The Money and Bond Markets in February

Short-term interest rates in February were buffeted by the speculative flows of funds surrounding the devaluation of the dollar. On the one hand, demand for dollar loans to buy foreign currencies pushed Euro-dollar rates sharply higher. On the other hand, the dollars absorbed by foreign central banks in defense of the exchange rates negotiated in the Smithsonian agreement of December 1971 were used to purchase Treasury bills and special nonmarketable Treasury issues. Bill rates fell to artificially low levels, and the floating supply of bills decreased sharply. In this environment, the Federal Reserve experienced some difficulty in managing bank reserves during the month. The restrained provision of nonborrowed reserves over the month forced member banks to meet a larger part of their reserve requirements by borrowing from their Reserve Banks. Reflecting the mounting pressure on bank reserve positions, the Federal funds rate rose from 6.35 percent in the week ended January 31 to 6.75 percent in the week ended February 28. Late in the month the Federal Reserve Banks increased their discount rate from 5 percent to 5½ percent. Most major commercial banks immediately raised their prime business loan rate ¼ percentage point to 6¼ percent.

Bond prices tended lower during February as market caution about the interest rate outlook deepened. Concern over rising short-term interest rates made Government securities dealers and others willing sellers of issues acquired in the Treasury's February financing, although future Treasury financing needs were reduced by the sizable foreign central bank purchases of special issues directly from the Treasury. Relatively light new issues of corporate and municipal bonds helped to sustain the markets for these securities, but syndicate sales slowed and bond prices declined toward the month end.

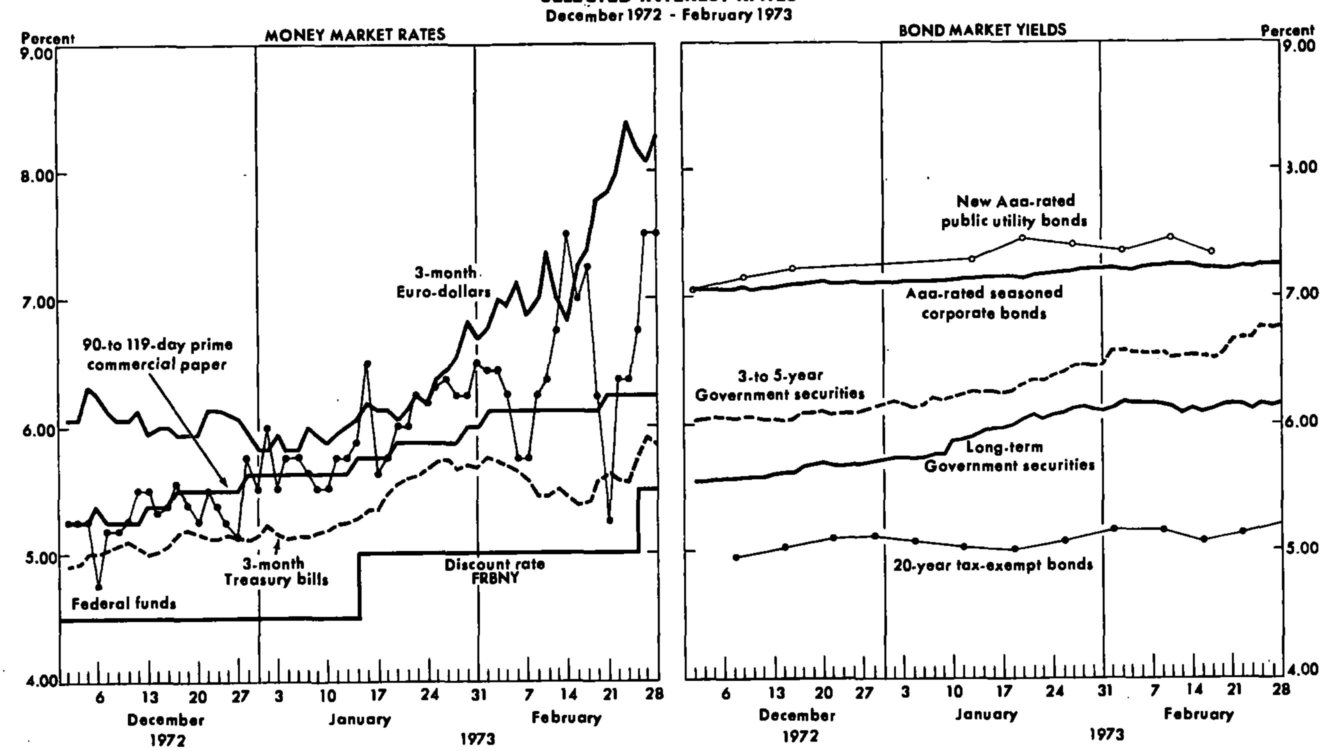
BANK RESERVES AND THE MONEY MARKET

Money market conditions generally continued to grow firmer in February, although rates fluctuated widely. The effective rate on Federal funds averaged 6.58 percent, up from 5.94 percent in January. In the first week of February the effective Federal funds rate averaged 6.21 percent. The rate climbed sharply during the following statement week, averaging 6.58 percent but reaching 7½ percent on Wednesday, February 14 (see Chart I), as foreign exchange flows complicated reserve management. As the week progressed the Federal Reserve was unable to provide reserves in sufficient volume through open market operations because of the small floating supply of Government securities in the market. The technical condition of the market reflected the prior investment in Treasury securities of a portion of the massive accumulation of dollars by the German and Japanese central banks in the first nine days of February as they defended the exchange rate limits established in the December 1971 Smithsonian agreement. On the evening of February 12, Secretary of the Treasury Shultz announced that President Nixon would ask the Congress to devalue the dollar 10 percent.

The massive flow of dollars from commercial banks to foreign central bank accounts in the second statement week threatened a substantial drain of reserves from the banking system. But the Treasury, which absorbed the major part of these funds through sales of special issues, made a record redeposit of $3 billion with the Class C bank depositories on February 14. The remainder was returned to bank reserves through foreign purchases of Treasury bills in the market. This buying, however, sharply reduced market supplies so that the Trading Desk was unable after the holiday weekend to provide reserves in sufficient volume to counter the cumulative reserve deficiencies of the major banks. Accordingly, Federal funds traded at rates as high as 8½ percent on the final day of the week, and borrowings at the discount window rose to nearly $2.8 billion.

Against this background, on February 14 the Trading Desk indicated its intention to supply funds through seven-day repurchase agreements for the following statement week. Although the Federal Reserve moved aggressively to provide reserves, the high Federal funds rate persisted as banks built up substantial reserve excesses over the sec-

Chart I
SELECTED INTEREST RATES
December 1972 - February 1973



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 five 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 Aaa-rated public utility bonds are based on prices asked by underwriting syndicates, adjusted to make them equivalent to a standard Aaa bond of at least twenty years' maturity; 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, Inc., and The Bond Buyer.

ond long holiday weekend. These excesses pushed the rate down sharply after the weekend, but the Federal funds rate averaged 6.79 percent for the week as a whole.

On February 23 the Board of Governors of the Federal Reserve System approved a ½ percentage point increase in the discount rate to 5½ percent at four Reserve Banks. This action was taken against the background of the strong credit demands generated by the rapid economic expansion, and the resultant rise in short-term market interest rates, and also in view of the developments in the foreign exchange markets. Similar increases in the discount rate at the eight remaining Reserve Banks were approved shortly thereafter. By the final statement week of February, average daily borrowed reserves had declined somewhat from the high levels seen at the peak of the exchange rate speculation at midmonth. However, borrowings of $1,479 million (see Table I) were still above the $1,309 million in the January 31 statement week.

According to preliminary estimates, the narrowly defined money supply (M_1)—adjusted private demand deposits plus currency outside banks—grew at a seasonally adjusted annual rate of about 6 percent in February, after having declined slightly during January. This brought the three-month growth in M_1 to 6½ percent at an annual rate and the twelve-month growth to 7½ percent (see Chart II). The growth of commercial bank time deposits other than large certificates of deposit (CDs) slowed so that the broadly defined money supply (M_2), which adds these time deposits to M_1, expanded at a 6 percent rate in February. For the three months ended in February, M_2 advanced at an 8 percent rate, and the increase over the year-earlier level was 9½ percent.

The adjusted bank credit proxy—which consists of daily average member bank deposits subject to reserve requirements plus liabilities to foreign branches and bank-related commercial paper—climbed sharply at a 16 percent rate in February. CDs continued to increase rapidly, as the banks sought to meet both strong domestic credit demands and those related to the foreign exchange crises. Yields offered by banks on new CDs reportedly reached the 6½ percent area by the month end for ninety-day maturities, and approached the 6¾ percent area for six-month maturities. The adjusted bank credit proxy has increased at rates of about 12½ percent over the past three- and twelve-month periods.

The demand for bank credit, particularly business loans, continued to expand rapidly in February. In addition to the increased demands for credit to finance expanding economic activity, there were some special factors contributing to the large increase in business loans. These included the demand for speculative funds with which to purchase foreign currencies, and the attraction of the relatively low bank prime rate compared with the cost of raising funds through commercial paper.

Early in February four commercial banks had raised their prime lending rate by ¼ point to 6¼ percent but shortly thereafter rescinded the increase after the Committee on Interest and Dividends requested justification. In requesting the explanation of the prime lending rate increase in terms of the banks' recent changes in costs and earnings, the Committee reiterated its view that "higher marginal costs of funds from sensitive market sources should not be permitted to unduly influence institutional lending rates". On February 23, after examining data submitted by one of the banks, the Committee removed its objection to a ¼ percentage point increase in the prime rate. On February 26, most major banks increased their prime rate to 6¼ percent.

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, FEBRUARY 1973

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

Factors	Changes in daily averages—week ended				Net changes
	Feb. 7	Feb. 14	Feb. 21	Feb. 28	
"Market" factors					
Member bank required reserves	+ 416	+ 62	+ 95	+ 224	+ 797
Operating transactions (subtotal)	+ 427	— 903	+ 510	— 454	— 420
Federal Reserve float	+ 944	— 426	+ 546	— 15	+1,049
Treasury operations*	— 336	— 211	+ 730	— 555	— 372
Gold and foreign account	+ 1	— 13	+ 20	— 102	— 94
Currency outside banks	— 121	— 480	— 708	+ 310	— 999
Other Federal Reserve liabilities and capital	— 61	+ 227	— 78	— 93	— 5
Total "market" factors	+ 843	— 841	+ 605	— 230	+ 377
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	—1,020	+ 110	+ 647	— 62	— 325
Outright holdings:					
Treasury securities	— 438	— 21	+ 199	+ 381	+ 121
Bankers' acceptances	+ 3	— 7	+ 6	— 5	— 3
Federal agency obligations	—	—	—	— 7	— 7
Repurchase agreements:					
Treasury securities	— 503	+ 94	+ 262	— 261	— 408
Bankers' acceptances	— 39	+ 32	+ 130	— 117	+ 6
Federal agency obligations	— 43	+ 12	+ 50	— 53	— 34
Member bank borrowings	— 78	+ 759	— 321	— 191	+ 169
Other Federal Reserve assets†	— 51	+ 14	— 675	+ 29	— 683
Total‡	—1,149	+ 883	— 349	— 225	— 840
Excess reserves‡	— 306	+ 41	+ 258	— 446	— 453
	Daily average levels				Monthly averages
Member bank:					
Total reserves, including vault cash‡	31,834	31,826	31,976	31,306	31,736§
Required reserves	31,687	31,632	31,530	31,306	31,539§
Excess reserves‡	147	188	446	—	195§
Borrowings	1,232	1,993	1,670	1,479	1,594§
Free, or net borrowed (—), reserves	—1,085	—1,803	—1,244	—1,479	—1,403§
Nonborrowed reserves	30,602	29,833	30,306	29,827	30,142§
Net carry-over, excess or deficit (—)‖	201	112	74	252	160§

Note: Because of rounding, figures do not necessarily add to totals.

* Includes changes in Treasury currency and cash.

† Includes assets denominated in foreign currencies.

‡ Adjusted to include $279 million of certain reserve deficiencies on which penalties can be waived for a transition period in connection with bank adaptation to Regulation J as amended effective November 9, 1972. (The adjustment amounted to $450 million from November 9 through December 27, 1972.)

§ Average for four weeks ended February 28.

‖ Not reflected in data above.

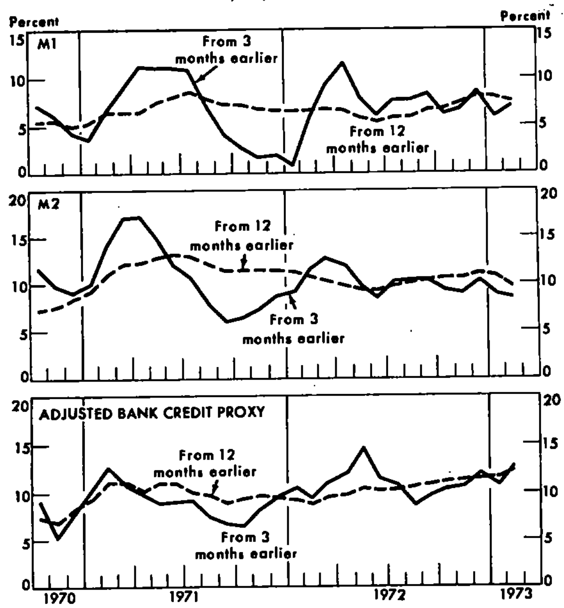
THE GOVERNMENT SECURITIES MARKET

While other money market rates rose during the first half of February, Treasury bill rates declined. Foreign central banks made large purchases of Treasury bills with the dollars they had acquired from speculators. Marketable United States Government securities held in custody by the Federal Reserve Banks for foreign and international accounts increased $2.5 billion in the first two weeks of February to a record $32.7 billion on February 14. By February 28 this figure had declined to $32.1 billion, still

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates



Note: Data for February 1973 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 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 the Federal Reserve Bank of New York.

$1.9 billion above the level at the end of January. Furthermore, the Treasury sold an additional $5.6 billion of nonmarketable issues, mostly to foreign central banks, by mid-February. Reflows of some speculative funds caused liquidation of about $700 million of these issues in the next two weeks. These nonmarketable securities totaled $25.4 billion at the end of February, a net increase of $4.9 billion for the month. The three-month Treasury bill rate declined during the first half of February. Once foreign demand was removed, however, Treasury bill rates rebounded sharply, spurred by increases in the Federal funds rates and other short-term market rates.

The pattern of weekly auctions of Treasury bills reflected the speculation prior to the devaluation announcement and the subsequent dollar reflows. The average issuing rate for three-month bills fell from 5.69 percent at January's last auction to 5.42 percent at the February 9 auction (see Table II). It subsequently rose to 5.81 percent at the February 26 auction. At the February 22 auction $1.8 billion of one-year bills was sold at an average issuing rate of 6.05 percent, 7 basis points above the January 26 offering. The $1.8 billion sale raised $100 million in new cash in addition to replacing $500 million of discontinued nine-month bills and $1.2 billion of one-year bills coming due.

Yields on United States Treasury coupon securities were relatively steady through midmonth but rose toward the month end. Renewed fears of inflation were sparked by reports of sharply higher wholesale and retail food prices and by statements from the Administration that these increases could be expected to continue for several months before leveling off. It also appeared that the devaluation of the dollar would increase the costs of imported goods, though imports are only 6 to 7 percent of gross national product. Perhaps more important for the domestic price outlook is the reduction in foreign competition with domestic products and the improved competitiveness of United States export food commodities. Bond market participants concluded that a more restrictive monetary policy was likely to be needed, and this view was reinforced by the testimony of the Federal Reserve Chairman and others before the Congressional Joint Economic Committee. Chairman Burns indicated that greater moderation in the provision of money and credit would be necessary in 1973 and that the Federal Reserve must "avoid efforts to hold open market interest rates at artificially low levels".

Two new Treasury coupon issues were sold early in the month. In the auction of $1 billion of 6⅝ percent 6¾-year notes, public participation was weaker than anticipated, resulting in an average auction yield of 6.74 percent. There was considerable attrition, as expected, in the exchange offering of new 6½ percent 3½-year notes. About $2.5 billion of the $4.7 billion of maturing February 15 notes held by the public was exchanged.

Federal agency financing was stepped up in February. Offerings of the Federal Home Loan Banks and the Federal Intermediate Credit Banks were well received by investors. An offering of two issues of the Federal National Mortgage Association toward the month end encountered considerable investor resistance, however.

OTHER SECURITIES MARKETS

The corporate bond market was steady in the early part of February, but some weakness developed in the final two weeks. The extremely light corporate new-issue calendar prompted good underwriter bidding, although investor interest was restrained somewhat by renewed fears of inflation, the devaluation, and rising short-term rates.

Only about $12 million of an aggressively priced $50 million issue of a Bell Telephone System subsidiary was sold while held in syndicate at 7.30 percent. A week later the remainder of this Aaa-rated debt was released from syndicate restrictions and sold out at about 7.41 percent. Similarly, two thirty-year maturity electric utility offerings of $100 million and $150 million brought only limited buyer interest. The $150 million issue, rated A by Moody's and BBB by Standard and Poor's, was originally offered at 7.70 percent but sold at 7.90 percent when syndicate restrictions were lifted. Later in the month there were no significant new corporate bond offerings. By the end of February, Moody's index of Aaa-rated seasoned corporate bonds had risen to 7.24 percent, compared with 7.20 percent on January 31.

In the tax-exempt bond market, a relatively light February calendar of new issues facilitated bond distributions, and new municipal offerings sold quickly during the first two weeks. As in the new-issue corporate market, however, buyers held back in the latter part of the month amid continuing foreign exchange rate uncertainty and rapid changes in short-term interest rate trends. The Blue List of advertised inventories of municipal bonds declined to $807 million on February 28, compared with $905 million on January 31. The Bond Buyer index of twenty municipal bond yields rose 6 basis points during February to 5.22 percent on March 1.

Table II

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates — February 1973			
	Feb. 5	Feb. 9	Feb. 16	Feb. 26
Three-months	5.665	5.424	5.455	5.811
Six-months	5.849	5.624	5.653	6.045
	Monthly auction dates—December 1972-February 1973			
	Dec. 26	Jan. 26	Feb. 22	
Fifty-two weeks	5.337	5.986	6.051	

* 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.