The Money and Bond Markets in May

Interest rates continued to climb sharply through the middle of May amid uncertainties that were magnified by the international currency crisis and resultant apprehensions over its possible implications for domestic monetary policy. Another source of concern was the rapid growth in the popular measures of the money supply in recent months, which aroused fears that money market conditions might be tightened sharply further to reduce the rate of increase in those aggregates. (Little attention was paid to the relatively slower growth of a more comprehensive aggregate of member bank liabilities—the adjusted bank credit proxy.) In addition, the continuing large supply of corporate and municipal issues contributed to the heavy tone of the securities markets.

Market sentiment brightened notably on May 19, however, when Chairman Burns of the Board of Governors of the Federal Reserve System, in testimony before the Senate Committee on Banking, Housing, and Urban Affairs, averred that he saw no real conflict between the nation's domestic and balance-of-payments objectives. Enumerating several proposals for improving the international position of the dollar, Chairman Burns added: "The frequently suggested prescription of raising interest rates would not meet our lasting needs at home or abroad." Following this reassurance, the credit markets experienced their first sustained recovery in two months.

At the peaks reached shortly after midmonth, yields on both long- and short-term securities were at their highest levels in recent months. (These yields were still, however, well below the record highs set in 1969-70 when, for example, the effective rate on Federal funds was often between 9½ percent and 10 percent, a corporate bond rated Aaa was priced to yield 9.30 percent, and the average issuing rate on three-month Treasury bills climbed to 8.1 percent.) In the subsequent rally, Treasury coupon issues recovered substantially, closing the month at yields only slightly above those prevailing at the start of the month (see Chart I). Yields on municipal and corporate bonds closed about ⅛ to ¼ percentage point higher, and most short-term rates were ¼ to ½ percentage point higher on balance over the month.

THE MONEY MARKET

Short-term interest rates continued to rise over the first two thirds of May. Then rates generally stabilized and some edged lower. Over the month as a whole, the effective rate on Federal funds averaged 4.63 percent, up 47 basis points from the previous month and the highest monthly average since December 1970. Most other short-term rates climbed back to levels last seen in mid-January 1971. For example, the prevailing rate on ninety-day directly placed finance company paper was raised ½ percentage point to 5 percent. Dealers' offering rates on prime ninety-day bankers' acceptances and four- to six-month commercial paper were increased ¼ percentage point to 5 percent and 5¼ percent, respectively. Major New York City banks raised their offering rates on ninety-day negotiable certificates of deposit (CD's) by ½ to ⅝ percentage point to about 5 to 5⅜ percent, also the highest levels since mid-January.

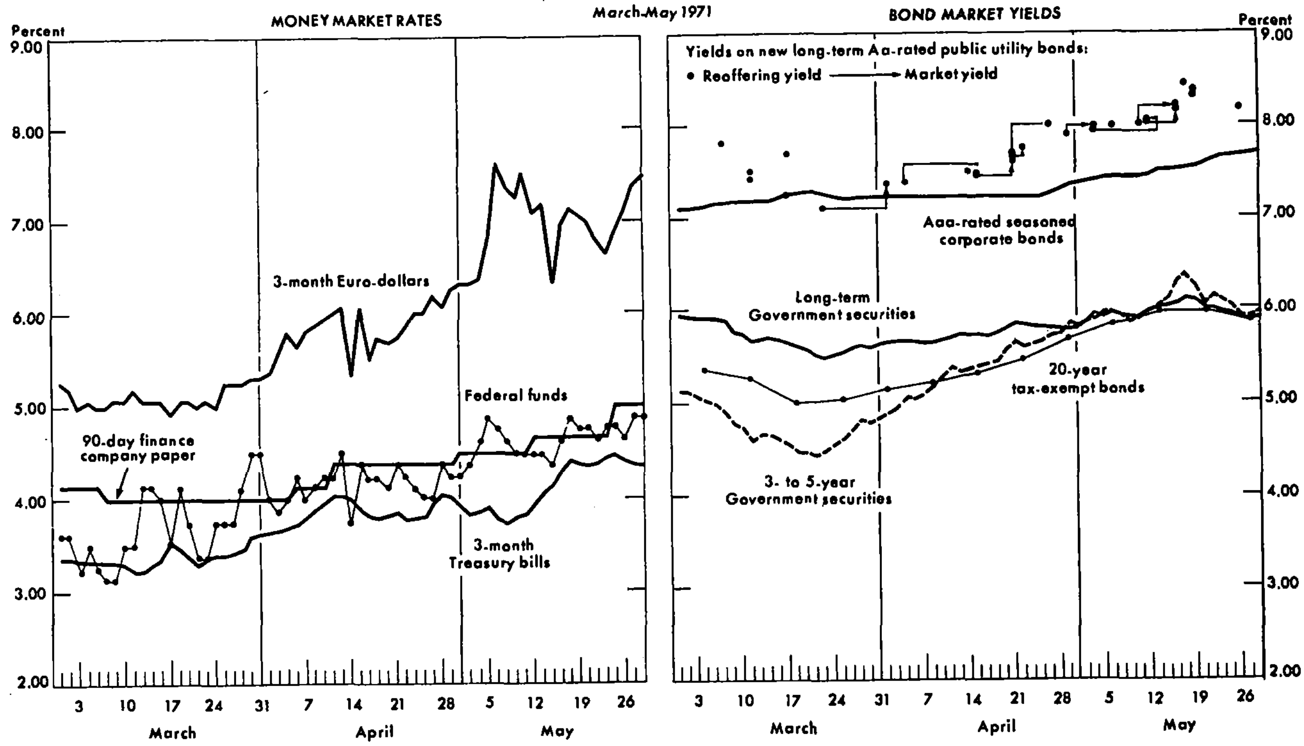
The major commercial banks that had resisted the move during April increased their prime lending rate to 5½ percent from 5¼ percent in response to the continued rise in money market rates and to at least a temporary improvement in loan demand. Among member banks as a whole, excess reserves increased by $67 million and borrowings from the Federal Reserve Banks by $61 million to $221 million and $213 million, respectively, on average during the four weeks ended May 26 (see Table I). Therefore, for the second consecutive month there was a slight net free reserve position, which averaged $9 million during the four statement weeks in May.

The popular measures of the money supply again rose sharply in May. Over the first five months of 1971, both M_1 and M_2 grew at annual rates about double those achieved during all of 1970. M_1—currency plus demand deposits held by the public—increased at an annual rate of nearly 11 percent from December 1970 to May 1971 (see Chart II), compared with 5.4 percent during 1970. M_2—defined as M_1 plus commercial bank savings and time deposits other than large CD's—expanded at an annual rate of over 16 percent during the first five months of

Chart I

SELECTED INTEREST RATES

March-May 1971



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 Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new 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.

1971, compared with 8.2 percent in 1970.

In contrast to these monetary aggregates, the growth of the adjusted bank credit proxy—member bank deposits subject to reserve requirements and certain nondeposit liabilities—slowed to about a 9 percent annual rate in the first five months of 1971 from 12.9 percent in the second half of last year. Over the entire year 1970 the proxy had grown by 8.3 percent. The slower growth in the adjusted bank credit proxy in relation to M_1 and M_2 in recent months reflects outright reductions in nondeposit liabilities and a marked slowdown in the rate of growth of CD's. Banks were reluctant to bid aggressively for these relatively high cost funds during much of this period in view of weak business loan demand and increasing uncertainties regarding the course of securities prices. In May, however, there were indications that some banks were beginning to step up their bidding for CD's. Liabilities of weekly reporting banks to their foreign branches declined by \$6.0 billion during the first five months of 1971, and bank-related commercial paper leveled off (see Chart III). CD's peaked at \$28.4 billion on March 17 and then declined to \$27.2 billion at the close of April. By May 26, they had risen again to \$28.0 billion, a gain of \$1.9 billion on balance since the beginning of the year.

THE GOVERNMENT SECURITIES MARKET

Yields on United States Government securities rose during May in the midst of investor uncertainty concerning the outcome of renewed pressure on the dollar

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, MAY 1971

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

Factors	Changes in daily averages— week ended May 5	May 12	May 19	May 26	Net changes
"Market" factors					
Member bank required reserves	− 306	+ 561	− 416	+ 197	+ 36
Operating transactions (subtotal)	− 182	− 1,008	− 16	+ 7	−1,199
Federal Reserve float	− 498	− 212	+ 426	− 187	− 471
Treasury operations*	+ 307	− 248	+ 83	+ 218	+ 360
Gold and foreign account	− 14	− 184	− 224	− 25	− 447
Currency outside banks	+ 129	− 351	− 446	+ 58	− 610
Other Federal Reserve liabilities and capital	− 106	− 12	+ 143	− 57	− 32
Total "market" factors	− 488	− 447	− 432	+ 204	−1,163
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 773	+ 276	+ 296	+ 154	+1,499
Outright holdings:					
Treasury securities	+ 384	+ 173	+ 471	+ 312	+1,340
Bankers' acceptances	+ 2	+ 4	+ 1	+ 1	+ 8
Repurchase agreements:					
Treasury securities	+ 328	+ 99	− 167	− 108	+ 92
Bankers' acceptances	+ 9	+ 6	− 5	+ 15	+ 25
Federal agency obligations	+ 50	− 6	− 4	− 6	+ 34
Member bank borrowings	− 2	− 75	+ 209	− 39	+ 93
Other Federal Reserve assets†	+ 34	+ 111	− 188	− 258	− 301
Total	+ 805	+ 312	+ 317	− 144	+1,290
Excess reserves	+ 317	− 135	− 115	+ 60	+ 127

	Daily average levels				Monthly averages
Member bank:					
Total reserves, including vault cash	30,780	30,084	30,385	30,248	30,374‡
Required reserves	30,415	29,854	30,270	30,073	30,153‡
Excess reserves	365	230	115	175	221‡
Borrowings	174	99	308	269	213‡
Free, or net borrowed (—), reserves	191	131	— 193	— 94	9‡
Nonborrowed reserves	30,606	29,985	30,077	29,979	30,162‡
Net carry-over, excess or deficit (—)§	— 1	187	142	65	98‡

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 May 26.
§ Not reflected in data above.

in foreign exchange markets. Treasury coupon issues experienced an almost steady price erosion over the first two thirds of the month, reflecting concern about the outlook for monetary policy and escalating yields in other debt markets. In contrast, rates on Treasury bills initially declined amid the uncertainty surrounding foreign exchange relationships because of demand from foreign central banks, which were acquiring dollars, and from others who welcomed such short-term investments as a relative haven during a period of turmoil. The improvement was not sustained, however, and the bill market also came under pressure as this foreign demand subsided and participants became more convinced that higher interest rates were probable in the near term. Discussions in the press about a possible further increase in the commercial bank prime rate added to this conviction.

Participants in both the bill and coupon markets derived encouragement from the statement of Chairman Burns on May 19 in which he proposed methods other than additional increases in domestic interest rates to strengthen the dollar internationally. Bill rates stabilized, and the Treasury coupon market rallied substantially for the first time since the middle of March.

The Treasury conducted its quarterly refinancing in early May at a time when participants in the securities markets were growing increasingly apprehensive about the outlook for interest rates. As the refunding progressed, the massive speculation against the dollar in the foreign exchange markets aggravated market anxieties. In this environment, prices fell in reaction to sizable selling pressure and a lack of demand for the securities offered in the refinancing. Some demand developed at the lower prices, however, and news of the rise in the unemployment rate prompted some reappraisal of expectations of higher interest rates. Moreover, the results of the refinancing, announced on May 7, while not generally favorable, were nevertheless better than some participants had expected. The public exchanged for the new notes \$4.1 billion of its \$5.9 billion holdings of the maturing issues, leaving \$1.8 billion to be redeemed for cash. This represented a 30.7 percent rate of attrition which was not exceptional considering the circumstances. The improved tone of the market was short-lived, however, and prices declined sharply until May 19 amid renewed anxieties over the course of interest rates.

The market recovered substantially in the wake of Chairman Burns's remarks and, over the remainder of the month, prices recouped a large part of the losses sustained earlier in May. On average, yields on both intermediate- and long-term Treasury securities closed about 16 basis points higher for the month.

Dealer positions in Treasury bills were small at the start of May, and bidding in the first weekly auction was fairly aggressive in anticipation of sizable demand from foreign central banks and from investors temporarily wary of the longer term markets. Demand was evident throughout the first week, and rates on most Treasury bills declined by 4 to 15 basis points between the end of April and May 7. A cautious undertone developed in the following week, when participants became increasingly concerned about international monetary problems subsequent to the floating of the German and Dutch currencies relative to the dollar. Moreover, the reinvestment demand from the maturing Treasury issues which were not exchanged for new notes was less than had been expected, and bill rates began to rise at a fairly steady pace.

On Friday evening, May 14, the Treasury announced that a $1.6 billion strip of bills would be auctioned on May 19, consisting of additions to eight weekly issues maturing between June 24 and August 12. This meant that, over the two remaining weeks of May, five bill auctions would be held and, with the prospect of such a concentrated supply, bill rates rose sharply on Monday, May 17. The average issuing rates on new three- and six-month bills in the weekly auction were up by 49 and 35 basis points, respectively (see Table II). Rates on outstanding issues adjusted higher after that auction, and a cautious tone was evident as the $1.6 billion strip auction approached. The atmosphere improved after mid-month, but rate declines were modest in the face of the concentration of auctions. During the month, rates on bills of longer than three months' maturity rose by 16 to 38 basis points, while shorter bill rates generally increased by 37 to 47 basis points.

Table II

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—May 1971				
	May 3	May 10	May 17	May 24	May 28
Three-month	3.865	3.861	4.352	4.478	4.344
Six-month	4.182	4.178	4.530	4.578	4.508

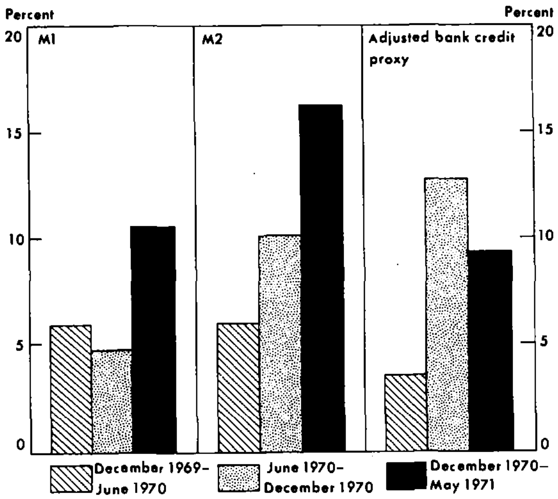
Maturities	Monthly auction dates—March-May 1971		
	March 25	April 27	May 27
Nine-month	3.507	4.402	4.688
One-year	3.586	4.422	4.700

* 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.

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates of change



Note: Data for May are preliminary.

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 liabilities, such as Euro-dollar borrowings and commercial paper issued by bank holding companies or other affiliates.

Source: Board of Governors of the Federal Reserve System.

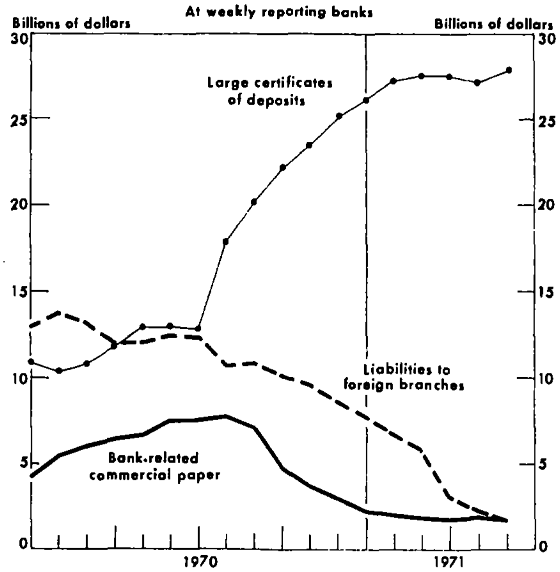
OTHER SECURITIES MARKETS

Prices of corporate and municipal bonds continued to fall during most of May, largely in response to a further heavy supply of new issues, considerable investor caution brought on by uncertainty concerning the international monetary situation, and the resultant sizable buildup of inventories in the hands of dealers. Several scheduled offerings were temporarily postponed because of unfavorable market conditions, but nonetheless an estimated $4.3 billion of new corporate and municipal issues was marketed during May. This was some $0.7 billion higher than the monthly average raised in the peak year of 1970. As a result, yields climbed back to the highest levels since late 1970 before a measure of stability was restored following Chairman Burns's reassurances. *The Weekly Bond Buyer's* index of yields on municipal bonds rose from 5.69 percent on April 29 to 5.96 percent on May 13, where it remained for two weeks before declining to 5.86 percent on May 27. Yields on major new Aa-rated corporate utility bonds rose from 7.95 percent early in May to 8.35

Chart III

LARGE CERTIFICATES OF DEPOSIT AND NONDEPOSIT LIABILITIES

At weekly reporting banks



Note: Data are as of the last Wednesday of each month, not seasonally adjusted.

Source: Board of Governors of the Federal Reserve System.

percent on May 19, and then fell to 8.18 percent on May 26.

The pattern of investor selectivity that characterized the month was first evidenced early in the period. On May 4, two major issues were marketed, both of which had been postponed from the preceding week. These were a $200 million A-rated offering of General Motors Acceptance Corporation debentures, priced to yield 8.10 percent, which was an immediate sellout, and a $50 million issue of Aa-rated utility bonds which got only a fair reception despite the fact that its yield of 7.95 percent was the highest on such an issue since early December. The response was lukewarm, in part because some investors were waiting to hear the terms on a comparably rated offering of Boston Edison bonds scheduled for two days later. That offering was priced to yield 8 percent and, because of the higher return as well as the fact that bonds from this company had until recently been rated Aaa, the Boston Edison issue was quickly sold to investors.

Following the weekend announcement that the German mark and Dutch guilder were going to float in relation to the dollar while the Austrian and Swiss currencies were being revalued, the corporate bond market weakened somewhat early in the week of May 10, as participants pondered the possible effects of these developments upon domestic monetary policy and interest rates. In this atmosphere, the Boston Edison bonds moved to a discount in the resale market, and a new issue of $110 million Aa-rated telephone company debentures, yielding no more than the original return on the Boston Edison bonds, was only about 40 percent sold on its first day. Benefiting from this experience, underwriters increased the yield somewhat on the next similarly rated new issue, and investors responded warmly. At the same time, several bond sales were postponed because of market conditions, and a number of recently marketed issues were freed from price restriction with a resultant increase in return of 8 to 20 basis points.

Prices on corporate bonds dropped sharply at midmonth in response to widespread discussion of an imminent prime rate increase at commercial banks, and yields on issues from disbanded syndicates rose by 16 to 25 basis points. On May 19, two Aa-rated utility issues were reoffered at yields of 8.32 percent and 8.35 percent, respectively, the highest such yields since November 1970. Both issues sold out following Chairman Burns's testimony, when the market began to recover, and the month's final offering of comparable securities was successfully retailed on May 26 at a yield of 8.18 percent.

In the market for tax-exempt securities, the Department of Housing and Urban Development (HUD) announced at the end of April that it would postpone close to one half of an auction of $357 million of local public housing authority bonds scheduled to be offered in May. While this decision provided some respite, the visible supply of new tax-exempt securities remained quite heavy and prices trended further downward as the month began. On May 4, HUD sold $342 million of short-term notes to finance urban renewal projects at an average interest cost of almost 3.14 percent—an increase of 57 basis points from its previous sale of such notes on April 13. That same day, prices on the unsold portion of some Aa-rated Austin, Texas, serial bonds were reduced enough to raise yields as much as 50 basis points above the original return. Two attractively priced new issues met with favorable investor reaction at the close of the first week in May, but the tone of the market became somewhat weaker after the European currency changes. As a result, several outstanding bonds were marked down in price, and the yields to be placed on new offerings were adjusted higher. Investors were not overly receptive, however, and some $43 million of a $100 million issue of Connecticut's Aaa-rated bonds went unsold when marketed on May 11 even though they provided yields that were about 15 basis points higher than those on Aa-rated bonds sold a week earlier.

Slackened demand on the part of commercial banks continued to concern market participants, and several new issues which elicited strong interest from insurance companies for the longer term bonds ran into difficulty in the shorter maturities which banks typically purchase. Thus, for example, a $156 million issue of New York State Housing Finance Agency bonds had an unsold balance of $30 million at the close on May 12, its offering date, and it was reportedly the shorter maturities which lacked retail demand.

There were several voluntary and involuntary postponements of tax-exempt offerings as the month progressed, but the calendar remained heavy, nonetheless, and prices deteriorated further. As was the case in the other securities markets, an improved atmosphere emerged during the last part of May, and investors were quite receptive to the two largest new issues retailed at that time. These were a $75 million Aaa-rated state of Ohio offering on May 20 and a $100 million Aa-rated Commonwealth of Pennsylvania bond flotation on May 26. Both issues were attractively priced and sold out completely soon after they were offered.