were postponed until 1976 when the volume of new offerings was expected to be lighter. A Bell System member offered $100 million of Aaa-rated forty-year debentures which sold quickly at a yield of 9.35 percent. Investor demand improved in mid-December, and a $150 million offering of Aa-rated 25-year debentures by an industrial company was well received at a yield of 8.85 percent shortly after midmonth. By the end of the month the yield on the telephone debentures sold three weeks earlier had declined about 40 basis points.

The volume of new offerings was moderate in the market for tax-exempt securities in December. Investors continued to stress safety, and demand favored highly rated issues. Yields on these securities declined from their end-of-November levels, but yields on lower rated municipal securities moved upward, as demand for these obligations continued to be affected by the financial problems of New York City, New York State, and its agencies.

Three New York State agencies—Housing Finance Agency, Dormitory Authority, and Medical Care Facilities—narrowly avoided default at midmonth when the state legislature voted to liquidate about $200 million in securities held by the State Insurance Fund, a special reserve set aside by the state to insure the payment of workmen's compensation claims to private employees in the state. Proceeds from the sales were then used to purchase securities issued by the three agencies. The New York State legislature passed, and Governor Carey signed into law, a package to raise $600 million in new taxes to help reduce the state budget deficit. The measures provide for a permanent increase in the corporate franchise tax and bank tax, in addition to a one-year surcharge on income of corporations and banks. All taxes are retroactive to January 1, 1975. Also, the collection schedule for the state sales tax was changed from a quarterly to a monthly basis.

In mid-December, a New York State court ruled that the moratorium which permits New York City to defer for at least three years the payment of principal and to reduce the interest paid on notes maturing before June 30, 1976 does not violate either the state or national constitutions. The decision is being appealed. In the meantime, the decision permitted the optional exchange of these maturing New York City notes for ten-year 8 percent MAC bonds to occur as scheduled on December 29. About 30 percent of the eligible notes were exchanged. The prices of these bonds dropped sharply at the end of the month, when they began trading in very light volume. At the same time, prices of previously issued MAC bonds were generally unchanged.

The Bond Buyer index of twenty bond yields on twenty-year tax-exempt bonds fell 10 basis points from the end of November to 7.29 percent on December 31. The Blue List of dealers' advertised inventories rose by $4 million and closed the month at $635 million.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—December 1975				
	Dec. 1	Dec. 8	Dec. 15	Dec. 19	Dec. 29
Three-month	5.550	5.633	5.491	5.340	5.208
Six-month	5.895	6.144	5.914	5.678	5.507
	Monthly auction dates—October-December 1975				
	Oct. 15	Nov. 13	Dec. 10		
Fifty-two weeks	6.601	6.010	6.439		

* 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.