The Money and Bond Markets in October

Interest rates declined on a broad front during October as investors viewed optimistically the prospects for a reduction of inflationary pressures and a more accommodative stance of monetary policy. The continuing slowdown in the growth of the monetary aggregates also encouraged market participants. Money market rate declines were punctuated by a reduction in the prime business loan rate of commercial banks. In a related development, a few major banks announced that they were abandoning the traditional prime rate concept altogether in favor of a floating rate pegged to the ninety-day commercial paper rate.

In the capital markets, yields declined substantially during October. As measured by one widely followed index, municipal bond yields fell to the lowest level in more than two and one-half years. Yields on high-grade corporate bonds also declined but remained above their lows of the year reached in the first quarter. In both the corporate and the municipal bond markets, investor resistance to the lower yields stiffened as the month progressed, and yields rose somewhat toward the end of the month. Yields on long-term United States Treasury bonds also edged lower, while yields on short- and intermediate-term Treasury issues posted larger declines. On October 27 the Treasury announced the terms of its November refunding. The improved tone of the market encouraged the Treasury to pre-refund four 1972 issues and to include in the offering a fifteen-year bond, the longest issue sold by the Treasury since 1965.

THE MONEY MARKET

The effective rate on Federal funds fell steadily from 5.43 percent in the statement week ended September 29 to 5.11 percent in the week ended October 27. The easing of reserve positions helped to take pressure off the Federal funds rate. Net borrowed reserves averaged $223 million for the four weeks ended October 27 (see Table I), compared with $310 million in the previous four weeks.

Rates on dealer-placed commercial paper and bankers' acceptances were reduced several times during the month by a total of ½ percentage point in each case. Euro-dollar rates continued to descend from the dizzy heights reached during the international turmoil of mid-August. Three-month rates, which had risen as high as 10 percent at that time, had declined to 7¾ percent by late September and dropped further to about 6 percent by the end of October. Banks lowered their offering rates on large certificates of deposit (CDs) several times. Quoted rates on most maturities declined about ½ to ¾ percentage point during October. These moves helped stem the inflow of new CD funds in the latter part of the month.

As market rates got progressively more out of line with the prime rate, expectations increased that the latter rate would be cut. On October 20, several large banks moved to reduce the prime rate by ¼ percentage point to 5¾ percent. Shortly thereafter, two major New York City banks announced that they would no longer maintain a fixed prime rate but would, in the future, tie their minimum business loan rate to a flexible market rate. At least initially, both of the banks set the rate ½ percentage point above the rate on dealer-placed ninety-day commercial paper. One bank chose the rate at which paper is offered to investors, while the other chose the rate paid by borrowers. Usually there is a ⅛ percentage point spread between these rates. The minimum business loan rate is to be altered, if necessary, once a week. Both the choice of market instrument and the spread may be subject to revision if conditions warrant. The minimum adjustment is ⅛ percentage point at one bank and ¼ percentage point at the other, and both initially set their minimum business loan rate at 5¾ percent. One rate floated downward to 5⅝ percent in early November, prior to a general reduction in the prime rate to 5½ percent on November 4.

In making the move to abandon the concept of a prime rate, first introduced in 1934, one bank cited the need for a commercial loan rate more immediately sensitive to market forces. In recent years, market rates have shown a much greater tendency to change by fairly large magnitudes in short periods of time. The prime rate has reflected these swings in market rates by becoming more flexible as well. As can be seen from Chart I, the prime rate was changed only twice during the years 1960 through 1965. From early 1966 through November 4, 1971, the prevailing rate was altered twenty-eight times by the major banks. Even so, the rate has retained some rigidity. Particularly at interest rate peaks and troughs, the prime rate has failed to move as far or as fast as it would have if it had been linked to the commercial paper rate. The result of such rigidity probably has been to exaggerate swings in the volume of bank commercial lending as well as commercial paper financing. Several other banks have expressed interest in adopting some sort of floating prime rate, and a few of them have also instituted such a plan.

M_1 continued to be weak in October, following the pattern of August and September. Based on preliminary data, M_1 decreased at a seasonally adjusted annual rate of 2 percent in October, a slightly smaller drop than September's 3.7 percent rate of decline. The expansion pattern of M_1 over the last few years has shown a tendency toward a relatively high growth rate around midyear, with the advances tailing off in September and October. A similar pattern seems to have emerged this year, which suggests the possibility that seasonal money-holding patterns may be changing. Since seasonal adjustment factors are developed over a number of years, it takes time for any such alteration in behavior to become fully reflected in the seasonal factors.

Table I

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

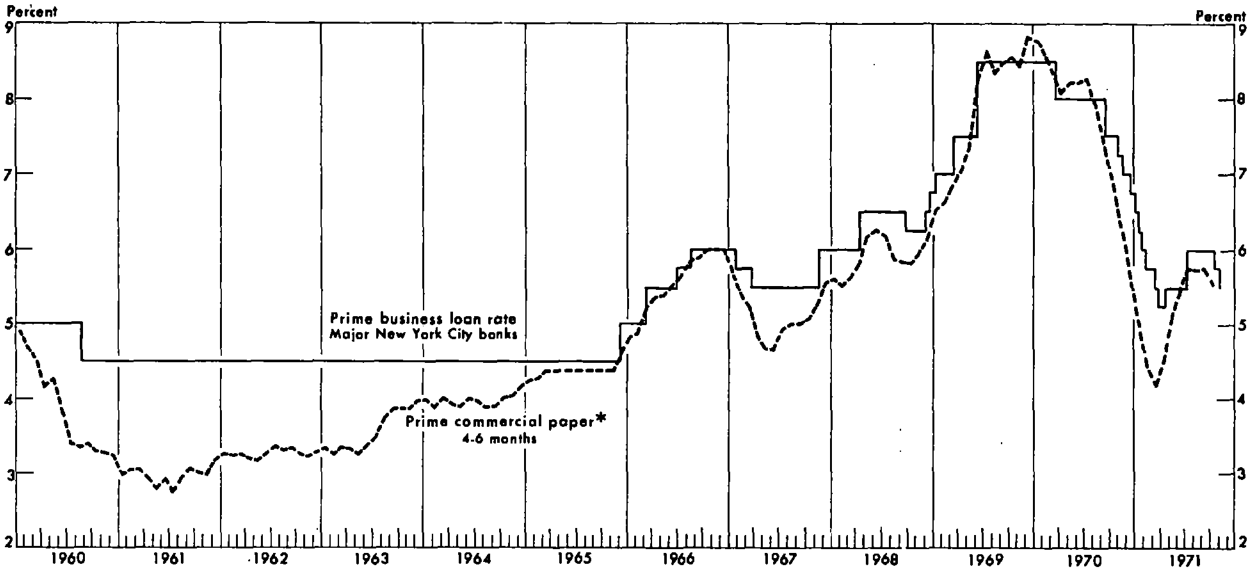
In millions of dollars; (+) denotes increase (−) decrease in excess reserves

Factors	Changes in daily averages— week ended				Net changes
	October 6	October 13	October 20	October 27	
"Market" factors					
Member bank required reserves	− 49	+ 126	− 204	+ 477	+ 350
Operating transactions (subtotal)	− 700	− 138	+ 453	− 362	− 747
Federal Reserve float	− 143	+ 83	+ 848	− 554	+ 234
Treasury operations*	− 139	+ 52	− 1	− 51	− 139
Gold and foreign account	− 37	+ 49	− 11	− 11	− 10
Currency outside banks	− 235	− 344	− 542	+ 263	− 858
Other Federal Reserve liabilities and capital	− 146	+ 21	+ 160	− 10	+ 25
Total "market" factors	− 749	− 12	+ 249	+ 115	− 397
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 691	− 357	+ 81	− 504	− 89
Outright holdings:					
Treasury securities	+ 547	−	− 166	− 239	+ 142
Bankers' acceptances	+ 4	+ 3	− 2	− 1	+ 4
Federal agency obligations	+ 39	+ 5	−	−	+ 44
Repurchase agreements:					
Treasury securities	+ 108	− 299	+ 193	− 193	− 191
Bankers' acceptances	+ 1	− 29	+ 21	− 27	− 34
Federal agency obligations	− 8	− 37	+ 35	− 44	− 54
Member bank borrowings	− 115	+ 140	− 117	+ 82	− 10
Other Federal Reserve assets†	+ 44	+ 64	+ 42	+ 47	+ 197
Total	+ 620	− 153	+ 6	− 375	+ 98
Excess reserves	− 129	− 165	+ 255	− 260	− 299
	Daily average levels				Monthly averages
Member bank:					
Total reserves, including vault cash	30,993	30,714	31,161	30,424	30,823‡
Required reserves	30,779	30,665	30,857	30,380	30,670‡
Excess reserves	214	49	304	44	153‡
Borrowings	309	449	332	414	376‡
Free, or net borrowed (−), reserves	− 95	− 400	− 28	− 370	− 223‡
Nonborrowed reserves	30,684	30,265	30,829	30,010	30,447‡
Net carry-over, excess or deficit (−)§	179	162	39	110	123‡

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 October 27.
§ Not reflected in data above.

Chart I

BANK PRIME RATE AND COMMERCIAL PAPER RATE



* Monthly averages of daily figures.

Source: Board of Governors of the Federal Reserve System.

Seasonal shifts have less of an impact on longer period growth rates, however. Over the six months ended in October, for example, M_1 grew at a relatively moderate annual rate of about 5 percent, compared with 11.8 percent during the six-month period ended in July.

M_2 advanced at an estimated 6 percent rate in October. The strength in this series came from a speedup in the growth of time and savings deposits other than large CDs. However, the 7½ percent growth in M_2 in the six months ended in October represents a marked slowdown from the 14.7 percent rate of advance recorded over the six months ended in July.

The adjusted bank credit proxy experienced a deceleration in October from its rapid advance in August and September. The proxy is estimated to have increased at a seasonally adjusted annual rate of 5 percent. The deceleration was largely accounted for by the more moderate growth in large CDs and by a decline in United States Government deposits at commercial banks. These deposits had risen dramatically in August when the Treasury issued $5 billion of special certificates of indebtedness to foreign central banks. The level of Government deposits was reduced somewhat in late September and early October partially as a result of a transfer of an extra $1 billion to the Treasury account at the Federal Reserve.

THE GOVERNMENT SECURITIES MARKET

Prices of United States Government securities rose during October amidst optimism over the prospects for lower interest rates in the future. Expectations about the future interest rate path were further reinforced by President Nixon's announcement on October 7 that Phase Two would include a Committee on Interest and Dividends. The subsequent presentation to the Congress of the formal request for legislative action gave still further impetus to price advances in the Government securities market. These yield declines were steeper on short- and intermediate-term issues than on long-term bonds.

Although considerable uncertainty concerning the size of future Treasury financing remains, the immediate threat of severe disruption arising from the international sector has receded. Foreign central banks bought massive quantities of special certificates of indebtedness in the two weeks following the President's suspension of dollar convertibility into gold. All of these certificates can be redeemed in advance of maturity. During September, fears were expressed that a wholesale redemption of these certificates could require the Treasury to replenish its account by borrowing in the domestic market, thereby depressing market prices. However, such apprehensions diminished during October when the level of certificates held by foreign central banks remained about constant. In October, the Treasury did redeem the remaining $1.1 billion of special certificates of indebtedness that had been issued to foreign branches of domestic commercial banks for balance-of-payments reasons. Still, the Treasury's cash needs in October were lower than they have been in the corresponding month during the last few years.

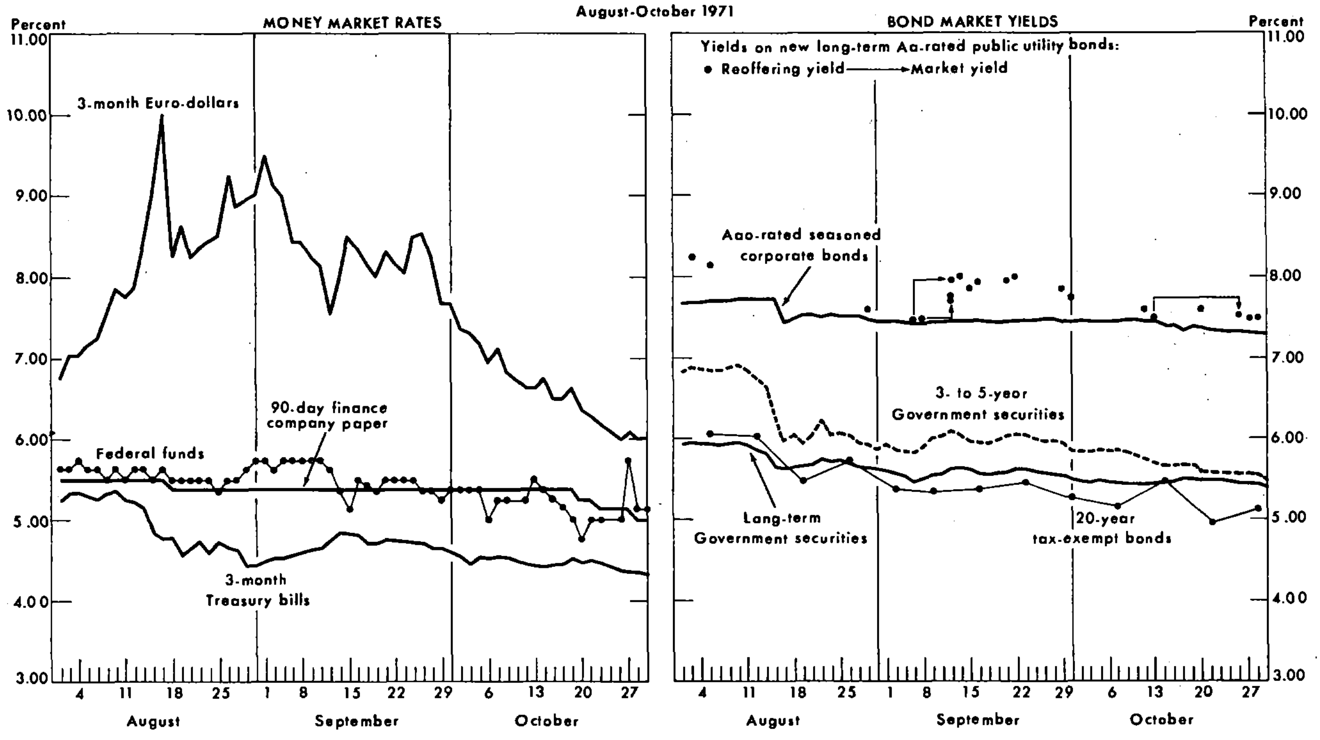
In the one new cash financing for the month, announced October 12, the Treasury raised $2 billion in cash through an auction of a three-year four-month 5⅞ percent note. The issue was well received by market participants. Yields on outstanding three- to five-year Government securities continued to decline between the announcement date and the auction (see Chart II). Bidding on the issue, for which banks were granted 100 percent credit to their Treasury Tax and Loan Accounts, was active as $4.6 billion of tenders was received for the $2 billion of notes. The average price accepted was 100.89 for an approximate yield of 5.58 percent.

As the month progressed, interest in the forthcoming Treasury refunding helped to raise prices on the issues maturing in the next year, amid speculation that the refi-

Chart II

SELECTED INTEREST RATES

August-October 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.

nancing of the November maturities might include an advance refunding. On October 27, the Treasury announced that it was offering holders of $7.9 billion[1] of maturing notes and bonds a choice of a seven-year 6 percent note or a fifteen-year 6⅛ percent bond. The new notes and bonds were priced to yield 6.04 percent and 6.15 percent, respectively. In addition, the new issues were made available to holders of $13.5 billion of securities maturing in May and August 1972. Cash subscriptions in amounts up to $10,000 were to be accepted for the bonds from individuals. This was the second offering of bonds since the Congress authorized the Treasury to market up to $10 billion in bonds without regard to the 4¼ percent ceiling. The first, offered as part of the August refunding, yielded 7.11 percent and generated only limited interest as $443 million of these bonds was taken.

The results of the refunding were announced on November 8. Of the $3.8 billion of publicly held maturities, $2.2 billion was exchanged for the new note and $0.4 billion for the bond for an attrition rate of 33.5 percent. An additional $3.1 billion of the notes and $0.15 billion of the bonds were taken by holders of the 1972 issues eligible for pre-refunding. Individual cash subscriptions for the bond amounted to only $24 million. The Federal Reserve and Government accounts will exchange $2.6 billion of their maturing securities for the new offerings. To cover the attrition and raise additional cash, the Treasury announced the auction of $2¾ billion of 4⅞ percent fifteen-month notes on November 9 for payment on November 15. In addition, the Federal Reserve and Government accounts exchanged their remaining $1.5 billion of issues maturing in November for the new 4⅞ percent note at the average price.

Treasury bill yields fell following the Phase Two announcement on October 7, and prices were further buoyed by the Treasury decision to raise cash with a coupon issue rather than a tax anticipation bill. Foreign central banks continued to be net purchasers of Treasury bills. Marketable United States Government securities held in custody by the Federal Reserve for foreign central banks increased by about $1,355 million in the four weeks ended October 27. This additional demand pressure on the market, of course, contributed further to the lowering of yields. Reflecting the fall in secondary market rates, the first two weekly auctions produced sizable yield declines. Average issuing rates on three- and six-month bills were respectively 19 and 38 basis points lower at the October 8 auction than they had been at the last auction in September. The rates of 4.486 percent and 4.595 percent for three- and six-month bills (see Table II) were the lowest new issue rates posted since May, when bill rates had been pushed downward because of heavy demand from foreign central banks. In spite of the large volume of bids, bill rates rose slightly at the October 18 auction but this was interpreted to be only a brief pause in the trend. Indeed, after the prime rate reduction, bill rates resumed their downward course. In the auction held Friday, October 22, in advance of the holiday weekend, rates dropped below their October 8 level. The average three-month rate was 4.443 percent and the average six-month rate was 4.530 percent.

Table II

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS
In percent

Maturities	Weekly auction dates—October 1971			
	October 4	October 8	October 18	October 22
Three-month	4.534	4.486	4.494	4.443
Six-month	4.743	4.595	4.635	4.530
	Monthly auction dates—August-October 1971			
	August 24	September 22	October 26	
Nine-month	5.090	5.242	4.495	
One-year	5.126	5.279	4.490	

* 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.

OTHER SECURITIES MARKETS

Corporate bond prices advanced sharply in October after having exhibited a rather uneven performance in September. The rally began with the President's late-September announcement that the second phase of the new economic program would contain "teeth". There was a brief pause in the advance of bond prices around mid-month, as the market participants contemplated the large volume of new issues due to reach the market on October 19 and 20. However, Treasury statements on the

[1] Of this, $3.8 billion was held by the public and $4.1 billion by the Federal Reserve Banks and Government accounts.

good prospects for lower interest rates made in conjunction with the presentation to the Congress of the proposed package of Phase Two legislation and the reduction by several banks in the prime rate on October 20 gave renewed impetus to the market. By the final week of the month, however, a heavy calendar temporarily halted the price advance, particularly for utility bonds.

Despite the general enthusiasm about the long-term prospects for interest rates that was developing during the month, several corporate issues met with considerable resistance because of what the market considered to be overly aggressive pricing. A forty-year Aaa-rated Bell Telephone bond issue, marketed early in the month and priced to yield 7.55 percent, met with a cool reception, although sales were aided somewhat by the general market advance in anticipation of the Phase Two speech. Yet, a utility issue rated Aa offered a week later at a yield of 7.60 percent sold quickly, while another Aa utility marketed a day later to yield 7.50 percent did moderately well. In the final week, several issues were given only lukewarm receptions. Again, aggressive pricing was blamed. For example, a Bell Telephone offering containing a forty-year bond yielding 20 basis points less than the earlier telephone issue elicited only slight interest initially. Underwriters were left with sizable unsold inventories at the end of the month, but these sold rapidly in early November.

In the early part of the month, price advances in the tax-exempt sector were even more dramatic than those of the corporate sector. *The Weekly Bond Buyer's* index of yields on twenty tax-free bonds dropped 25 basis points in the first two weeks of October to 4.99 percent. This was the lowest rate reached by this index since February 1969. Commercial banks, faced with large inflows of CDs and other time deposits, exhibited strong demand for the newly offered municipal securities. Eventually, however, it began to appear that yields had fallen so far that further declines were likely to come much more reluctantly. Indeed, the *Bond Buyer's* municipal index declined only another 2 basis points in the third week, then it turned around in the final week and climbed to 5.11 percent. Dealers' inventories mounted toward the end of the month. The Blue List of advertised inventories of tax-exempt bonds rose to $970 million at the end of October, up $234 million over the month to the highest level reached since December 1970.