The Money and Bond Markets in January

Interest rates in the money and capital markets generally declined during the first half of January amid quite comfortable conditions in the money market. As a result of the Federal Reserve System's generous provision of reserves, Federal funds traded well below the discount rate. While the availability of bank reserves was ample, credit demands by corporations were slack. This dearth of demand in the face of sharply declining market rates prompted most large commercial banks to reduce their prime lending rate to 4¾ percent. In the Treasury bill market, rates declined by 29 to 75 basis points over the first ten days of January, mainly in response to the easier money market conditions and to the reduction in the rates on Federal Reserve repurchase agreements, which were made at rates as low as 3½ percent. Reflecting these developments, rates on intermediate- and long-term Treasury notes and bonds, corporate bonds, and tax-exempt bonds also registered declines.

During the second half of the month, yields rose in most sectors of the credit markets. Uncertainty about the near-term outlook for interest rates and rumors, which were eventually confirmed, of exceptionally large Federal deficits for both the 1972 and 1973 fiscal years increasingly dampened market psychology. In this heavy atmosphere, the Treasury announced on January 26 the terms of its February refunding (for details, see page 36). Although the market rallied briefly, the underlying uncertainty about the future course of interest rates was an overriding influence, and yields on intermediate- and long-term issues continued to rise. In contrast, short-term interest rates worked lower toward the end of the month.

THE MONEY MARKET

Conditions in the money market were generally comfortable in January as the System continued to provide reserves generously. The effective rate on Federal funds averaged 3.50 percent, down 64 basis points from December and the lowest monthly average since October 1964. With Federal funds often trading a full percentage point below the discount rate of 4½ percent, member banks were under no pressure to borrow from the System. Consequently, member bank borrowings averaged only $25 million for the month (see Table I), the lowest monthly level since 1943. Net free reserves averaged $209 million, an increase of $161 million over December and the highest monthly level since November 1967.

The easier money market conditions in January were reflected in substantial declines in virtually all short-term interest rates (see Chart I). Dealers in bankers' acceptances pared their rates by ⅜ percentage point to 4 percent during January. The three-month Euro-dollar rate fell by ¾ percentage point during the month to 5 percent. Rates on dealer-placed commercial paper fell ½ percentage point, while bank offering rates on newly issued negotiable certificates of deposit (CDs) declined by about ⅛ to ½ percentage point. Lately, rates on commercial paper and CDs have taken on added significance because several large commercial banks have pegged their prime lending rate to one or both of these market rates.

In response to the declines in short-term rates, as well as to the sluggish business loan demand, virtually all the major money market banks had reduced their prime rate to 4¾ percent by January 21. Moreover, at the end of the month, two major New York City banks again reduced their basic lending rate to 4½ percent, which was the level of the prime rate prevailing from August 1960 until December 1965, when it was raised to 5 percent. In a related development, one of these same banks announced that, beginning February 1, it was also reducing the rate paid on regular passbook savings accounts by ½ percentage point to 4 percent. Late in December, a large West Coast bank had lowered the rate it pays on these accounts to 4 percent.

Preliminary estimates, which are subject to revision, indicate that the narrow money supply (M_1) rose in January (see Chart II) at a seasonally adjusted annual rate of about 3½ percent. This increase followed a 2.6 percent rate of rise in December, and brought the growth over the six months ended in January to an annual rate of about 1.3 percent.

The growth of the broader money supply (M_2) also accelerated in January, rising at an estimated 14 percent annual rate. This compares with the 8.0 percent rate of growth achieved in the previous quarter and the 11.1 percent rise over all of 1971. The strength in the growth of consumer-type time and savings deposits, of course, was the major contributing factor to the acceleration in M_2 growth. The precipitous decline in interest rates on competing market instruments has made time deposits a relatively attractive outlet for investor funds.

Also reflecting the strong growth of time deposits, the adjusted bank credit proxy increased in January at an estimated 11 percent annual rate. Although below the 13.1 percent rise recorded in December, this rate of growth was above the increases of about 9½ percent posted during the previous quarter and during the year 1971.

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JANUARY 1972

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

Factors	Changes in daily averages— week ended				Net changes
	Jan. 5	Jan. 12	Jan. 19	Jan. 26	
"Market" factors					
Member bank required reserves	— 891	— 269	— 685	+1,051	— 794
Operating transactions (subtotal)	— 125	+ 22	+ 419	— 490	— 174
Federal Reserve float	— 384	— 626	— 229	— 329	—1,568
Treasury operations*	— 234	— 215	+ 247	— 582	— 784
Gold and foreign account	+ 173	+ 127	+ 23	— 12	+ 311
Currency outside banks	+ 325	+ 603	+ 434	+ 469	+1,831
Other Federal Reserve liabilities and capital	— 5	+ 132	— 56	— 36	+ 35
Total "market" factors	—1,016	— 247	— 266	+ 561	— 968
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+1,191	— 7	+ 429	— 649	+ 964
Outright holdings:					
Treasury securities	+ 582	+ 526	+ 349	—	+1,457
Bankers' acceptances	+ 1	— 1	— 1	— 1	— 2
Federal agency obligations	— 3	+ 168	—	—	+ 165
Repurchase agreements:					
Treasury securities	+ 516	— 589	+ 87	— 547	— 533
Bankers' acceptances	+ 46	— 60	+ 12	— 78	— 80
Federal agency obligations	+ 49	— 51	— 18	— 23	— 43
Member bank borrowings	— 159	— 40	— 4	—	— 203
Other Federal Reserve assets†	— 18	+ 47	+ 54	+ 47	+ 130
Total	+1,015	—	+ 479	— 601	+ 893
Excess reserves	— 1	— 208	+ 174	— 40	— 75

	Daily average levels				Monthly averages
Member bank:					
Total reserves, including vault cash	32.814	32,875	33,734	32,643	33,017‡
Required reserves	32,501	32.770	33,455	32,404	32,783‡
Excess reserves	313	105	279	239	234‡
Borrowings	57	17	13	13	25‡
Free, or net borrowed (—), reserves	256	88	266	226	209‡
Nonborrowed reserves	32,757	32,858	33,721	32,630	32,992‡
Net carry-over, excess or deficit (—)§	135	195	126	126	147‡

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 January 26.
§ Not reflected in data above.

THE GOVERNMENT SECURITIES MARKET

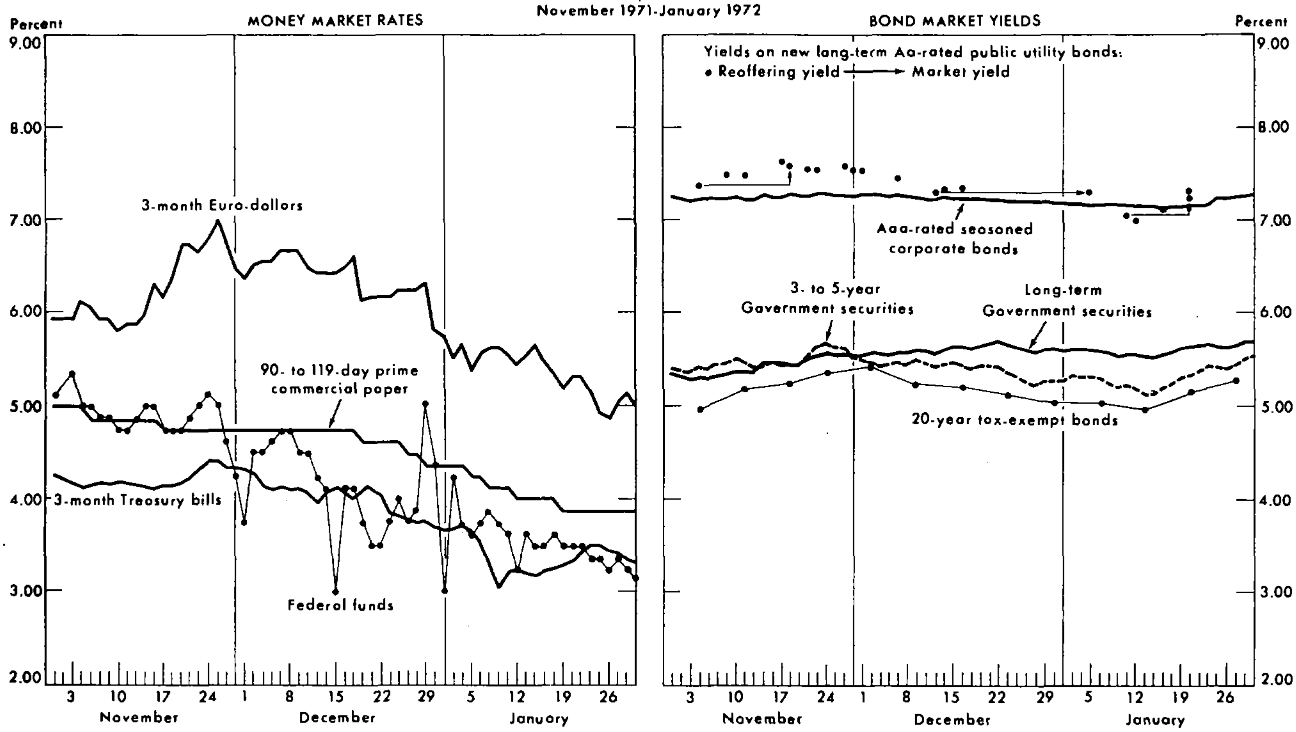
The buoyant tone that characterized the Government securities market during most of December continued during the first two weeks of January. Amid the easy conditions in the money market, the underlying strength in the Government securities market reflected a strong belief that banks would increasingly look to intermediate-term Treasury coupon issues as relatively attractive investments. Market participants were also encouraged by the System use of repurchase agreements at rates as low as 3½ percent. This level, a full percentage point below the discount rate, was the lowest since 1964. The market gained further encouragement from the widespread reductions in the prime lending rate and sizable System purchases of short- and intermediate-term issues. After midmonth, however, investor demand began to wane in the face of concern over the durability of the lower rate levels and the proximity of the Treasury February refunding. These developments, in conjunction with the prospects of heavy Treasury financing over the coming months, dampened market sentiment, and yields generally rose throughout the maturity spectrum over most of the remainder of the month.

The underlying strength in the Treasury bill market during the first half of the month partly reflected the ready availability of reserves and the resultant low Federal funds rate. Beyond this, however, the supply of bills available in the market had been diminished considerably by heavy demand, while the anticipated bank selling of bills in early January failed to develop in the expected volume. The continued presence of foreign demand for bills and, consequently, the absence of the widely expected reflow of dollars contributed to the strong performance in this sector. As a result, during the weekly auction held on January 10, rates on the new three- and six-month bills fell respectively to 3.109 percent and 3.375 percent (see Table II), the lowest levels in more than seven years. In contrast, during the tight money period at the end of 1969, three-

Chart I

SELECTED INTEREST RATES

November 1971-January 1972



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Bid rates for three-month Euro-dollars in London; offering rates (quoted in terms of rate of discount) on 90- to 119-day prime commercial paper quoted by three of the four dealers that report their rates, or the midpoint of the range quoted if no consensus is available; 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.

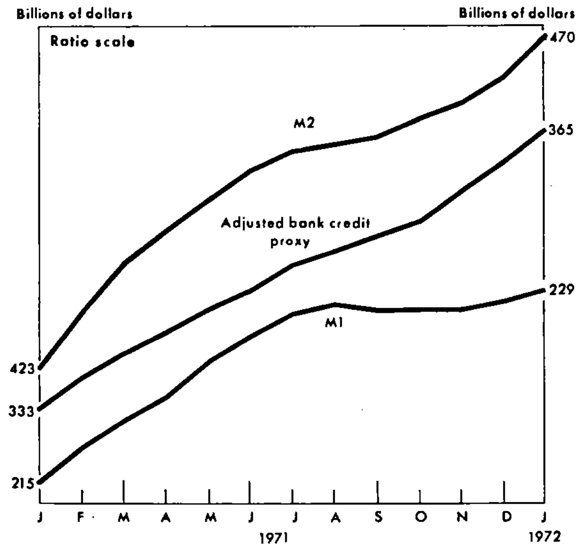
month bills were auctioned at a record 8.096 percent. After midmonth, however, the demand for bills began to slacken as market participants became cautious over the lower rate levels. Discussions about an expanding Federal budget deficit induced further investor caution. Consequently, during the weekly auctions held on January 17 and January 24, rates on new three- and six-month bills registered sizable increases. These increases, however, were partially reversed on January 31 when the new three- and six-month bills were auctioned at 3.367 percent and 3.733 percent, respectively. During the monthly auction held on January 25, rates on the new nine- and twelve-month bills were little changed from a month earlier, the former declining by about 4 basis points to 3.892 percent and the latter rising by 1 basis point to 3.936 percent. For the month as a whole, rates on outstanding Treasury bills still declined by 6 to 45 basis points.

The steep decline in Treasury bill rates over the first half of the month also enhanced the relative attractiveness of higher yielding coupon instruments, and the sharply rising slope of the yield curve led to an expansion of professional demand for intermediate-term issues. This development, in conjunction with sizable System purchases in this area as well, led to declines in most short- and intermediate-term yields over this interval. Long-term bond prices, reflecting both developments in the corporate sector and widespread reductions in the prime lending rate, also registered increases. As the month progressed, however, interest rates throughout the maturity spectrum began to rise. This trend toward higher long-term rates continued through the remainder of the month, in part because inflationary fears may have again been rekindled by projections of a $38.8 billion Federal budget deficit in the current fiscal year and a $25.5 billion deficit in fiscal 1973. The proximity of the Treasury's February refunding also provided a dampening influence on the market. By the end of the month, yields on most short- and intermediate-term issues were 13 to 32 basis points higher than at the end of December and yields on long-term bonds were generally 7 to 16 basis points higher.

At the close of business on Wednesday, January 26, the Treasury announced the terms of its February refunding. The Treasury offered holders of the February 1972 maturities the right to exchange their securities for new 5¾ percent notes maturing in four years and three months or new ten-year 6⅜ percent bonds. The new securities, both priced at par, were offered to refinance $4.5 billion of notes and bonds maturing on February 15, of which $3.8 billion was held by the public. In addition, holders of $14.3 billion of securities maturing in February 1974 and May 1974 were offered the right to exchange into the ten-year bonds. The bonds were also offered for cash subscriptions to individuals in amounts not to exceed $10,000 for any one person. This was the first time since 1965 that the Treasury has offered to refund securities maturing more than a year from the exchange date.

The initial market response to the refinancing terms was quite enthusiastic, and the new "when-issued" securities began trading at substantial premiums. Prices drifted lower over the next few days but turned around and recouped a sizable portion of their losses by the time the subscription books closed on February 2. According to preliminary results, the public exchanged $2.57 billion of its maturing issues for $2.35 billion of the new notes and $222 million of the new bonds. The resulting "attrition" of $1.19 billion, or 31.7 percent, was about as expected. Individual cash subscriptions to the bonds totaled $66 million. In addition, of the $11.7 billion of eligible 1974 maturities in the hands of the public, $1.34 billion was exchanged for the new bonds.

Chart II
MONETARY AND CREDIT AGGREGATES
Seasonally adjusted



Note: Data for January 1972 are preliminary estimates.

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 sources of funds, such as Euro-dollar borrowings and the proceeds of commercial paper issued by bank holding companies or other affiliates.

Sources: Board of Governors of the Federal Reserve System and Federal Reserve Bank of New York.

OTHER SECURITIES MARKETS

The buoyant atmosphere that pervaded the money and capital markets during the first half of January enabled the corporate sector to absorb a moderate volume of new issues at declining yields. During this period, market participants also took encouragement from the reduction in the prime rate and from the view that monetary policy was becoming more expansionary. A two-part $125 million Bell System offering auctioned on January 5 was regarded by most observers as the month's bellwether issue. The prime offering consisted of $75 million of 7⅛ percent debentures due in 2012 and $50 million of 6⅜ percent notes due in 1979. The debentures were priced to yield 7.20 percent, the lowest return on a long-term obligation issued by an AT&T unit since last March, when the same yield was offered by New Jersey Bell. Both the new note and bond issues were priced a bit ahead of the market and about 60 percent of each was initially sold. Despite the overhang of these inventories, underwriters continued to bid aggressively for new issues, pushing yields lower. On January 13, a $50 million Aaa-rated utility issue was reoffered to yield 7⅛ percent, the lowest return in almost a year on a comparably rated long-term issue.

During the remainder of the month, uncertainty about the near-term outlook for interest rates and the impact of the announced Federal deficit began to dampen the interest rate outlook. On January 25, an Aaa-rated

Table II

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—January 1972				
	Jan. 3	Jan. 10	Jan. 17	Jan. 24	Jan. 31
Three-month	3.735	3.109	3.276	3.493	3.367
Six-month	4.043	3.375	3.452	3.754	3.733
	Monthly auction dates—November 1971-January 1972				
	Nov. 23	Dec. 28	Jan. 25		
Nine-month	4.581	3.930	3.892		
One-year	4.563	3.927	3.936		

* 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.

telephone offering of $50 million each of notes and debentures was auctioned. The 7¼ percent forty-year debentures were priced to yield 7.30 percent and the 6¾ percent seven-year notes were priced to yield 6.70 percent—10 and 32 basis points higher, respectively, than returns on the previous Bell System offering on January 5. Despite the highest return among comparable securities since November 15, 1971, the debentures attracted only lukewarm interest.

In an area of the capital market related to the corporate bond market, the United States Postal Service offered $250 million of twenty-five year bonds on January 12. This was the first such offering by the Postal Service. The 6⅞ percent bonds, which were offered at par, were well received by investors.

Prices in the tax-exempt sector responded to the same factors that affected the corporate market. The major issue of the month reached the market on January 11 when the State of New York offered $142.5 million of Aa-rated bonds. After midmonth, as most of the new issues met only fair receptions, prices of outstanding long-term issues sustained sizable declines. Dealers succeeded in reducing their swollen inventories only by terminating price restrictions or reducing prices. *The Weekly Bond Buyer's* twenty-bond index of municipal bond yields closed at 5.29 percent, 27 basis points above its level at the beginning of the month.