The Money and Bond Markets in February

Interest rates fell considerably in early February, but sharp yield increases toward the end of the month erased much of the earlier declines. In the money market, downward pressure on rates emerged as market participants observed a greater availability of reserves in the banking system early in the month and projected a further easing of monetary policy. Although revisions of these projections caused some rates to rise toward the close of the month, the rate on four- to six-month commercial paper dropped 50 basis points over the course of the month, while the average effective rate on Federal funds fell 68 basis points below its January average. These declines were accompanied by three ¼ percentage point reductions in the commercial bank prime lending rate on loans to large business borrowers. As a result, the prime rate closed the month at 8¾ percent, its lowest level since July 30, 1973.

Early in the month the easing of money market conditions provided a firm undertone for the Government securities market, and the rally which began late in January gathered strength. Treasury bill rates and yields on intermediate-term coupon issues dropped sharply in the first statement week of the month, and the Treasury's refunding operation was highly successful. The downward movement of long-term rates was more restrained, however, as investors remained concerned about the future course of inflation and the longer run outlook for interest rates. The rally subsequently faded in the wake of Chairman Burns's Congressional testimony which was interpreted as indicating that the apparent easing of monetary policy would not be pushed further. Near the end of the month, market participants began to press their accumulated positions on the market and yields rose. Long-term corporate and municipal bond yields also rose. Over the month, the Federal Reserve Board's index of yields on newly issued Aaa-rated utility bonds increased 4 basis points to 8.30 percent and The Bond Buyer index of municipal bond yields rose 6 basis points to 5.26 percent.

Available data suggest that the seasonally adjusted narrow money supply (M_1)—private demand deposits adjusted plus currency outside commercial banks—grew substantially in the first three statement weeks of February following the decline experienced in January. Time and savings deposits at commercial banks, other than large negotiable certificates of deposit (CDs), apparently grew at a fairly rapid rate over the first three weeks of February as well. Consequently, the broad money supply (M_2)—M_1 plus consumer-type time and savings accounts at commercial banks—rose sharply. However, the adjusted bank credit proxy, which includes all deposits of member banks plus certain nondeposit liabilities, appears to have experienced a slight decline in the three-statement-week interval ended February 20, as increases in private deposits were offset by a fairly large decline in Government balances at commercial banks.

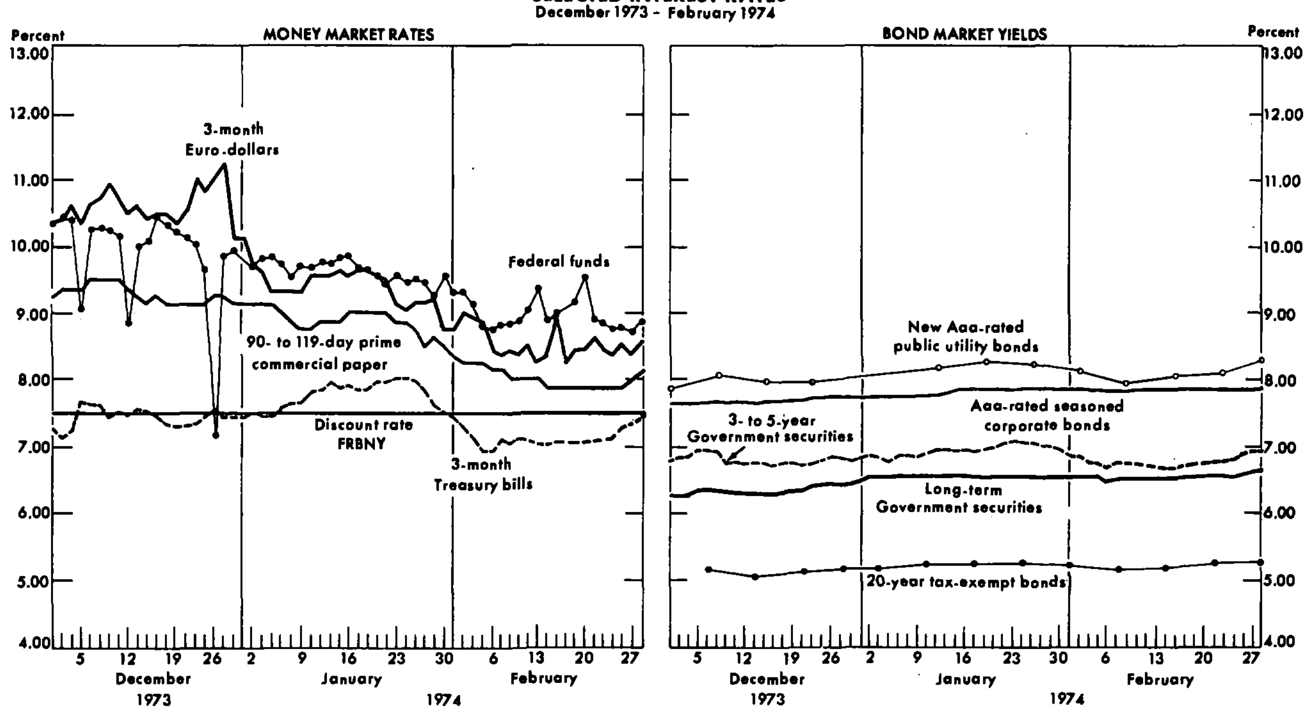
THE MONEY MARKET, BANK RESERVES, AND THE MONETARY AGGREGATES

Rates on most money market instruments continued to fall sharply early in February but then rose somewhat over the remainder of the month (see Chart I). For the month as a whole, the effective rate on Federal funds averaged 8.97 percent, 68 basis points below January's average and its lowest level since June 1973. The bid rate on bankers' acceptances closed the month at 8⅛ percent, down from a level of 8⅞ percent at the end of January. In the commercial paper market, rate declines on directly placed and dealer-placed paper ranged from 25 to 75 basis points. In line with the drop in other money market rates, most major commercial banks reduced their prime lending rates to large business borrowers in three ¼ percentage point steps to 8¾ percent. Member bank borrowings from the Federal Reserve System, however, edged upward in February (see Table I), after declining over the five preceding months.

According to available data, both M_1 and M_2 rose rapidly in the first three statement weeks of February, but the bank credit proxy declined slightly. Since short-run changes in these monetary aggregates are often influenced by random unpredictable movements that belie underlying

Chart I

SELECTED INTEREST RATES
December 1973 - February 1974



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.

trends, it is useful to consider the behavior of the monetary aggregates within a longer run perspective. Over the last year the growth of M_1, for example, has slowed appreciably. Seasonally adjusted daily average M_1 from the four-week interval ended mid-February 1973 to the four-week interval ended February 20, 1974 rose 5.4 percent (see Chart II). This represents a 3 percentage point deceleration in M_1 growth from that experienced over the preceding year. During the same period, the rate of change of M_2 fell 1.6 percent from its rate of growth in the preceding year to 8.7 percent.

With short-term interest rates declining, banks reduced offering rates on large negotiable CDs and still attracted a substantial volume of funds through this instrument. The offering rate on three-month CDs in the secondary market declined 80 basis points to 8.07 percent by the end of February despite some increase in the rate toward the close of the month. On a seasonally adjusted annual basis, CDs grew at the rapid rate of 40.1 percent in the four statement weeks ended February 20, compared with the preceding four-statement-week period. From December 12, when the marginal reserve requirement on CDs was lowered to 8 percent, through February 20, CDs grew at a seasonally adjusted annual rate of about 29 percent, compared with the seasonally adjusted decline of CDs outstanding at virtually the same rate while the 11 percent marginal reserve requirement was in effect from September 19 through

December 12. Despite this resurgence of CD growth, the increase of the adjusted bank credit proxy has remained moderate, with its recent growth inhibited by the rundown of Government deposits at commercial banks. Relative to its four-week average level in the period ended thirteen weeks earlier, the proxy grew at a seasonally adjusted annual rate of 6.5 percent over the four-week interval ended February 20. This is an acceleration from the rate of increase experienced by the proxy in the preceding thirteen-week interval, but it is well below the growth rates of the proxy experienced in early 1973.

THE GOVERNMENT SECURITIES MARKET

As February began, a major rally was in progress in the market for United States Treasury obligations. The rally had been sparked in late January by signs that some easing of monetary policy was in progress. These indications were reinforced by further injections of reserves by the Federal Reserve System in early February. In addition, market sentiment was bolstered by the removal of restrictions on foreign capital flows, including the interest equalization tax, and the terms of the Treasury's February refunding. The latter development was viewed positively since the Treasury announced plans to pay down about $0.5 billion of debt.

In this environment, rates on Treasury bills dropped sharply during the initial statement week of the month. Bidding was very aggressive at the first regular weekly auction in February, and the average issuing rates on the new three- and six-month bills fell to 6.95 percent and 6.75 percent, respectively (see Table II), their lowest levels since May 1973. Together with the yield declines registered at the preceding week's auction, these decreases brought the three- and six-month auction rates down more than 100 basis points from their levels of mid-January and more than 200 basis points below their peaks of August 1973. Some profit taking emerged shortly after the auction, but the market firmed prior to the monthly sale of 52-week bills. This issue was auctioned at an average rate of 6.34 percent, down 61 basis points from the January issuing rate. Subsequently, the market softened in the wake of Chairman Burns's testimony before Congress which was interpreted as indicating that monetary policy would not ease significantly further. The auction on February 26 of $1.5 billion of tax anticipation bills due April 19, 1974 drew only routine bidding and the average issuing rate was set at 7.45 percent. With the rise of rates toward the end of February, the market yield on the three-month bill closed the month only 2 basis points below its end-of-January level and the yields on the six-month and 52-week

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, FEBRUARY 1974

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

Factors	Changes in daily averages— week ended				Net changes
	Feb. 6	Feb. 13	Feb. 20	Feb. 27	
"Market" factors					
Member bank required reserves	+ 529	+ 303	— 221	+ 625	+1,236
Operating transactions (subtotal)	+ 212	— 633	— 492	+ 655	— 258
Federal Reserve float	+ 36	+ 100	+ 18	+ 131	+ 285
Treasury operations*	+ 30	— 325	+ 599	+ 189	+ 493
Gold and foreign account	+ 188	+ 50	— 71	+ 67	+ 234
Currency outside banks	— 111	— 626	— 875	+ 346	—1,266
Other Federal Reserve liabilities and capital	+ 69	+ 166	— 162	— 77	— 4
Total "market" factors	+ 741	— 330	— 713	+1,280	+ 978
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	— 685	+ 270	+ 887	—1,000	— 528
Outright holdings:					
Treasury securities	— 482	+ 260	+ 382	— 373	— 213
Bankers' acceptances	+ 3	—	+ 1	+ 1	+ 5
Federal agency obligations	— 18	— 22	+ 120	— 3	+ 77
Repurchase agreements:					
Treasury securities	— 131	+ 16	+ 290	— 498	— 323
Bankers' acceptances	— 7	— 1	+ 29	— 43	— 22
Federal agency obligations	— 50	+ 17	+ 65	— 84	— 52
Member bank borrowings	— 223	+ 155	+ 224	— 122	+ 34
Seasonal borrowings†	+ 1	— 3	+ 5	— 4	— 1
Other Federal Reserve assets‡	+ 33	+ 100	— 593	— 41	— 501
Total	— 876	+ 525	+ 518	—1,163	— 996
Excess reserves‡	— 135	+ 195	— 195	+ 117	— 18

	Daily average levels				Monthly averages§
Member bank:					
Total reserves, including vault cash‡	35,475	35,367	35,393	34,885	35,280
Required reserves	35,351	35,048	35,269	34,644	35,078
Excess reserves	124	319	124	241	202
Total borrowings	998	1,153	1,377	1,255	1,196
Seasonal borrowings†	18	15	20	16	17
Nonborrowed reserves	34,477	34,214	34,016	33,630	34,084
Net carry-over, excess or deficit (—)‖	96	42	167	128	108

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.
§ Average for four weeks ended February 27, 1974.
‖ Not reflected in data above.

bills closed 13 and 5 basis points, respectively, above their end-of-January levels.

Indications of an easing in money market conditions, the favorable terms of the refunding, and the drop in bill rates prompted substantial declines in rates on intermediate-term Government securities during the early part of February. Yields on issues of more than ten years' maturity moved only modestly lower, however. On Tuesday, February 5, the Treasury auctioned $1.5 billion of seven-year 7 percent notes. Interest in this issue, part of the February refunding package, was enthusiastic, and the average issuing rate was set at 6.95 percent. Interest in the 3¼-year 6⅞ percent note offering the following day was somewhat subdued. Nonetheless, the average issue price was above par, providing a yield of 6.70 percent. Following the auction the tone of the market deteriorated somewhat in response to Chairman Burns's testimony, but the auction of $300 million of bonds due in August 1993, the final part of the refinancing, attracted strong interest. The Treasury employed the technique of awarding all of the bonds at the price of the lowest accepted bid, and the yield to maturity was set at 7.45 percent. Yields on Treasury coupon issues generally rose during the second half of the month. Yields on intermediate-term issues closed the month up about 4 to 9 basis points, while yields on issues due in ten years or more ranged from 6 to 20 basis points higher.

The market for Federally sponsored credit agency securities benefited initially from the good tone of the Government securities market which prevailed early in the month. About $2.3 billion in new agency securities was marketed in February. The early issues were well received at yields considerably below those on recent previous offerings. At the beginning of the month, one of the farm credit agencies, the Federal Land Banks, marketed $389 million of 5½-year 7.15 percent bonds. Shortly thereafter, the Federal Home Loan Banks sold $300 million of eighteen-month 6.80 percent bonds and $300 million of six-year 7.05 percent bonds. This offering represented a net paydown of about $650 million of debt, and investor interest in these issues was strong. The paydown reflected the reduced dependence of savings and loan associations upon Federal Home Loan Bank advances as a source of funds now that rapid growth of savings deposits has resumed and mortgage demand has slackened. Later in the month, the Export-Import Bank sold $400 million of five-year 7 percent debentures priced to yield 6.95 percent. This issue did not encounter a good reception, and the underwriters cut prices sharply in order to distribute the large unsold portion of the issue. A Federal National Mortgage Association $1.2 billion issue met a mixed reception as optimism faded in the final week of the month.

OTHER SECURITIES MARKETS

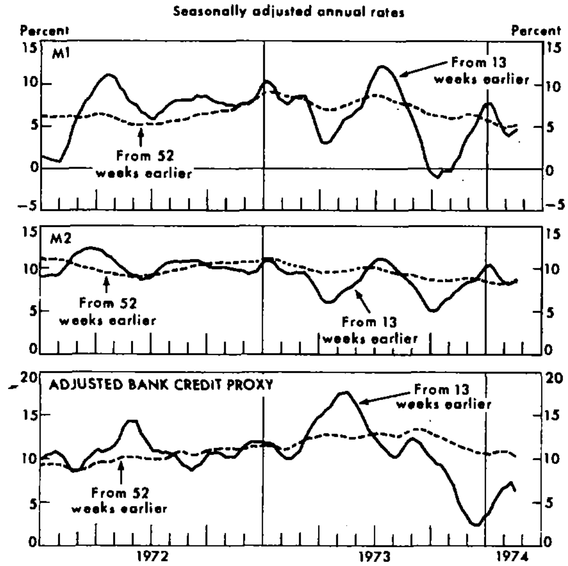
Yields on short-dated municipals declined in February. However, offerings of newly issued municipal and corporate long-term debt met stiff investor resistance when underwriters sought to attain lower rate levels, and long-term rates changed little. Investors generally felt it prudent to avoid lower yields at present, in anticipation of better buys in the future. As a result, a number of aggressively priced issues failed to attract investor attention and a substantial buildup in dealer inventories developed. This backlog of issues in inventory gradually came to weigh heavily on the market and, as the month progressed, syndicate price restrictions on a number of slow-moving issues were removed, resulting in considerable upward adjustments in yields.

The corporate bond market absorbed large volumes of intermediate-term issues in February, as manifested by the rapid sellout of three Aaa-rated bank holding company

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates



Note: Growth rates are computed on the basis of four-week averages of daily figures for periods ended in the statement week plotted, 13 weeks earlier and 52 weeks earlier. The latest statement week plotted is February 20, 1974.

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.

Source: Board of Governors of the Federal Reserve System.

note offerings. These bank note offerings represent part of an extraordinarily large volume of bank issues scheduled to be marketed in 1974. The difficulty of marketing long-term debt at lower yields became apparent early in the month when $50 million of Aa-rated twenty-year utility bonds met a poor reception when priced to yield 7.97 percent. This was about the same rate as that on an Aaa-rated utility issue sold at the end of January. Investors were somewhat more enthusiastic about an offering of $70 million of thirty-year utility bonds priced to yield 8.22 percent. Although this issue was rated Aa by one rating agency and only A by another, investors considered it comparable to the Aa-rated utility marketed earlier and bid more aggressively for it. Nonetheless, yields on both issues rose when underwriters removed syndicate restrictions later in the month. Subsequent to these issues, market attention focused upon a $300 million offering—the largest of the year to date—of forty-year 8 percent debentures of a major Bell System subsidiary. As it turned out, the Aaa-rated issue attracted only moderate interest when priced to yield 8.06 percent, 1 basis point above the yield on an Aaa-rated Bell issue sold the month before. Further evidence of the lack of interest in long-term issues materialized later in the month, as $100 million of Aaa-rated thirty-year bank holding company debentures met a poor reception when priced to yield 8.19 percent, despite the fine reception accorded the company's note offering.

In the tax-exempt market, the major long-term issues of the month also experienced relatively modest retail demand. Early in the month, $168 million of A1-rated bonds sold slowly when offered to yield from 4.20 percent in 1974 to 5.90 percent in 2015. Later in the month, two Aaa-rated municipal offerings attracted only fair receptions. In the first, $59.6 million of bonds was priced to yield from 3.75 percent in 1975 to 5.25 percent in 1994. Subsequently, a $100 million issue, priced to return from 3.75 percent in 1975 to 5.00 percent in 1994, was marketed. Syndicate restrictions had to be removed from both issues for the offerings to sell out. Although short-dated issues sold well, the Blue List of dealers' advertised inventories rose $108 million to $1,142 million by the end of the month.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—February 1974			
	Feb. 4	Feb. 11	Feb. 15	Feb. 25
Three-month	6.951	7.081	7.018	7.188
Six-month	6.747	6.882	6.787	7.081
	Monthly auction dates—December 1973-February 1974			
	Dec. 12	Jan. 9	Feb. 6	
Fifty-two weeks	6.881	6.948	6.348	

* 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.