The Money and Bond Markets in September

Interest rates fluctuated in a narrow range during September following rather steady declines over the summer months. After edging slightly lower in the three previous statement weeks, rates adjusted upward subsequent to the announcement on September 23 of a massive increase in the money stock during the week ended September 15. The one-week increase more than offset declines in earlier weeks, and it dampened previous speculation among market participants that the Federal Reserve System would encourage slightly lower short-term interest rates. During the statement week ended September 22, however, the increase in the money supply for the previous week was substantially reversed by a large decline. Rates on new corporate bond issues dipped below the year's previous lows in April, and this development apparently prompted a number of corporate borrowers to schedule new financings. As a result, the calendar of forthcoming issues grew as the month progressed, further tempering market sentiment. The Treasury continued with its program of fairly regular coupon offerings, and the two new issues were sold during the month. The sluggish state of business loan demand and the low rates available to borrowers in the commercial paper market induced a number of major banks to reduce the prime lending rate by ¼ percentage point to 6¾ percent. Early in October the 6¾ percent rate became widespread, as most major banks joined in the reduction.

Preliminary estimates indicate that in September the narrowly defined money stock (M_1) showed a modest rise, on balance, after substantial week-to-week fluctuation. The broadly defined money stock (M_2) continued to reflect rapid growth in consumer-type time deposits and rose at a relatively strong rate. Further declines in the volume of large negotiable certificates of deposit (CDs) outstanding held the bank credit proxy to a small increase.

THE MONEY MARKET AND THE MONETARY AGGREGATES

Interest rates on most money market instruments were little changed on balance in September. At its meeting on August 17, the Federal Open Market Committee (FOMC) specified that the Federal funds rate should be held within a 5 to 5½ percent range during the period until the next meeting on September 21. During that interval, the funds rate remained around the 5¼ percent level that has prevailed since early in the summer (see Chart I). During September as a whole, the effective rate on Federal funds averaged 5.25 percent, down 4 basis points from its average in August. At the end of September, the rate on 90- to 119-day commercial paper was 5¼ percent, ⅛ percentage point below the end-of-August level. Rates on bankers' acceptances also changed little and closed the month at 5¼ percent. Similarly, CDs maturing in 90 days traded in the secondary market at 5.28 percent at the end of the period, a decline of 5 basis points over the month. In view of the continued sluggishness in business loan demand and the downward drift of commercial paper rates in recent months, a number of large banks lowered their prime lending rate by ¼ percentage point to 6¾ percent, with most others joining in this action in early October.

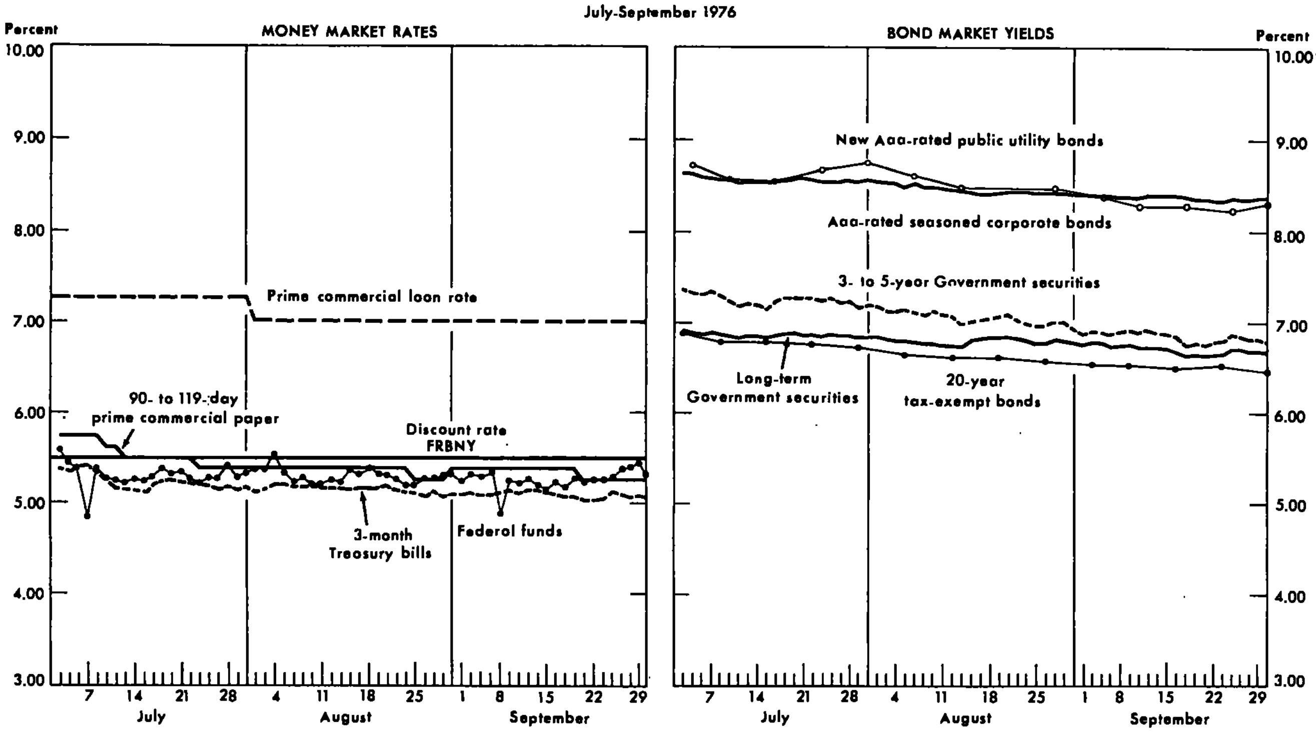
Federal Reserve open market operations in September were, in part, concerned with offsetting the impact on bank reserves of the September 15 tax date for corporate and individual income taxes. As tax payments accumulate in the Treasury Tax and Loan Accounts at commercial banks, the Treasury typically transfers such receipts to its accounts at Federal Reserve Banks. These transfers —Treasury calls—drained reserves from the banking system in the last two statement weeks of September. Federal Reserve open market operations supplied reserves and offset these drains (see Table I).

The Federal Reserve adds reserves to the banking system either through outright purchase of securities or through repurchase agreements, under which it buys securities from dealers who enter into agreements to buy the same securities back at a later date. These agreements have short-term maturities, usually from one to seven days. In the past, dealers had the option of withdrawing early from all repurchase agreements that had an initial maturity of more than one business day. When a contract was terminated prior to maturity, it drained reserves from the banking system and thus offset part of the reserve

Chart I

SELECTED INTEREST RATES

July-September 1976



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.

injection made by the Federal Reserve. Early terminations of outstanding agreements were often large, and their volume was not readily predictable. At the end of September, the Trading Desk of the Federal Reserve informed dealers it would enter into four- and seven-day repurchase agreements at the start of the October 6 statement week and, in this operation, the seven-day contracts would not include the right of early withdrawal. Similar fixed-term contracts with a six-day maturity were made on October 1.

Preliminary estimates indicate that M_1—private demand deposits adjusted plus currency outside commercial banks—grew in September at a somewhat slower pace than in the previous two months. The average level for the four weeks ended September 22 stood at 3.0 percent (seasonally adjusted annual rate) above its average level in the four statement weeks ended eight weeks earlier. At its August meeting, the FOMC established a tolerance range of 4 to 8 percent for growth of M_1 over the two months ended with September. As a consequence of somewhat more rapid expansion of time and savings deposits in September, the spread between the growth of M_2—M_1 plus these deposits other than large negotiable CDs—and M_1 widened. A wider spread between growth of M_2 and M_1 is often associated with a decline in money market yields relative to yields prevailing on time and savings deposits, such as occurred during the June-August period. Over the four statement weeks ended September 22, the average for M_2 was 9.9 percent at an annual rate above its average during the four statement weeks ended eight weeks earlier. The FOMC tolerance range for M_2 growth over the two months ended in September was 7.5 to 11.5 percent. Comparing the averages for the four weeks ended September 22 with similar averages fifty-two weeks earlier, M_1 and M_2 have expanded 4.3 percent and 10.1 percent, respectively (see Chart II). After posting a modest decline in August, the bank credit proxy—total member bank deposits subject to reserve requirements plus certain nondeposit sources of funds—was little changed in September, as large negotiable CDs outstanding continued to slide in response to weak demand for business loans.

THE GOVERNMENT SECURITIES MARKETS

Yields on United States Treasury securities declined during most of September before partially retracing these steps late in the month. Participants initially believed that the pause in the economic recovery and the slow growth of M_1 would lead the monetary authorities to encourage interest rates to edge lower. However, the sharp increase in M_1 announced after midmonth prompted some revisions in this outlook, and thereafter money market interest rates were generally anticipated to remain stable in the near term.

In the Treasury bill market, the extension of earlier declines in bill rates was reflected in the auction of 52-week bills on September 15. The average yield in this auction was 5.56 percent, 7 basis points below the auction four weeks earlier (see Table II) and the lowest average rate since February 1975. The apparent tempering of market sentiment after midmonth, however, resulted in a reversal of generally declining rates at the auctions of three- and six-month bills. At the last regular auction in September, the average issuing rates on these bills were 5.07 percent and 5.33 percent, respectively, up 4 and 9 basis points from the previous week. No new cash was raised in September by the Treasury on these short-term issues. Rates on most bills ended September unchanged to 9 basis points below levels at the end of the previous month.

The Treasury continued during September to raise cash by auctioning coupon issues. On September 22, $2.5 billion of two-year notes was sold at an average yield of 6.30 percent, 37 basis points below the return on a similar offering of two-year notes in the previous month. The issue, which raised $819 million in new cash, attracted broad-based bidding interest. On September 28, $2.5 billion of five-year notes was auctioned, all for new cash. The average issuing rate at this auction was 7.08 percent, down from 7.63 percent for a similar offering on June 29.

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, SEPTEMBER 1976

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

Factors	Changes in daily averages—week ended: Sept. 1	Sept. 8	Sept. 15	Sept. 22	Sept. 29	Net changes
"Market" factors						
Member bank required reserves	— 67	+ 465	— 263	+ 121	— 925	— 669
Operating transactions (subtotal)	+ 419	+3,471	+3,493	—6,296	—2,421	—1,334
Federal Reserve float	+ 208	— 138	+1,017	— 360	— 698	+ 29
Treasury operations*	+ 23	+3,399	+3,007	—5,542	—2,975	—2,088
Gold and foreign account	— 19	— 8	+ 5	+ 33	+ 9	+ 20
Currency outside banks	+ 653	— 408	— 297	— 504	+1,361	+ 805
Other Federal Resesrve liabilities and capital	— 446	+ 626	— 240	+ 79	— 119	— 100
Total "market" factors	+ 352	+3,936	+3,230	—6,175	—3,346	—2,003
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	— 591	—3,771	—3,466	+5,991	+3,493	+1,656
Outright holdings:						
Treasury securities	+ 230	+ 74	—3,324	+3,154	+1,166	+1,300
Bankers' acceptances	— 14	— 8	— 4	— 21	— 17	— 64
Federal agency obligations	— 23	—	— 18	— 3	—	— 44
Repurchase agreements:						
Treasury securities	— 839	—3,226	— 107	+2,479	+2,192	+ 499
Bankers' acceptances	+ 80	— 496	— 9	+ 318	+ 70	— 37
Federal agency obligations	— 25	— 115	— 4	+ 64	+ 82	+ 2
Member bank borrowings	+ 26	— 47	+ 15	— 17	+ 44	+ 21
Seasonal borrowings†	+ 2	— 2	— 2	+ 1	+ 5	+ 4
Other Federal Reserve assets‡	+ 271	— 152	+ 211	— 16	— 19	+ 295
Total	— 294	—3,970	—3,240	+5,958	+3,520	+1,974
Excess reserves‡§	+ 58	— 34	— 10	— 217	+ 174	— 29

Member bank:	Daily average levels					Monthly averages‖
Total reserves, including vault cash‡§	34,078	33,579	33,839	33,501	34,600	33,919
Required reserves	33,772	33,307	33,570	33,449	34,374	33,694
Excess reserves§	306	272	269	52	226	225
Total borrowings	93	46	61	44	88	66
Seasonal borrowings†	32	30	28	29	34	54
Nonborrowed reserves	33,985	33,533	33,778	33,457	34,512	33,853
Net carry-over, excess or deficit (—)¶	123	154	159	135	62	127

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 waivers or penalities for reserve deficiencies in accordance with the Regulation D change effective November 19, 1975.
‖ Average for five weeks ended September 29, 1976.
¶ Not included in data above.

Trading in seasoned coupon issues followed the general market pattern, and the index of three- to five-year bonds closed the month 10 basis points lower than its level at the end of August. Similarly, the index of long-term bonds fell 9 basis points over the month.

Yields on Federal agency issues moved modestly lower in September. The Government National Mortgage Association raised $264.6 million through the auction of 7½ percent modified pass-through securities on September 14. These securities, which have an average life of about twelve years, were well received when reoffered to yield 8.25 percent on a corporate bond equivalent basis. The Farm Credit Banks redeemed $82 million of maturing securities and refunded the remainder with $1,419.3 million of new issues, consisting of $569.6 million of six-month Banks for Cooperatives bonds yielding 5.60 percent and $849.7 million of nine-month Federal Intermediate Credit Bank bonds yielding 5.80 percent. On September 22, the Federal National Mortgage Association raised $400 million of new cash through the sale of fifteen-year debentures at 7.80 percent. At the end of the month, the Federal Land Banks offered $1.66 billion of bonds consisting of $450 million of fifteen-month bonds priced to yield 6.10 percent, $858.2 million of 4¼-year bonds yielding 7.10 percent, and $350 million of twenty-year securities with a return of 7.95 percent. These issues generally encountered a good reception by investors.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

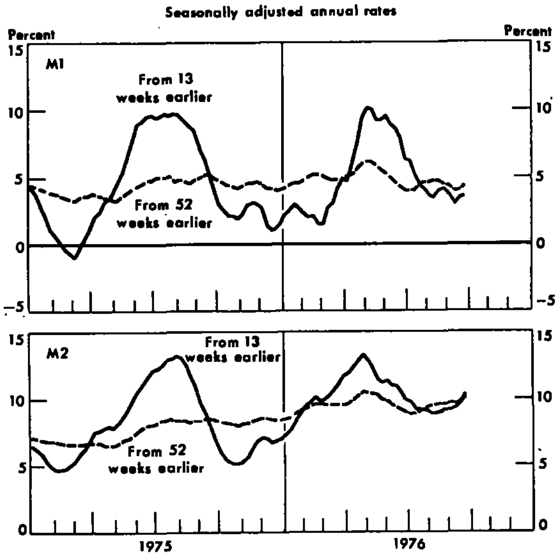
Maturity	Weekly auction dates—September 1976			
	Sept. 3	Sept. 13	Sept. 20	Sept. 27
Three-month	5.087	5.009	5.028	5.072
Six-month	5.333	5.309	5.236	5.325
	Monthly auction dates—July-September 1976			
	July 21	Aug. 18	Sept. 15	
Fifty-two weeks	5.887	5.633	5.561	

* Interest rates on bills are quoted in terms of a 360-day year, with 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

GROWTH OF SELECTED MONEY STOCK MEASURES

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 September 22, 1976.

M1 = Currency plus adjusted demand deposits held by the public.

M2 = M1 plus commercial bank time and savings deposits held by the public, less negotiable certificates of deposit issued in denominations of $100,000 or more.

Source: Board of Governors of the Federal Reserve System.

OTHER SECURITIES MARKETS

Yields on corporate and high-grade municipal bonds extended the declines of the previous three months during most of September. Increased supplies of new issues, together with uncertainty over the future course of monetary policy, however, put upward pressure on yields late in the month. The number of new corporate offerings was slim early in the period, but the calendar expanded steadily as corporations were attracted by the lowest interest costs in three years. Heavy new issue activity in the tax-exempt market throughout the period generally encountered good investor demand.

The decline in yields in the corporate sector was exemplified by the successful sale early in the month of a $60 million offering of Aa-rated electric utility bonds priced to yield 8.45 percent in thirty years. This return was 22 basis points below that of a comparable issue, which sold slowly when offered in July, and was the lowest yield on an Aa-rated electric utility since March 1974. The attractiveness of prevailing yields to corporate borrowers brought forth a $100 million offering of Aaa-rated telephone debentures which had been postponed earlier in the year. The bonds were priced to yield 8.00 percent, 25 basis points below a comparably rated telephone issue offered the previous month. This was, moreover, the lowest return on such an issue in nearly three years. The yield was set in anticipation of further interest rate declines and did not initially prove attractive to investors. At the end of the month, the bonds were released from syndicate price restrictions and subsequently traded in the market at yield increases in excess of 10 basis points. Underwriters priced $250 million of Aa-rated debentures of Hydro-Quebec to yield 8.60 percent in thirty years. This was 70 basis points below the yield on a similar offering last June. It proved insufficient to attract investors, and a large volume remained in dealer hands at the month end.

Lower interest rates established this past summer in the tax-exempt sector were little changed over the month of September. For example, good receptions were afforded both South Carolina's $70 million of Aaa-rated bonds scaled to yield from 3.0 percent in 1977 to 5.05 percent in 1991 and Ohio's $70 million of Aa-rated bonds with yields ranging from 3.5 percent in 1978 to 6.2 percent in 2002. The return in 1977 on the South Carolina issue was 20 basis points below a comparably rated offering marketed in June. However, New Jersey's $75 million offering, rated Aa/AAA (Moody's/Standard & Poor's), sold slowly when priced to yield from 3.5 percent in 1978 to 5.8 percent in 1996. These yields were as much as 30 basis points below those on the state's previous offering in January. In one of the largest of such offerings, $700 million of Pennsylvania 8½-month notes sold quickly at a yield of 3.2 percent. Late in the month Texas issued $40 million of Aaa-rated bonds, with yields ranging from 4.50 percent in 1985 to 5.30 percent in 1993.

The New York State Housing Finance Agency (HFA) passed a key test in September, marking a milestone on the road to renewed access for New York State to the capital markets. The issue was a $149 million package of State University of New York A/AA-rated construction bonds, consisting of $18 million of serial bonds priced to yield from 5.50 percent in 1977 to 7.50 percent in 1986 and $131 million of term bonds priced to return 8.50 percent in thirty years. The offering provided for the retirement of some bonds issued earlier in the year as part of a plan by New York State to keep the HFA and several other state agencies out of default. The size of the issue was originally $50 million but was raised to $97 million subsequently. Demand for the new bonds was so strong by the time it came to market that the HFA increased the amount of the offering to $149 million.