The Money and Bond Markets in August

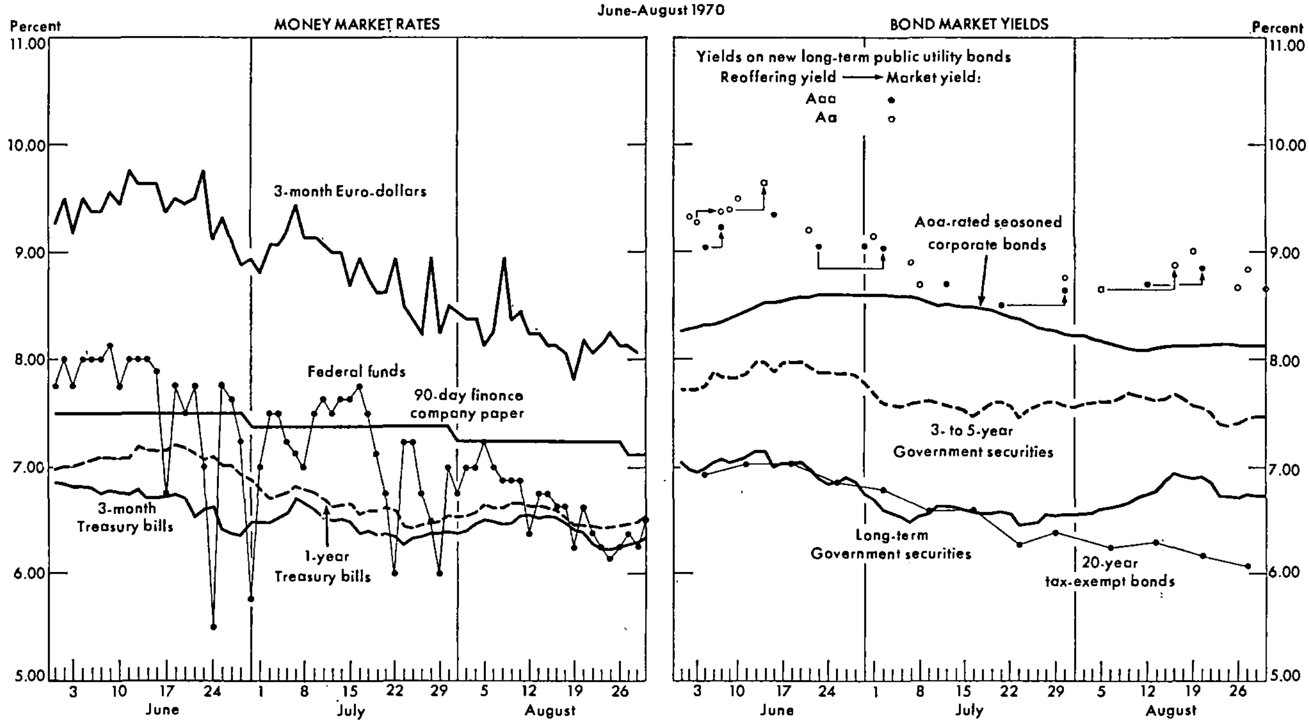
Pressures on the nation's financial markets continued to moderate during August, as the tense atmosphere that had developed in late spring and early summer receded further. In the Government securities market, the month began on an optimistic note when the Treasury's $6.5 billion refunding encountered an enthusiastic reception. Despite this increase in the volume of new securities available, rates on intermediate-term Government obligations declined almost uninterruptedly throughout the month. Prices of long-term debt, however, temporarily declined in early August, as the calendar of forthcoming corporate and Federal agency issues continued to mount and a backlog of previous financings overhung this market. Thus, rates on most long-term securities rose over the first half of the month, reversing in part the improvement in June and July (see Chart I). Yields began to decline again later in August when underwriters and investors, leaning to the view that monetary policy was moving to a less restrictive stance, again became encouraged about the outlook for interest rates. The tax-exempt bond market turned in a particularly strong performance in August and, by the month end, yields on some high-grade state and local government securities were at their lowest level in a year. To some extent, pressures evident early in the month were concentrated in the corporate market and reflected liquidity rebuilding by many borrowers. Corporations appear to have been refunding short-term bank and commercial paper debt through the sale of long-term securities, and this development has given further impetus to the growing stability apparent in the commercial paper market.

Money market conditions gradually became more comfortable in August, and most short-term interest rates declined. The improving atmosphere in the commercial paper market during the month mitigated pressures on the banking system, and member banks reduced their borrowings at Federal Reserve Banks from the unusually high levels posted in July. Commercial banks also received a sizable inflow of time deposits for the second successive month, while the outstanding volume of bank-related commercial paper declined somewhat. Amendments to Regulation D on reserve requirements, adopted by the Board of Governors of the Federal Reserve System on August 17, will change the relative cost to banks of alternative sources of funds. The Board is reducing member bank reserve requirements on time deposits in excess of $5 million from 6 percent to 5 percent and imposing an equivalent 5 percent reserve requirement on all funds raised by member banks through the sale of bank-related commercial paper with a maturity of thirty days or longer. Regulation D reserve requirements on demand deposits are to be imposed on funds raised by banks from sales of commercial paper of less than thirty days' maturity. This dual action will take effect in the reserve-computation period beginning on October 1 and places most bank-related commercial paper outstanding after September 17 on substantially the same basis with respect to reserve requirements as negotiable time CD's. The combined effect of the amendments will reduce required reserves by about $350 million for the banking system. The effective date of the change was timed to coincide with the fall period of seasonal reserve needs.

BANK RESERVES AND THE MONEY MARKET

Conditions in the money market became gradually more comfortable in August. Reserves provided through open market operations more than offset reserve drains during the month. Average borrowings from the Federal Reserve Banks fell to $881 million in August, (see Table I), down from the high level of $1,317 million in July. The basic reserve deficit of the forty-six major reserve city banks deepened considerably, however, from an average of $5.3 billion in July to $6.3 billion in August, (see Table II), as these banks helped finance increased dealer inventories of Government securities and, on balance, lost private demand deposits. Heavy dealer and bank participation in the Treasury financing, combined with some operating difficulties caused by a fire in the New York financial district, contributed to a sharp rise in the deficit during the second week of August (see Chart II). However, the major reserve city banks experienced no particular difficulty in adjusting to this marked deteri-

Chart I
SELECTED INTEREST RATES
June-August 1970



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Bid rates for three-month Euro-dollars in London; 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-month and one-year Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new Aaa- and Aa-rated public utility bonds (arrows point from underwriting syndicate reoffering yield on a given issue to market yield on the same issue immediately after it has been released from syndicate restrictions); 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, and *The Weekly Bond Buyer*.

oration of their basic reserve position. The average effective rate on Federal funds declined from 7.21 percent in July to 6.62 percent in August.

There was a slight moderation in commercial bank loan expansion during the month, compared with July, and banks were able to continue rebuilding liquidity by increasing the size of their investment portfolios. The nation's banking system experienced sustained time deposit inflows during August, although the pace of expansion slowed somewhat from the extremely rapid growth that followed the partial suspension of Regulation Q ceilings in late June.

These developments were evident in the behavior of the adjusted bank credit proxy. On the basis of preliminary data, this measure of the sources of funds used to finance credit by the banking system increased at a seasonally adjusted annual rate of about 24 percent in August. The adjusted proxy[1] expanded at approximately a 17 percent rate in the June-August period. In part, the growth of bank credit apparently took the place of financing in the commercial paper market, although the latter market showed signs of stabilizing following the difficulties that had developed in the aftermath of the Penn-Central insolvency.

[1] The adjusted bank credit proxy consists of total member bank deposits subject to reserve requirements plus nondeposit liabilities, including Euro-dollar borrowings and commercial paper issued by bank holding companies or other affiliates.

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, AUGUST 1970

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

Factors	Changes in daily averages— week ended on				Net changes
	August 5	August 12	August 19	August 26	
"Market" factors					
Member bank required reserves	+ 76	— 354	— 139	+ 411	— 6
Operating transactions (subtotal)	— 449	— 193	— 172	+ 225	— 589
Federal Reserve float	— 166	— 13	+ 249	— 177	— 107
Treasury operations*	+ 9	+ 73	— 161	+ 120	+ 41
Gold and foreign account	— 17	+ 19	— 8	— 8	— 14
Currency outside banks	— 125	— 177	— 377	+ 211	— 468
Other Federal Reserve liabilities and capital	— 151	— 94	+ 125	+ 79	— 41
Total "market" factors	— 373	— 547	— 311	+ 636	— 595
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 583	+ 427	+ 724	— 322	+1,412
Outright holdings:					
Government securities	+ 293	+ 266	+ 644	+ 209	+1,412
Bankers' acceptances	—	— 1	+ 1	—	—
Repurchase agreements:					
Government securities	+ 247	+ 196	+ 9	— 452	—
Bankers' acceptances	+ 10	— 6	+ 25	— 29	—
Federal agency obligations	+ 33	— 28	+ 45	— 50	—
Member bank borrowings	— 222	+ 164	— 493	— 20	— 571
Other Federal Reserve assets†	+ 47	+ 48	— 118	— 249	— 272
Total	+ 408	+ 639	+ 113	— 593	+ 567
Excess reserves	+ 35	+ 92	— 198	+ 43	— 28

	Daily average levels				Monthly averages
Member bank:					
Total reserves, including vault cash	28,142	28,588	28,529	28,161	28,355‡
Required reserves	27,954	28,308	28,447	28,036	28,186‡
Excess reserves	188	280	82	125	169‡
Borrowings	1,010	1,174	680	660	881‡
Free, or net borrowed (—), reserves	— 822	— 894	— 598	— 535	— 712‡
Nonborrowed reserves	27,132	27,414	27,849	27,501	27,474‡
Net carry-over, excess or deficit (—)§	141	138	160	82	130‡

	Changes in Wednesday levels				Net changes
System Account holdings of Government securities maturing in:					
Less than one year	+1,252	— 347	+ 509	— 155	+1,259
More than one year	—	—	+ 21	—	+ 21
Total	+1,252	— 347	+ 530	— 155	+1,280

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† Includes assets denominated in foreign currencies.
‡ Average for four weeks ended on August 26.
§ Not reflected in data above.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS AUGUST 1970

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on				Averages of four weeks ended on August 26
	August 5	August 12	August 19	August 26	
Eight banks in New York City					
Reserve excess or deficiency (—)*	— 58	24	— 28	12	— 12
Less borrowings from Reserve Banks	114	382	21	56	143
Less net interbank Federal funds purchases or sales (—)	1,788	3,040	2,146	1,544	2,130
Gross purchases	2,742	3,641	2,757	2,357	2,874
Gross sales	954	600	611	812	744
Equals net basic reserve surplus or deficit (—)	—1,960	—3,398	—2,195	—1,588	—2,285
Net loans to Government securities dealers	937	934	641	1,158	918
Net carry-over, excess or deficit (—)†	30	8	39	7	21
Thirty-eight banks outside New York City					
Reserve excess or deficiency (—)*	62	— 2	— 1	— 11	12
Less borrowings from Reserve Banks	362	362	243	144	278
Less net interbank Federal funds purchases or sales (—)	3,497	4,116	3,875	3,652	3,785
Gross purchases	5,172	6,185	5,747	5,580	5,673
Gross sales	1,676	2,069	1,873	1,934	1,888
Equals net basic reserve surplus or deficit (—)	—3,797	—4,480	—4,119	—3,807	—4,051
Net loans to Government securities dealers	849	563	711	842	741
Net carry-over, excess or deficit (—)†	26	60	28	21	34

Note: Because of rounding, figures do not necessarily add to totals.
* Reserves held after all adjustments applicable to the reporting period less required reserves.
† Not reflected in data above.

Table III

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—August 1970				
	August 3	August 10	August 17	August 24	August 31
Three-month	6.413	6.512	6.527	6.198	6.342
Six-month	6.496	6.682	6.587	6.338	6.508

	Monthly auction dates—June-August 1970		
	June 23	July 23	August 25
Nine-month	7.069	6.467	6.510
One-year	7.079	6.379	6.396

* 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.

Commercial bank reliance on nondeposit sources of funds was reduced slightly in August. Euro-dollar borrowings rose somewhat, following a sharp decline in July. Bank-related commercial paper sales declined, however, and banks began to repay maturing obligations in the wake of the Board of Governors' application of reserve requirements to such obligations. Although the rate on bank-related commercial paper was higher than that on 30- to 59-day large CD's in August, the cost of funds to banks from the two sources was about equivalent, since reserves were not yet required against funds raised through sales of commercial paper.

The reduction in bank dependence on nondeposit sources of funds was accompanied by heavy deposit inflows. Preliminary data indicate that seasonally adjusted daily average time deposits at all commercial banks grew at about a 28 percent annual rate in August. Demand deposits also increased, and the narrowly defined money supply appears to have risen at a seasonally adjusted annual rate of about 11 percent after increasing at a 4 percent rate in July. The seasonally adjusted daily average money supply appears to have risen at an annual rate of about 11 percent after increasing at a 4 percent rate in July. It should be stressed that short-run movements in economic time series, such as the money supply, are difficult to gauge because it is hard to distinguish between underlying trends and temporary phenomena whose influence may not be significant in the long run. The daily average money supply grew at approximately a 4½ percent seasonally adjusted annual rate in the June-August period.

THE GOVERNMENT SECURITIES MARKET

The excellent reception encountered by the new issues offered at the beginning of August in connection with the Treasury's cash and exchange operation underscored the notable improvement in the market for intermediate-term Government securities that had taken root over the summer. Yields on outstanding intermediate-term Treasury securities declined over the month despite the expanded supply of new notes. This contrasted sharply with marked rate increases experienced last May at the time of the previous refinancing. A rally in the long-term sector faded somewhat in early August, and yields rose as investors sold Governments and purchased higher yielding corporate securities. However, price declines eroded only a part of the gains achieved in June and July, and prices were rising strongly toward the end of August. Bill rates fluctuated narrowly within a higher range over the first two weeks of the period as banks sold tax anticipation bills (TAB's) acquired the previous month, but they declined over the remainder of the month along with other short-term rates.

Trading activity in the early part of August centered on the Treasury's refunding operation. Holders of $6.5 billion of maturing issues could exchange their securities between August 3 and 5 for new 3½-year 7¾ percent notes priced at par and/or seven-year 7¾ percent notes, priced to yield about 7.80 percent. Prices of the new securities on a "when-issued" basis moved immediately to a large premium, and dealers purchased substantial quantities of maturing issues or rights which were used to subscribe to the new issues while order books were open. The Treasury's cash offering on August 5 of an eighteen-month 7½ percent note, priced to yield 7.54 percent, encountered an excellent reception. On August 18, the Treasury announced the results of its financing operation and disclosed that it had raised a net $2.3 billion of cash, reflecting low attrition on exchangeable securities and strong demand for the new eighteen-month note.[2]

The August 17 announcement of a reduction in reserve requirements on time deposits and the simultaneous imposition of requirements on bank-related commercial paper, which will on balance release some funds in the banking system, led dealers to anticipate increased purchases of securities by commercial banks in the near future, and this development had a favorable impact on long-term securities markets. Earlier in the month, the demand for long-term Governments had been adversely affected by the growing congestion in the corporate bond market. Steadily increasing yields on a large supply of new highly rated corporate issues had led investors to switch out of Governments and into private securities. Prices of long-term Government notes and bonds moved up strongly in the last half of the month, however, as conditions in the corporate sector improved.

The Treasury bill market was subject to moderate pressure in early August, while banks sold TAB's acquired at two auctions in July. As the month progressed, bank selling gradually subsided and, given the steady easing of money market rates and the cost of financing inventories, dealers were not particularly anxious even though their inventories

[2] Of the approximately $5.6 billion of maturing issues in the hands of the public, about $4.8 billion was exchanged into the two new issues: the 7¾ percent notes due in February 1974, and the 7¾ percent notes due in August 1977. The 14.8 percent attrition rate on this exchange was less than one half the rate of the previous refunding in May. In the cash offering of 7½ percent Treasury notes due in February 1972, subscriptions totaled $18.6 billion from the public of which $3.2 billion was accepted, providing a 9.5 percent allotment on large subscriptions. This contrasts sharply with the 100 percent allotment on a similar offering in May.

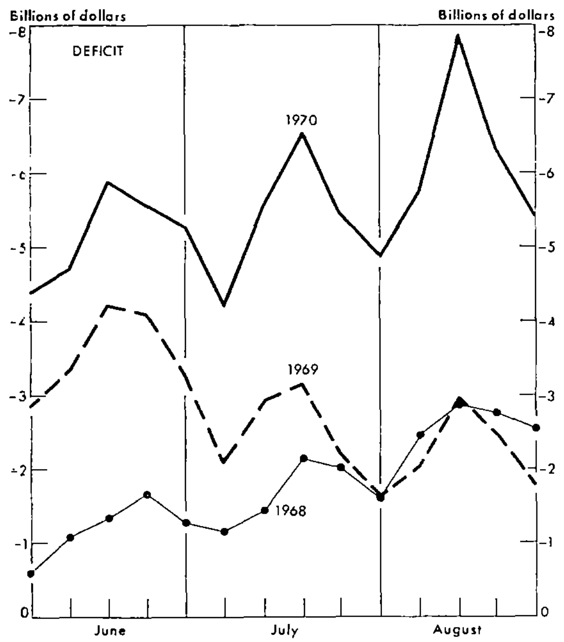
had increased sizably in late July and early August. Over the month as a whole, rates on bills due within three months were generally 5 to 15 basis points lower and rates on longer term bills ranged from 3 basis points higher to 14 basis points lower.

OTHER SECURITIES MARKETS

A relatively heavy supply of new securities issues and a rapidly growing calendar of forthcoming debt flotations tended to depress corporate bond prices during the first half of August. This increase in yields on long-term debt contrasted with developments in other financial markets, as most short- and intermediate-term interest rates declined. A rally in the taxable sector in June and July had most likely encouraged corporate borrowers to refinance existing short-term debt through the sale of long-term obligations. The rally petered out toward the end of July when dealers and investors became convinced that bond yields would come under upward pressure until there was some reduction in the visible supply of new securities. The poor reception encountered by a large competitive offering in the first week of August reinforced this growing pessimism about the course of long-term interest rates in the near future. The issue, marketed on August 5, consisted of $100 million of Aa-rated thirty-year first mortgage bonds issued by the Duke Power Company. The 8⅝ percent bonds were priced to yield 8.65 percent, 10 basis points below a similarly rated issue offered in the last week of July and the lowest offered during the summer on a high-grade electric utility issue. Underwriters were reportedly able to market only about one third of the securities before they were freed from price restrictions on August 17. Shortly thereafter the price of the bonds fell until they were yielding about 8.90 percent. Many other new financings in the first half of the month failed to receive good receptions, and a number of underwriting syndicates were disbanded during the second week of August. The rise in corporate bond yields was temporary, however, and conditions in this sector began to show notable improvement in the latter part of August. The action of the Federal National Mortgage Association in postponing a $200 million offering of twenty-year mortgage-backed bonds, and some tapering-off of the visible supply of other new offerings, encouraged market participants. More importantly, however, the easing of money market rates and the Board's move on reserve requirements prompted discussion of a possible cut in the prime rate and reinforced optimism that monetary policy was becoming less restrictive.

Chart II

BASIC RESERVE POSITION OF MAJOR MONEY MARKET BANKS



Note: Calculation of the basic reserve position is illustrated in Table II.

Although the tax-exempt sector was faced with supply problems similar to those in the corporate sector, new issue activity was temporarily reduced early in the month, and this contributed to an easing of congestion at that time. A July ruling by the Internal Revenue Service led to increased purchases of state and local government securities by commercial banks in late July and early August. This movement gained impetus later in August when the Federal Reserve Board announced the amendments to Regulation D. Many banks will have funds released when the lower reserve requirement on time deposits becomes effective. Debt flotations are subscribed to about one month before they are paid for, and commercial bank orders for new tax-exempt securities began to pick up shortly after the Board's action was announced. By the end of August, yields on some high-grade state and local government securities had fallen to their lowest levels in over a year. *The Weekly Bond Buyer's* index of yields on twenty municipal bonds fell by 33 basis points to 6.07 in the four weeks ended on August 26.