The Money and Bond Markets in December

The increase in the Federal Reserve discount rate from 4 per cent to 4½ per cent—made effective first at the Federal Reserve Banks of New York and Chicago on December 6[1] and shortly thereafter at the remaining ten Federal Reserve Banks—was the single most important factor shaping developments in the money and bond markets in December. In preceding weeks, market participants had already begun to doubt the tenability of prevailing interest rate levels, but the actual timing of the ½ percentage point rise in the discount rate came as a surprise. Subsequent rate and price adjustments in the money and securities markets proceeded in an orderly manner as yields rose to their highest levels since early 1960.

Although the major market adjustment took place immediately after the discount rate increase, rates on Treasury bills continued to move higher through the midmonth tax and dividend dates and over much of the remainder of the month. Increases in rates on bankers' acceptances, commercial paper, and finance company paper also occurred during the month. Prices of intermediate- and long-term Government securities declined irregularly, raising yields on intermediate-term issues over the month by about ½ percentage point to almost 5 per cent (bid), while yields on long-term issues rose by about ⅛ percentage point. Initial declines in prices of corporate and tax-exempt issues paralleled those on long-term Governments, but after these adjustments most new corporate and tax-exempt bonds were accorded generally favorable receptions at the higher rate levels.

The upward adjustment in the maximum interest rate ceilings on time deposits under Regulation Q[1], which accompanied the discount rate change, also affected the money and bond markets in December. Posted rates on new negotiable time certificates of deposit moved upward by about 25 to 35 basis points.

Aided by a larger than seasonal provision of reserves by the Federal Reserve System, the money market handled without difficulty the heavy flows of credit and deposits typical of December. The tone of the money market fluctuated between ease and firmness during the month, as banks experienced the usual amount of difficulty in anticipating the extent of their reserve needs. The banking system moved from a position of $110 million daily average net borrowed reserves in the week ended December 1 to free reserves of $73 million two weeks later. The System first accommodated the adjustment to the discount rate change and then sought to alleviate the buildup of pressure around the midmonth corporate tax and dividend dates. After midmonth, a firm tone reappeared in the money market as the banking system gradually returned to a net borrowed reserves position, and this firm tone generally prevailed through the remainder of the month with Federal funds trading largely at rates of 4½ per cent and 4⅝ per cent.

THE MONEY MARKET AND BANK RESERVES

Immediately after the discount rate increase, most commercial banks raised their prime loan rate from 4½ per cent to 5 per cent. By the end of the month, increases in rates on the various maturities of finance company paper amounted to ⅜ to ½ of a per cent, while commercial paper rates and rates on bankers' acceptances had been increased by ⅜ of a per cent and ½ of a per cent, respectively. Following the Regulation Q revision and similar revisions by the New York State Banking Board, major banks in New York City posted rates on new time certificates of deposit. Three-month certificates were offered in a 4.75-4.80 per cent range at the end of the month, and rates on six-month and over one-year certificates were quoted in a 4¾-4⅞ per cent range, as against the previous ceiling of 4½ per cent for all these maturities. Rates on prime certificates trading in the secondary market rose to as high as 5 per cent in some cases.

The money market was quite firm early in December, on the eve of the discount rate change. After the weekend announcement of the increase to 4½ per cent in the dis-

[1] For the details, see this *Review*, December 1965, pages 254-55.

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, DECEMBER 1965

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

Factors	Changes in daily averages—week ended Dec. 1	Dec. 8	Dec. 15	Dec. 22	Dec. 29	Net changes
"Market" factors						
Member bank required reserves*	− 249	− 114	− 22	− 606	− 49	− 1,100
Operating transactions (subtotal)	− 536	− 298	+ 267	+ 671	− 109	− 5
Federal Reserve float	− 462	+ 58	+ 193	+ 823	− 163	+ 440
Treasury operations†	+ 111	+ 99	+ 64	− 66	+ 31	+ 229
Gold and foreign account	− 14	+ 5	− 4	+ 13	− 36	− 36
Currency outside banks*	− 63	− 421	− 25	− 144	+ 44	− 609
Other Federal Reserve accounts (net)‡	− 111	− 38	+ 50	+ 46	+ 14	− 39
Total "market" factors	− 785	− 412	+ 245	+ 5	− 158	− 1,105
Direct Federal Reserve credit transactions						
Open market instruments						
Outright holdings:						
Government securities	+ 747	+ 376	− 87	− 22	− 171	+ 843
Bankers' acceptances	+ 1	+ 7	+ 1	+ 5	+ 4	+ 18
Repurchase agreements:						
Government securities	—	+ 103	− 48	− 33	+ 199	+ 231
Bankers' acceptances	+ 58	+ 11	− 12	− 7	+ 9	+ 59
Member bank borrowings	+ 173	− 56	+ 8	− 268	+ 328	+ 185
Other loans, discounts, and advances	—	+ 3	− 4	− 2	+ 17	+ 13
Total	+ 979	+ 443	− 141	− 328	+ 386	+ 1,339
Excess reserves*	+ 194	+ 31	+ 104	− 323	+ 228	+ 234

Member bank:	Daily average levels Dec. 1	Dec. 8	Dec. 15	Dec. 22	Dec. 29	
Total reserves, including vault cash*	22,190	22,335	22,461	22,804	23,081	22,574§
Required reserves*	21,766	21,880	21,902	22,568	22,617	22,147§
Excess reserves*	424	455	559	236	464	428§
Borrowings	534	478	486	218	546	452§
Free reserves*	− 110	− 23	73	18	− 82	− 24§
Nonborrowed reserves*	21,656	21,857	21,975	22,586	22,535	22,122§

System Account holdings of Government securities maturing in:	Changes in Wednesday levels Dec. 1	Dec. 8	Dec. 15	Dec. 22	Dec. 29	
Less than one year	+ 690	+ 144	− 102	− 193	+ 258	+ 803
More than one year	—	—	—	—	—	—
Total	+ 690	+ 144	− 102	− 193	+ 258	+ 803

Note: Because of rounding, figures do not necessarily add to totals.
* These figures are estimated.
† Includes changes in Treasury currency and cash.
‡ Includes assets denominated in foreign currencies.
§ Average for five weeks ended December 29.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS DECEMBER 1965

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended Dec. 1	Dec. 8	Dec. 15	Dec. 22	Dec. 29	Average of five weeks ended Dec. 29
Eight banks in New York City						
Reserve excess or deficiency(−)†	46	58	43	21	11	36
Less borrowings from Reserve Banks	107	39	124	66	138	95
Less net interbank Federal funds purchases or sales(−)	295	309	392	1,080	811	577
Gross purchases	*733*	*770*	*1,133*	*1,629*	*1,435*	*1,140*
Gross sales	*438*	*461*	*741*	*548*	*625*	*563*
Equals net basic reserve surplus or deficit(−)	− 355	− 290	− 472	− 1,125	− 937	− 636
Net loans to Government securities dealers	691	590	859	752	718	722
Thirty-eight banks outside New York City						
Reserve excess or deficiency(−)†	25	62	40	19	34	36
Less borrowings from Reserve Banks	70	103	142	22	158	99
Less net interbank Federal funds purchases or sales(−)	256	399	499	671	371	439
Gross purchases	*1,071*	*1,017*	*1,081*	*1,440*	*1,198*	*1,161*
Gross sales	*816*	*618*	*582*	*768*	*827*	*722*
Equals net basic reserve surplus or deficit(−)	− 301	− 440	− 600	− 674	− 494	− 502
Net loans to Government securities dealers	189	116	168	192	96	152

Note: Because of rounding, figures do not necessarily add to totals.
† Reserves held after all adjustments applicable to the reporting period less required reserves and carry-over reserve deficiencies.

Table III

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

In per cent

Maturities	Weekly auction dates—December 1965 Dec. 6	Dec. 13	Dec. 17	Dec. 27
Three-month	4.344	4.391	4.505	4.457
Six-month	4.468	4.553	4.692	4.655

	Monthly auction dates—October-December 1965 Oct. 26	Nov. 24	Dec. 23
One-year	4.192	4.276	4.731

* 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.

count rates of the New York and Chicago[2] Reserve Banks, borrowings from the other Reserve Banks, which still quoted the 4 per cent rate, bulged sharply on Monday, December 6. When the market opened that day, the System purchased Treasury bills in volume to facilitate orderly rate adjustments in the Government securities market. The cumulative effects of excess reserves amassed by heavy borrowings at other Reserve Banks and as a result of System purchases in the open market led to an easier tone in the Federal funds market. Borrowings from the Federal Reserve dropped to nominal levels on the last two days of the December 8 statement period, averaging $478 million for the week as a whole. The Federal funds rate, which rose briefly to 4½ per cent immediately after the discount rate change, declined to ½ per cent by Wednesday, December 8, as large unused reserve excesses piled up at money market banks. On a daily average basis, System open market operations provided $497 million of reserves, and net borrowed reserves declined from $110 million in the preceding week to $23 million for the week ended December 8 (see Table I).

In the following week the money market readily accommodated the large transfers of funds associated with the quarterly corporate tax and dividend dates, both of which fell within the period. The money market was generally quite firm. Federal funds were strongly bid at 4½ per cent, and some funds moved at 4⅝ per cent on several days as "country" banks accumulated excess reserves which averaged about $440 million in the first week of their two-week reserve settlement period. As the major reserve city banks came under increased pressure, they purchased Federal funds in volume and borrowed rather heavily from the Reserve Banks (see Table II). On the final day of the week, however, the major New York City banks found that they had provided for more than their reserve needs. Therefore, they sought to sell reserves, and some Federal funds traded at 1½ per cent. Country banks were heavy purchasers of funds at the low rates, but the eight major New York City banks nevertheless ended the period with cumulative reserve excesses of over $300 million.

During the December 15 statement period, the weekly reporting member banks increased their total loans[3] and investments by approximately $3.2 billion, with the rise in loans accounting for $2.9 billion of the gain. Much of the expansion in bank credit during this period reflected credit needs of businesses and nonbank financial intermediaries over the midmonth tax and dividend period. On the liabilities side of bank balance sheets, total demand deposits (including checks in process of collection) at weekly reporting member banks rose by $8.4 billion as corporations built up the deposits with which to pay dividends and Federal taxes.

As the second half of the month began, the money market displayed a firm tone. Banks in New York and in other major money centers were under heavy reserve pressure as they continued to carry a large volume of the loans extended over the tax date and experienced deposit drains as dividend and tax checks cleared. However, Federal funds were in fairly good supply at rates of 4½ to 4⅝ per cent from banks outside the money centers, and member bank borrowings from the Federal Reserve declined to fairly low levels. In the final statement week of the month the money market was firm, with Federal funds trading predominantly at 4⅝ per cent. Some of the reserve pressure, which had lingered in the money market after the tax and dividend period, abated; however, country banks built up excess reserves during the week which was the first week of their new reserve settlement period. With nationwide reserve availability also declining, member bank borrowings from the Reserve Banks rose to the levels characteristic of earlier months.

THE GOVERNMENT SECURITIES MARKET

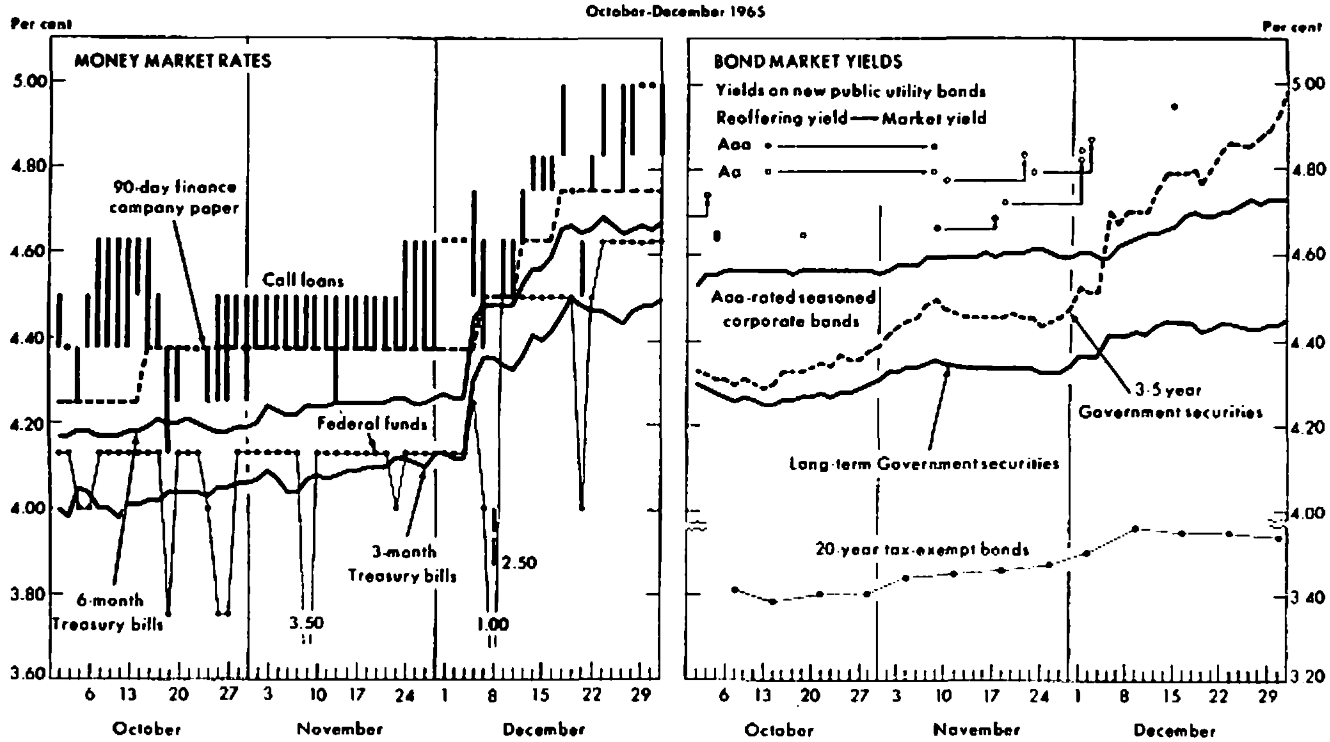
A cautious atmosphere characterized the Government securities market at the beginning of the month in the aftermath of a late November shift in market expectations toward anticipations of higher interest rate levels—a shift which followed news of an enlarged Federal deficit for the current fiscal year. Nevertheless, the Board of Governors' announcement of a rise in the discount rate and changes in Regulation Q caught the market by surprise, and sharp adjustments followed. Treasury bill rates initially moved about 15 to 25 basis points higher (see the left-hand panel of the chart), but comfortable money market conditions and System purchases contributed to orderly adjustments in the bill sector. Nevertheless, considerable uncertainty continued, as the market watched the rate adjustments on new negotiable time certificates of deposit which compete with Treasury bills for investment funds. The ultimate extent of their rise was considered a key element affecting the entire structure of short-term rates. Additional factors contributing to uncertainty—and thus caution—included expectations of new Treasury cash financings in the bill market during January, and the high costs of refinancing the sizable volume of

[2] After a short interval, the other ten Reserve Banks followed suit.

[3] Exclusive of loans to domestic commercial banks and after deduction of valuation reserves.

SELECTED INTEREST RATES *

October-December 1965



Note: Data are shown for business days only.

* MONEY MARKET RATES QUOTED: Daily range of rates posted by major New York City banks on new call loans (in Federal funds) secured by United States Government securities (a point indicates the absence of any range); offering rates for directly placed finance company paper; 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- and six-month Treasury bills.

BOND MARKET YIELDS QUOTED: Yields of new Aaa- and Aa-rated public utility bonds are plotted around a line showing daily average yields of seasoned Aaa-rated corporate bonds (arrows point from underwriting syndicate reoffering yield of a given issue to market yield of the same issue immediately after it has been released from syndicate restrictions); daily averages of yields of long-term Government securities (bonds due or callable in ten years or more) and of Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields of 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, and The Weekly Bond Buyer.

bills returning to dealers in December from maturing repurchase agreements.

On December 22, the Treasury outlined a portion of its cash financing plans for the remainder of the fiscal year ending in June 1966. It announced that it would auction on December 29, for payment on January 5, an additional $1 billion of tax anticipation bills maturing on June 22, 1966 and would permit commercial banks to make payment through credits to Treasury Tax and Loan Accounts. The Treasury also disclosed that—beginning with the January 3 regular bill auction—it would increase the weekly three-month bill issues by $100 million each, probably until the full thirteen-week cycle of bill maturities has been rolled over. The Treasury also announced that it would make another short-term cash offering of approximately $1.5 billion early in 1966. These borrowings will fill the bulk of the Treasury's $5 billion cash needs for the rest of the fiscal year.

The Treasury's announcement triggered some further upward adjustments in yields of Treasury bills, and rates edged irregularly upward over the remainder of the month. At the higher emerging rate levels, investment interest expanded both for outstanding bills and for the new bills auctioned during the period. The Treasury's sale of June tax bills attracted considerable interest from commercial banks anxious to obtain the accompanying Tax and Loan Account deposits, and a 4.281 per cent average issuing rate was set. Demand for outstanding bills favored short maturities which were sought for seasonal year-end statement purposes. The newest outstanding three- and six-month

Treasury bills closed the month at 4.49 per cent and 4.67 per cent bid, respectively.

After the initial price markdowns of from ½ point to almost a full point following the discount rate change, an atmosphere of caution continued to dominate the market for intermediate- and long-term Government issues. The vigorous performance of the economy, renewed concern over the mounting defense spending caused by the Vietnamese conflict, and the prospects of increased Treasury financing needs during the first half of 1966 were the primary factors contributing to market uncertainty. The downward pressure on prices was especially pronounced in the case of intermediate Government issues. The market expected the 4¼ per cent interest rate ceiling applying to coupons on Government bonds to restrict Treasury financing to the under-five-year area. Pressure developed initially from the efforts of dealers to reduce positions rather than from an expansion in outright investor selling. Late in the month, market sentiment was temporarily buoyed by discussion of possible peace overtures in Vietnam. As the year drew to a close, a large volume of tax-swapping operations dominated market activity, but some outright investment and professional offerings also developed.

OTHER SECURITIES MARKETS

Prices of corporate and tax-exempt bonds drifted lower during early December in light trading. After December 6, activity expanded and prices of corporate and tax-exempt bonds went down sharply, paralleling the price declines recorded by long-term Government securities. Subsequently, demand for corporate and tax-exempt issues expanded at the lower price levels, and new issues marketed after the Federal Reserve action were accorded fair to excellent receptions. One of the largest issues of the period, a $100 million Aa-rated utility company issue, reached the market at midmonth. The issue, which consisted of 5 per cent first and refunding mortgage bonds maturing in 1996 and nonrefundable for five years, was reoffered to yield 4.95 per cent and received an excellent investor response. By the end of the month the issue had risen in price to the point that the yield to the investor was 4.84 per cent. As the year drew to a close, activity contracted in both the corporate and tax-exempt sectors and prices fluctuated narrowly.

Over the month as a whole, the average yields on Moody's seasoned Aaa-rated corporate bonds rose by 13 basis points to 4.73 per cent, while *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues (carrying ratings ranging from Aaa to Baa) rose by 7 basis points to 3.54 per cent (see the right-hand panel of the chart).