The Money and Bond Markets in September

After edging up early in the month, interest rates generally declined dramatically during the second half of September as market pressures cooled and evidence mounted that the growth of the monetary aggregates was slowing. During the final two weeks of the period, participants became convinced that monetary policy was turning toward a less restrictive stance and, against this background, rates on most money market instruments moved lower. Rates on most maturities of commercial paper decreased by ½ to ⅞ percentage point over the month and rates on large-denomination certificates of deposit (CDs) fell significantly toward the end of the period. The average effective rate on Federal funds remained about unchanged from the previous month. Earlier in the month, the Federal Reserve raised marginal reserve requirements on large CDs, bank-related commercial paper, and finance bills in a further step to control the rapid expansion of bank credit. This measure increased the cost of such funds to banks and was followed by a boost in the prime lending rate to large business borrowers to 10 percent from 9¾ percent.

The rally in the United States Government securities market which began in the middle of August continued throughout September, except for one brief but sharp downturn in conjunction with the announcement of the increase in reserve requirements. Treasury bill rates declined sharply over the second half of the month to levels that had last prevailed in June. Prices of Treasury coupon securities advanced considerably over most of the month. Inventories were light, and reactions to shifting expectations were dramatic. Prices of Federal agency securities also increased during September despite a continued heavy calendar of new issues. New issue activity in the corporate and municipal bond markets was modest, and prices of older outstanding corporate and tax-exempt securities also rose over much of the month.

In September, the narrow money supply (M_1)—demand deposits adjusted plus currency outside banks—contracted for the second consecutive month. M_2, which includes time and savings deposits other than large CDs, expanded considerably less rapidly in September than it had in August. The slowing in the growth of these deposits together with a slackening in the rise of large CDs contributed to the moderation in the growth of the adjusted bank credit proxy compared with its growth over the past few months.

BANK RESERVES AND THE MONEY MARKET

Short-term interest rates generally held steady during the first three weeks of September, but dropped rapidly late in the month (see Chart I). The rate on 90- to 119-day commercial paper fell ⅞ percentage point to close the month at 9⅝ percent. Rates on bankers' acceptances also moved lower in September, falling ¾ percentage point over the month. The average effective rate on Federal funds was fairly steady throughout September. In the statement week ended September 26, the effective rate on Federal funds averaged 10.84 percent in comparison with the 10.79 percent average of the August 29 statement week. However, member bank borrowings from the Federal Reserve, although still sizable, declined from the very high $2.14 billion averaged in August to $1.94 billion in September (see Table I).

With corporate cash needs seasonally high in September, reflecting tax and dividend payment dates, the demand for bank credit continued strong. A large volume of CDs held by corporations matured on or before September 15, providing some of the necessary liquidity. Rates on large CDs remained high over the first half of the month but declined thereafter. At the month's end, three-month CD rates in the secondary market were around 9½ percent, down about 1½ percentage points over the month. However, the effective cost to commercial banks of acquiring funds through CDs was increased as a result of a boost in marginal reserve requirements applicable to such deposits. In a further effort to curb the rapid expansion of bank credit, the Board of Governors of the Federal Reserve System on September 7 announced an increase in the marginal reserve requirements on large-denomination CDs, bank-related commercial paper, and finance bills. The action raised the reserve requirement on increases in the level of these liabilities since the week ended May 16 from 8 percent to 11 percent, effective September 20. Member banks are required to maintain the additional reserves in the statement week beginning October 4. A 5 percent reserve requirement continues to be applied to CDs and commercial paper up to the quantity outstanding in the statement week ended May 16. The 11 percent marginal reserve requirement does not apply to banks with a combined total of less than $10 million of CDs and bank-related commercial paper outstanding. This is the second time this year that the Federal Reserve has resorted to increasing the marginal reserve requirements on these liabilities.

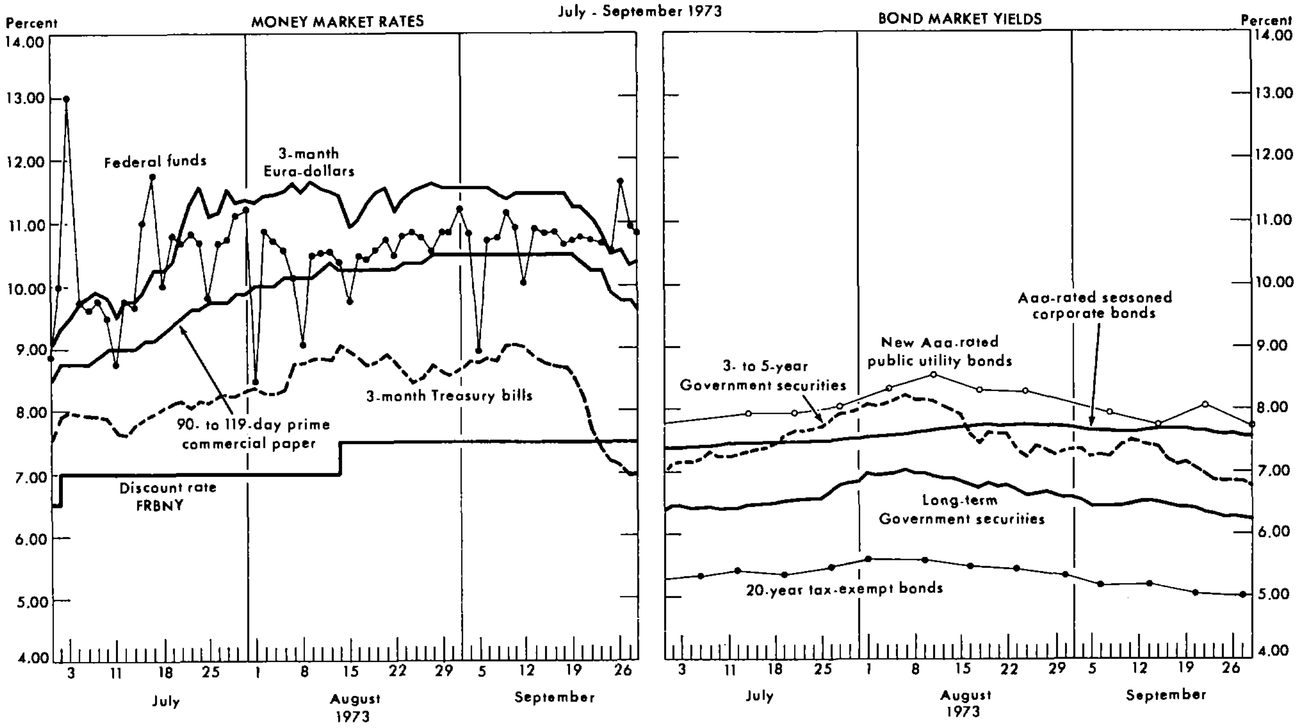
Commercial banks increased their prime lending rate for large business borrowers by ¼ percentage point to 10 percent in the statement week ended September 19. With the gap between the prime rate and commercial paper rates slowly narrowing, corporations began to find the commercial paper market a more attractive source of funds. The volume of dealer-placed nonbank-related commercial paper outstanding, after declining steadily over the year to a low of $7.5 billion in mid-August, rose modestly throughout September.

The latest data confirm that the growth of most of the monetary aggregates has slackened considerably in recent months after a prolonged period of rapid expansion. Pre-

Chart I

SELECTED INTEREST RATES

July - September 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-rated 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.

liminary estimates indicate that M_1 declined in September for the second consecutive month. During the past three months, M_1 has shown virtually no growth (see Chart II). Over the twelve months ended in September, M_1 increased by 5¼ percent. The growth of time deposits other than large negotiable CDs slowed in September, after having been buoyed in August by the increase in interest rate ceilings on consumer time and savings deposits and the abandonment of ceiling restrictions on deposits of maturities of four years or more. The combined effect of the expansion of these time deposits and the decline in M_1 resulted in an advance of the broad money supply (M_2) at an annual rate of about 2½ percent in September. This is well under the pace of expansion experienced over the twelve months ended in September.

The adjusted bank credit proxy—which consists of daily average member bank deposits subject to reserve requirements and certain nondeposit liabilities—expanded at an estimated 5½ percent seasonally adjusted annual rate in September. This is considerably slower growth than the 13 percent advance over the last twelve months. The growth of large CDs decelerated markedly in September, as such deposits increased at a rate of less than 4 percent. In comparison, over the first eight months of 1973 large CDs expanded at an explosive 82.6 percent annual rate. Reserves available to support private nonbank deposits advanced at an annual rate of about 13½ percent in September.

THE GOVERNMENT SECURITIES MARKET

Treasury bill rates declined over much of September, and fell dramatically in the latter days of the month. Throughout the period, the market was very sensitive to actions of the Federal Reserve. Early in the month, market sentiment was jolted by the Federal Reserve's announcement of an increase in reserve requirements on large CDs, bank-related commercial paper, and finance bills. Rates rose sharply and, in fact, new interest rate peaks for some issues were established. The rise in yields was short-lived, however, as a much firmer tone developed around midmonth. Shortly thereafter, the rally gained momentum when market participants interpreted a purchase of bills by the Federal Reserve for both customer and System accounts as an indication that monetary policy was becoming less restrictive. In a flurry of spirited activity, the rate on three-month bills declined by about 177 basis points over the second half of the month. For the month as a whole, secondary market rates on most Treasury bills were about 76 to 170 basis points below their opening levels. These sharp declines contrast with the

Table I

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

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

Factors	Changes in daily averages—week ended				Net changes
	Sept. 5	Sept. 12	Sept. 19	Sept. 26	
"Market" factors					
Member bank required reserves	+ 29	+ 231	— 305	— 350	— 395
Operating transactions (subtotal)	— 34	+2,913	— 300	—1,703	+ 876
Federal Reserve float	— 282	+1,652	+ 414	—1,259	+ 525
Treasury operations*	+ 570	+1,102	— 343	— 978	+ 351
Gold and foreign account	+ 15	— 65	— 28	— 9	— 87
Currency outside banks	— 204	— 211	— 144	+ 545	— 14
Other Federal Reserve liabilities and capital	— 133	+ 435	— 199	— 2	+ 101
Total "market" factors	— 5	+3,144	— 605	—2,053	+ 481
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 530	—2,683	+ 356	+1.438	— 359
Outright holdings:					
Treasury securities	+ 300	—2,345	+ 494	+1,339	— 212
Bankers' acceptances	— 2	— 6	— 3	—	— 11
Special certificates	—	+ 131	+ 6	— 137	—
Federal agency obligations	— 11	— 14	— 15	—	— 40
Repurchase agreements:					
Treasury securities	+ 162	— 288	— 116	+ 170	— 72
Bankers' acceptances	— 11	— 18	— 3	+ 24	— 8
Federal agency obligations	+ 92	— 143	— 7	+ 42	— 16
Member bank borrowings	— 194	— 876	+ 219	+ 484	— 367
Seasonal borrowings†	— 17	— 23	— 6	+ 11	— 35
Other Federal Reserve assets‡	+ 33	+ 53	+ 67	+ 39	+ 192
Total§	+ 366	—3,504	+ 642	+1.960	— 536
Excess reserves‡	+ 361	— 360	+ 37	— 93	— 55

	Daily average levels				Monthly changes
Member bank:					
Total reserves, including vault cash‡	34.128	33,537	33,879	34.136	33,920‖
Required reserves	33.644	33.413	33,718	34.068	33,711‖
Excess reserves§	484	124	161	68	209‖
Total borrowings	2,364	1,488	1,707	2,191	1,938‖
Seasonal borrowings†	168	145	139	150	151‖
Nonborrowed reserves	31,764	32,049	32,172	31,945	31,983‖
Net carry-over, excess or deficit (—)‡‡	157	92	27	24	75‖

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

* Includes changes in Treasury currency and cash.

† Included in total member bank borrowings.

‡ Includes assets denominated in foreign currencies.

§ Adjusted to include $112 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, $279 million from December 28, 1972 through March 28, 1973, and $172 million from March 29 through June 27, 1973.

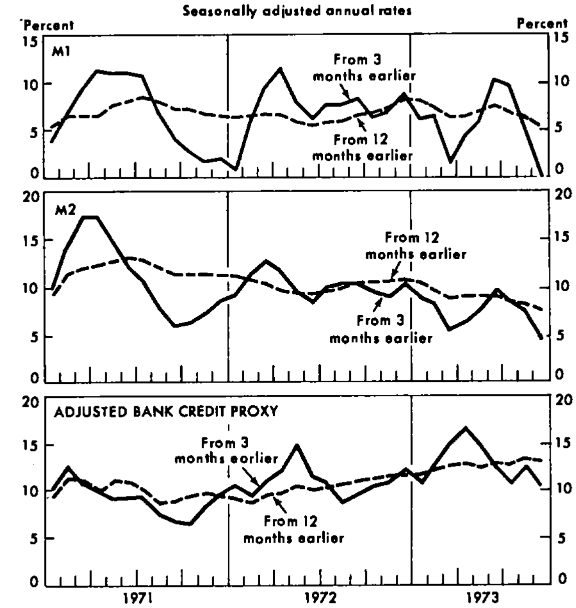
‖ Average for four weeks ended September 26.

‡‡ Not reflected in data above.

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates



Note: Data for September 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.

more modest reductions in some other short-term rates in September.

After a record yield was established for the three-month bill in the September 10 weekly auction, rates declined sharply (see Table II). In the September 24 auction, average issuing rates on the three- and six-month issues were 145 and 107 basis points lower, respectively, than the rates set in the auction of August 31. The yield on 52-week bills in the monthly auction held September 19 was 8.06 percent, about 33 basis points below the rate established at the previous month's auction.

Prices of Treasury coupon securities advanced during much of September. Good technical position and improved investor demand served to support the longer term market. The evident slowing in the growth of the monetary aggregates led to expectations that monetary policy would become less restrictive and consequently that interest rates were at or near their peaks. The improvement in the United States balance of payments and the dollar's better performance in the exchange markets contributed to the firm market atmosphere. Over the month, yields on most three- to five-year issues declined by an average of 58 basis points, while yields on longer term issues generally fell by about 36 basis points.

Prices of Federal agency securities rose appreciably during September despite a substantial volume of new issues. Investor demand was strong in this sector, in part because the positive spread between yields on agency and Treasury issues has widened. Federal agency financing, particularly from the housing support agencies, has been heavy throughout 1973. During the first eight months of the year, agency financings were 87 percent above the level of the comparable period a year earlier. In September, the market for agency issues benefited from the good overall technical position of the capital markets and from the sentiment that interest rates had peaked. Early in the month, the Federal Home Loan Bank Board announced an offering consisting of $500 million each of four-month, seventeen-month, and 56-month securities. The three maturities were priced to yield 9.38 percent, 8.70 percent, and 7.60 percent, respectively. These securities, which raised $1.5 billion of new money, experienced good initial investor demand but subsequently traded at discounts during the weakening market of the second week of the month. Also during the second week, the farm credit agencies announced a $1.5 billion financing, consisting of $306 million of five-month bonds, $302 million of six-month bonds, $200 million of 42-month debentures, and $699 million of nine-month bonds. These issues, priced to yield 9.90 percent, 9.85 percent, 7.70 percent, and 9.75 percent, respectively, quickly rose to premiums. Later in the month, the Federal National Mortgage Association marketed $500 million of fifty-month debentures priced to yield 7.55 percent and $400 million of 83-month bonds priced to yield 7.50 percent. These issues met a favorable reception.

OTHER SECURITIES MARKETS

Prices of corporate and municipal securities increased on balance during September. The advance was interrupted briefly by the additional measures instituted by the Federal Reserve to curb the expansion in bank credit. Thereafter, the corporate bond market was aided by the strength of the Treasury coupon sector, and prices moved higher. The technical condition of the corporate sector was excellent, and the price increases in this sector undoubtedly stemmed, in part, from the prolonged scarcity of new issues. Thus far in 1973 there has been about a 40 percent reduction in the volume of new corporate securities offered publicly by comparison with the 1972 level.

Most new issues marketed in September carried yields well below similar securities offered in August. On September 5, $25 million of A-rated public service bonds priced to yield 8.13 percent sold out quickly. The same day, however, an A-rated power company issue attracted only modest interest when aggressively priced to return 8.10 percent. This yield was 70 basis points less than that of a similar issue marketed one-month earlier. On September 11, $150 million of forty-year Aaa-rated Bell System debentures encountered a lukewarm reception. The issue was originally priced to yield 7.85 percent, 35 basis points lower than a similar issue marketed three weeks earlier; however, when syndicate price restrictions were removed, the yield rose 17 basis points. In subsequent trading later in the month, the issue recovered virtually all of this price loss. During the middle of the month $75 million of Aaa-rated first mortgage bonds, priced to yield 8.02 percent in thirty years, was initially afforded only a fair reception, but subsequently the bonds were swept up in the rally which pervaded the capital markets. Several aggressively priced smaller issues marketed later in the month experienced heavy investor demand.

Prices of tax-exempt securities also moved higher during the month. The stable tone experienced throughout the period was attributed, in part, to a relatively light supply of new issues. Of course, this market also reacted to changes in the participants' views of Federal Reserve policy. Prior to the increase in reserve requirements, a $75 million issue of Aa-rated bonds attracted excellent demand when priced to return from 4.50 percent in 1977 to 4.65 percent in 1984. The buoyant atmosphere which developed in the capital markets during the final two weeks of September helped to generate good demand for several high-quality issues. On September 26, $292.7 million of Aaa-rated bonds was reoffered to yield from 4.20 percent in 1974 to 5.15 percent in 2014—about 15 to 20 basis points below the returns provided by the same borrower in June. On the same day, a power authority offered $110 million of A-1 rated debentures scaled to yield from 4.85 percent in 1986 to 5.44 percent in 2010. These issues were quickly sold. The Bond Buyer index of twenty tax-exempt bond yields fell from 5.34 percent on August 30 to 5.00 percent on September 27. The Blue List of dealers' advertised inventories rose $226.5 million over the month to $711.5 million.

Table II

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—September 1973		
	Sept. 10	Sept. 17	Sept. 24
Three-month	9.016	8.786	7.331
Six-month	8.921	8.832	7.661
	Monthly auction dates—July-September 1973		
	July 24	Aug. 22	Sept. 19
Fifty-two weeks	8.393	8.388	8.057

* 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.