The Money and Bond Markets in November

Almost all interest rates fell steeply in November. Long-term rates moved lower after having been relatively flat during the preceding three months, while the downward trend in short-term rates gained considerable momentum. The broad-based decline in money market interest rates was fostered by slack demand for bank loans and short-term funds and the continuation of a moderately expansive monetary policy. Long-term rates fell as investors, convinced that interest rates were headed lower, bought fixed-income securities aggressively. As market rates plummeted, both the Federal Reserve discount rate and the commercial bank prime lending rate were reduced twice.

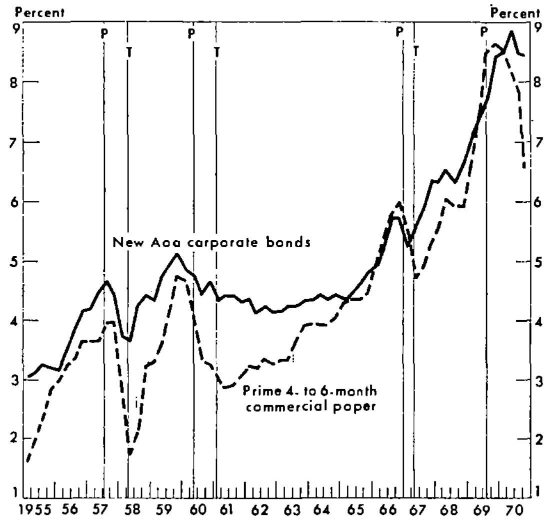
This pronounced decline in market interest rates, following their sharp rise in 1969 and early 1970, is to a large extent typical of the behavior of interest rates over the business cycle. Historically, interest rates have conformed positively to the business cycle—rising with expansions in business activity and falling with business contractions (see Chart I). In the postwar period, interest rates have tended to peak slightly before the peak in business activity, and both long- and short-term rates have usually reached their turning points at about the same time. The generally coincident movement in interest rates and the level of business activity reflects cyclical shifts in the demand and supply of loanable funds. In expansions, strong business demand for funds, prompted by the prospect of favorably high rates of return on physical investment, bids up interest rates. As the expansion progresses and a more restrictive monetary policy comes into play, the supply of loanable funds is constrained relative to continuing strong demand, and this contributes to the upswing in rates. On the other hand, in a period of economic sluggishness, the demand for funds weakens as investors become less willing to undertake capital expenditures in view of the uncertain outlook. The weaker demand, combined with an augmented supply of loanable funds resulting from a more expansive monetary policy acts to bring rates down.

The behavior of interest rates in 1969-70 was somewhat different from the typical pattern in that rates peaked quite late in the cycle, and that the turning point in long-term rates occurred considerably after short-term rates had started to decline. A factor contributing to this behavior was the persistence of inflationary expectations. When investors anticipate that prices will rise, they demand a higher nominal rate of return to safeguard the purchasing power of their future stream of income. Since price increases in recent years had been sharp, expectations of continued strong inflation persisted, thus keeping nominal interest rates rising even after the downturn in business activity. An experience similar to this had occurred in 1957-58, the previous cycle in which the rate of inflation was relatively rapid.

In 1970 the rise in long-term rates continued even after short-term rates had begun trending downward. Since long-term rates are heavily influenced by expectations of rates in the future, this behavior may have been indicative of continued expectations of strong increases in prices and interest rates. Moreover, massive demands for funds in the capital market contributed to upward pressure on long-term rates. After peaking at midyear, long-term interest rates declined only moderately as

Chart I

INTEREST RATES OVER THE BUSINESS CYCLE



Note: Peaks and troughs dated by the National Bureau of Economic Research (1957-58 and 1960-61) and turning points in the index of industrial production (1966-67 and 1969-70). Quarterly average data and average of October and November 1970.

Sources: Board of Governors of the Federal Reserve System and First National City Bank.

extraordinarily large volume of financing was carried out in this sector. In November, however, the conviction that interest rates were headed lower combined with a moderately expansive monetary policy to bring most long-term rates down (see Chart II) despite heavy demands on the capital market.

THE MONEY MARKET

Money market conditions were quite comfortable during November. Member bank borrowings from the Federal Reserve Banks declined to $409 million on average during the four weeks ended November 25 (see table), about $60 million below the October average and the lowest for any month since February 1968 when such borrowings started trending sharply upward. The reduced level of borrowing from the Federal Reserve reflected the ample provision of reserves by the System through open market operations. Moreover, sharply lower market rates of interest made borrowing at the discount window less attractive than earlier in the year, when market rates substantially exceeded the discount rate. To bring it into better alignment with the lower range of other short-term interest rates, the twelve Federal Reserve Banks reduced the discount rate from 6 percent to 5¾ percent during the week of November 9. As market interest rates continued to post steep declines, the discount rate was further reduced to 5½ percent in early December.

A contraseasonal sluggishness in bank loans, which had been evident from mid-September, persisted through November. Corporate borrowers bypassed banks as they continued to rely heavily on long-term funds. Some borrowers may also have been attracted by the lower range of rates prevailing in the commercial paper market, but in general the emphasis on repaying short-term liabilities with the proceeds of long-term debt remained a dominant factor contributing to weak loan demand. Over the four weeks ended November 25, the volume of commercial and industrial loans outstanding at all weekly reporting banks fell by $648 million,[1] compared with increases of $371 million and $1.5 billion during the comparable periods of 1969 and 1968, respectively. To stimulate loan demand, commercial banks lowered their prime lending rate in two ¼ percentage point reductions to 7 percent during the month.

As a result of the slack demand for short-term credit and a moderately expansive monetary policy, interest rates on all money market instruments declined substantially over the month. Short-term rates are now far below their early 1970 peaks. The interest rate on dealer-placed prime four- to six-month commercial paper, which stood at 9⅛ percent in early January, fell from 6⅝ percent at the end of October to 5¾ percent at the end of November. Rates on all maturities of directly placed commercial paper and bankers' acceptances also declined steadily during November, and were 1 percentage point or more below their end-of-October levels and about 3 percentage points below their January peaks by the month end. Most short-term rates are now at their lowest levels since early 1968.

Offering rates on large certificates of deposit (CD's) were similarly reduced during November, but the volume of these obligations outstanding once again showed a strong gain, increasing by $1.7 billion in the four weeks ended November 25. Since the partial suspension of Regulation Q in late June, the volume of large CD's outstanding at all weekly reporting banks has increased by over $12 billion, bringing the outstanding total at the end of November to a record high of $25.2 billion.

The narrowly defined money supply—currency and demand deposits held by the public—grew at a 2.7 per-

[1] Not including those loans repurchased from affiliates in connection with the redemption of commercial paper obligations.

cent annual rate[2] during November. This figure is based on a revision of the money supply series that was announced by the Board of Governors of the Federal Reserve System on November 27. A minor part of the revision stems from the annual review of seasonal factors and the correction of nonmember bank deposit data based on the latest "call report" information. The major portion arises from the elimination of a downward bias in the measured money supply, which had resulted from the deduction of "cash items in the process of collection" that arise in the clearance of payments by the large money market banks for certain specialized international banking institutions.[3]

These institutions have been handling an increasingly large volume of payments—representing mainly transfers of Euro-dollars and foreign exchange—for their parent firms as well as other customers. Typically, they have no direct way to clear checks and thus redeposit immediately with the large money market banks the funds they receive each day from their depositors. On the New York banks'

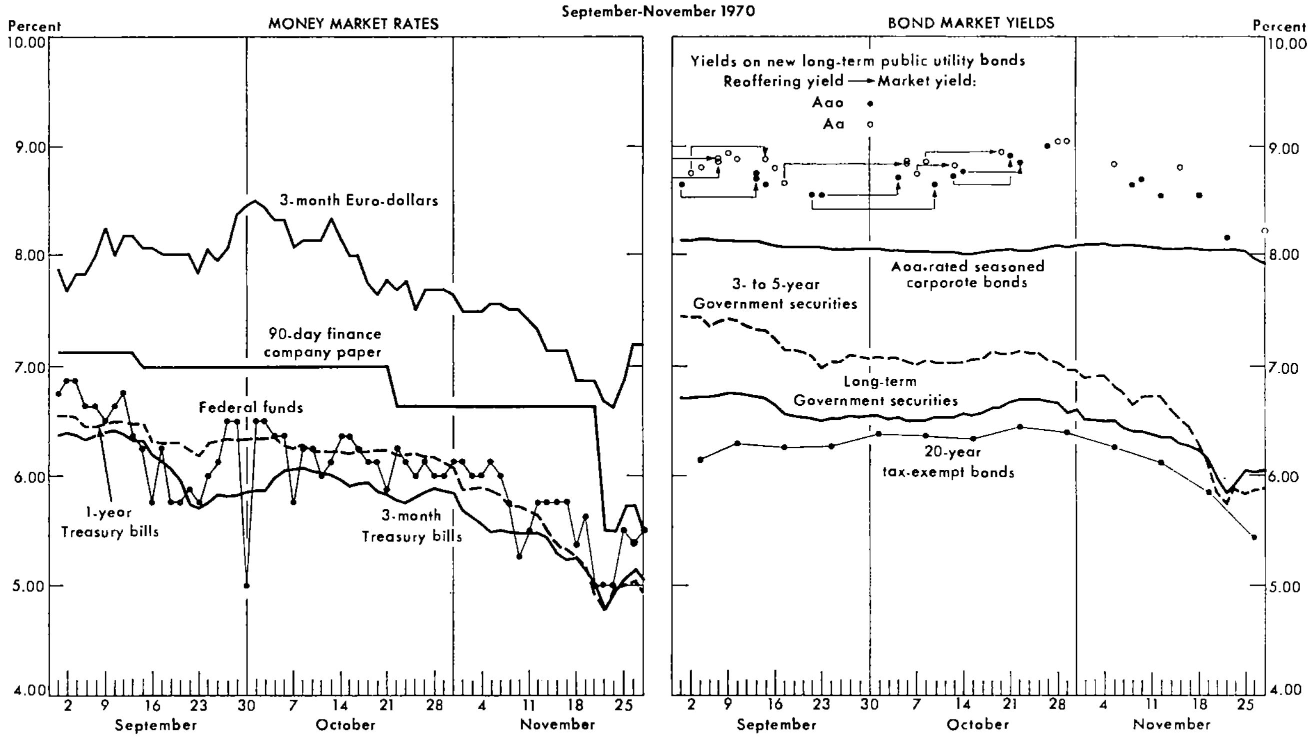
[2] Because final November data are not yet available, growth rates of the money supply and adjusted bank credit proxy are based on an average of the four weeks ended November 25.

[3] These institutions are agencies and branches of foreign banks and subsidiaries of United States banks organized under the Edge Act to engage in international banking.

Chart II

SELECTED INTEREST RATES

September-November 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.

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

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

Factors	Changes in daily averages— week ended on				Net changes
	Nov. 4	Nov. 11	Nov. 18	Nov. 25	
"Market" factors					
Member bank required reserves	— 78	— 109	+ 164	+ 312	+ 289
Operating transactions (subtotal)	— 342	+ 112	— 326	+ 104	— 452
Federal Reserve float	— 324	+ 422	— 173	+ 261	+ 186
Treasury operations*	+ 146	+ 81	+ 88	+ 153	+ 468
Gold and foreign account	— 24	— 1	+ 17	+ 18	+ 10
Currency outside banks	— 13	— 294	— 533	— 303	—1,143
Other Federal Reserve liabilities and capital	— 126	— 95	+ 276	— 26	+ 29
Total "market" factors	— 420	+ 8	— 162	+ 416	— 163
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 702	— 70	+ 786	—247	+1,171
Outright holdings:					
Government securities	+ 241	— 94	+ 509	+ 407	+1,063
Bankers' acceptances	+ 1	—	—	+ 1	+ 2
Repurchase agreements:					
Government securities	+ 369	+ 19	+ 202	— 500	+ 90
Bankers' acceptances	+ 28	+ 11	+ 13	— 48	+ 4
Federal agency obligations	+ 63	— 6	+ 62	— 107	+ 12
Member bank borrowings	— 12	+ 22	— 113	+ 103	—
Other Federal Reserve assets†	— 145	+ 9	— 260	— 369	— 765
Total	+ 547	— 39	+ 413	— 513	+ 408
Excess reserves	+ 127	— 36	— 77	— 97	— 83

	Daily average levels				Monthly averages
Member bank:					
Total reserves, including vault cash	28.652	28,725	28,812	28.403	28,648‡
Required reserves	28.334	28.443	28,607	28.295	28.420‡
Excess reserves	318	282	205	108	228‡
Borrowings	423	445	332	435	409‡
Free, or net borrowed (—), reserves	— 105	— 163	— 127	— 327	— 181‡
Nonborrowed reserves	28.229	28,280	28.480	27,968	28,239‡
Net carry-over, excess or deficit (—)§	134	189	160	132	154‡

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 November 25.
§ Not reflected in data above.

books, these deposits are reflected in large increases in cash items and in large credit entries to the deposit accounts due to the international banking institutions. These deposit accounts are classified by the city banks as "due to domestic commercial banks". In calculating the money supply, cash items in the process of collection are subtracted from gross demand deposits to avoid double counting the funds that are in the process of being transferred from one bank to the next. In addition, deposits due to domestic commercial banks are excluded because such balances presumably represent offsetting assets and liabilities for the banking system as a whole. Now, since the cash-items deduction in calculating the money supply includes the checks presented for collection by the specialized international institutions but their deposits with commercial banks are not included in the totals covered by the money supply, there is an understatement of the money supply—that is, the money supply is understated by the amount of cash items outstanding each day that are associated with credits to the deposit accounts due to the specialized institutions. Since funds had been transferred through these institutions continuously, and on a growing scale, the cash-items bias had been increasing.

The correction of the money supply data for the cash-items bias has been accomplished by adding to deposits essentially the volume of checks presented each day to commercial banks for collection by the specialized international institutions. However, as part of this revision, it was found desirable to include also those deposit liabilities of the institutions that remain relatively stable from day to day. Unlike the funds that flow in and out on the same day, these balances are relatively small. Thus, the net addition to the money supply (excluding the correction for the cash-items bias) is virtually negligible.

As a result of the corrections and adjustments, the money supply is now measured as having grown considerably faster in recent months than indicated by the previously published series. Over the first ten months of 1970, the revised money supply grew at a 5.5 percent annual rate, compared with a previously published rate of 3.8 percent. However, the basic pattern of very slow growth of the money supply in the second half of 1969 and more rapid expansion in 1970 is not changed by the revisions (see Chart III).

The adjusted bank credit proxy, a measure of bank liabilities which includes deposits subject to reserve requirements and Euro-dollar and commercial paper liabilities, increased at an 8.1 percent annual rate in November, or at a 7.6 percent annual rate since the beginning of the year. Strong time deposit growth continued to furnish most of the proxy's strength.

The level of bank-related commercial paper declined in November, as it has in each month since the announcement in late August of the imposition of a 5 percent reserve requirement on funds raised by banks through the sale by their affiliates of commercial paper maturing in thirty days or more and the simultaneous reduction to 5 percent in

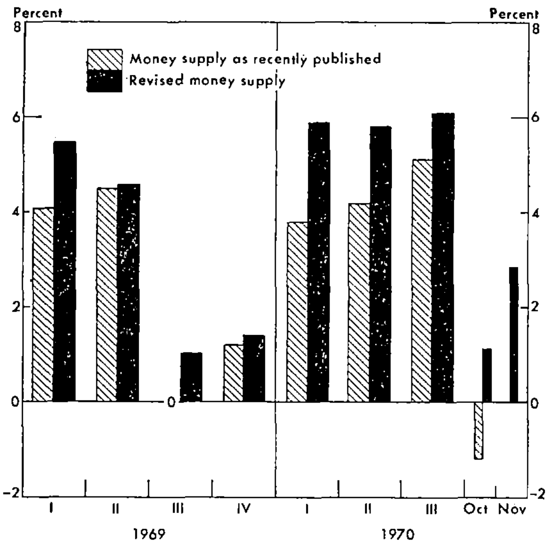


Chart III
REVISION OF THE MONEY SUPPLY
Seasonally adjusted annual growth rates

Source: Board of Governors of the Federal Reserve System.

reserves required against time deposits in excess of $5 million. The reduction in the level of bank-related commercial paper outstanding during the four weeks ended November 25 amounted to $544 million, bringing the outstanding total to $3.1 billion—less than half the level outstanding at the end of August.

Bank Euro-dollar liabilities also declined, falling by $861 million to an $8.76 billion level in the four weeks ended November 25. Banks have made substantial repayments of Euro-dollar liabilities since late June because of their ability to attract large CD's and the relatively high cost of Euro-dollars. Some banks have reduced their level of Euro-dollar liabilities below their May 1969 reserve-free bases, which were established last year when reserve requirements were imposed on such liabilities. To encourage banks to preserve their reserve-free bases against future need, rather than allowing their bases to be permanently lowered as occurs when their borrowings fall below the base, the Board raised from 10 percent to 20 percent the reserves required to be held against Euro-dollar borrowings that exceed the reserve-free base. The measure becomes effective in the four-week reserve computation period ending December 23. Partly so as not to penalize those banks that currently have Euro-dollar liabilities in excess of their bases, the Board also amended its regulations regarding the computation of the reserve-free base. Banks will now have a reserve-free base equal to the average level of their Euro-dollar borrowings outstanding in the four weeks ended November 25, 1970. These new reserve-free bases will be permanently reduced to the lowest average level of Euro-dollar liabilities held during any subsequent four-week computation period whenever the average of such borrowings falls below the new base average. Alternatively, a bank may use as its reserve-free base an amount that is equal to 3 percent of its deposits subject to reserve requirements during the current computation period. A bank in this group that has had foreign branches in operation for more than ninety days will, however, also have its reserve-free base permanently reduced to the lowest average total of its Euro-dollar liabilities in any computation period beginning after December 24, 1970, whenever that amount is less than 3 percent of its total deposits subject to reserve requirements during the current computation period. These changes become effective January 7, 1971.

THE GOVERNMENT SECURITIES MARKET

Yields on all maturities of Government securities plummeted in November, as market participants' growing conviction that interest rates were headed downward bolstered demand for both bills and coupon issues. The ebullience of the market reflected the expectations that sluggish bank loan demand would lead to a decline in the prime lending rate of banks and that banks would become active investors in fixed-income securities. In addition, new appraisals of the economic outlook suggested to many that a more expansive monetary policy was likely over the months ahead. Sizable bank buying of intermediate issues during November reinforced the bullish outlook in the market.

Demand for Treasury issues was good at the beginning of November and became even stronger as the month progressed. Widespread expectations of an imminent reduction in the prime rate and discount rate sparked considerable buying early in the month. The success of the Treasury's financing operations also added to the good investor outlook at this time. The refunding of the $6.0 billion of publicly held Treasury notes maturing in November resulted in a relatively small attrition of 10.8 percent.

To cover the attrition and raise new cash, the Treasury auctioned $2 billion in new 6¾ percent eighteen-month notes on November 5. This was the first time in thirty-five years that the Treasury had sold notes at auction. Under the more typical procedure, the Treasury sets both the amount and price of the new issue in advance. In the note auction, the Treasury determined in advance the amount to be issued but stipulated only a minimum acceptable price of 99.76. As it turned out, bidding was very aggressive, and all bids accepted were for prices which not only exceeded the minimum, but were well above par. The average return to investors on the new issue was 6.21 percent. Thus, the auction technique allowed the Treasury to take advantage of the substantial improvement in market conditions that had occurred between the announcement of the terms of the issue and the sale of the debt. Subsequent to this operation, the Treasury announced that it would raise $2.2 billion more in new cash before the end of the year by auctioning an additional $100 million in bills at the November 23 auction and by a $2.1 billion "strip" offering on November 25. The latter consisted of a $300 million addition to each weekly series of bills maturing between January 7 and February 18, 1971.

Although investors continued to be confident that substantial interest rate declines lay ahead, some market participants were briefly disappointed when the discount rate was reduced by only ¼ of a percentage point in early November. However, demand for Treasury issues continued to grow, and even the settlement of the automobile strike on November 12, with its inflationary implications, did not dampen investor enthusiasm for fixed-income securities. Strong buying continued through the remainder of November, and price increases were rapid and large. Expectations of even further reductions in the discount and prime rates were widespread and added to the buoyant market tone. Over the month, yields on intermediate-term Treasury issues fell by approximately 106 to 145 basis points and yields on long-term bonds fell by about 34 to 102 basis points. This brought yields on most coupon issues to their lowest levels since early 1969. Yields on Treasury bills of all maturities also tumbled. The yield on three-month bills fell from 6.01 at the end of October to 5.17 at the end of November, the sharpest monthly decline thus far this year. By the close of the month, bill rates were at their lowest levels in about 2½ years.

OTHER SECURITIES MARKETS

The market for corporate securities turned in a very strong performance in November, with a record heavy volume of debt marketed at declining yields. Signs of slack in the economy, expectations of a continued moderately expansive monetary policy, and the downward spiral in money market rates prompted strong investor demand.

Within the corporate sector, the month's new issue volume set a record at $3.4 billion. The concern of industrial borrowers with repayment of short-term debt and bank loans again played a major role in prompting heavy long-term corporate borrowing. Most of the new corporate bond issues introduced to the market during November met very good receptions. A majority of the month's offerings were quickly subscribed to, and many rose to substantial premiums in subsequent trading. The recent improvement in market conditions was evident in the terms of a major Bell Telephone System offering. On November 10, American Telephone & Telegraph Company floated $350 million of 32-year debentures yielding 8.70 percent and $150 million of seven-year notes priced to yield 7.68 percent. The 8.70 percent yield on the longer issue was 30 basis points lower than the yield on a similar issue of an AT&T subsidiary marketed in late October. As prices rose at a very rapid pace, another long-term offering by a Bell System affiliate was marketed on November 24 at a price that yielded investors a return of 8.16 percent. This was the lowest reoffering yield on an issue of an AT&T unit since July 1969. By the close of the month, even those corporate issues that initially had met a somewhat cooler reception because of their more aggressive pricing were in demand, and unsold balances in dealers' inventories were substantially reduced.

Although new issue yields posted steep declines, yields on outstanding corporate securities, as measured by Moody's seasoned Aaa-rated corporate bond index, were almost unchanged until quite late in November (see Chart II). However, this index is not highly sensitive to current interest rate changes since the issues in the index are highly rated industrial bonds which are in thin supply and are sometimes traded infrequently.

Prices of outstanding municipal securities showed dramatic increases in November. Over the month, *The Weekly Bond Buyer's* index of yields on twenty municipal securities dropped by 96 basis points to 5.44 percent. About $1.7 billion in new tax-exempt bonds was introduced in the sector, and despite rising prices almost all offerings were well received. While professional buying was strong early in the month when dealers were anticipating a cut in key lending rates, retail demand increased as the period progressed. In the face of slack loan demand, commercial banks again made sizable purchases of municipal securities. The marked improvement in prices of tax-exempt issues was underscored on November 18 when $98.8 million in issues offered by the Department of Housing and Urban Development, which had failed to receive any bids on October 28 because of their 6 percent interest ceiling, was successfully marketed at rates below the ceiling. Through the remainder of the month, yields continued to drop sharply, and as November drew to a close the return to investors on a highly rated tax-exempt bond was at its lowest level in over a year and a half.