The Money and Bond Markets in September

Pressures in the financial markets, particularly in the short-term sectors, eased in September after a summer of record-high interest rates. Market sentiment was buoyed by a drop in the Federal funds rate, a temporary reduction in the Treasury's bill sales, and the elimination of the marginal reserve requirement on large certificates of deposit (CDs) with maturities of four months or more. At the same time, the decline reported in industrial production for August reinforced judgments that the economy had cooled and that rapid growth would not resume quickly. This prospect promoted expectations that credit demands would moderate further and that the Federal Reserve might adopt a somewhat less restrictive monetary policy in the months ahead. As a result, most short-term rates fell sharply in September while yields on long-term securities edged modestly lower.

The most dramatic decline in short-term rates occurred in the Treasury securities market, where rates on Treasury bills dropped by about 135 to 325 basis points over the month. Contributing to these declines were a reduction in the supply of new bills, coupled with a high volume of noncompetitive tenders at the weekly auctions, and large purchases of marketable Treasury debt by foreign official institutions. Improvement in the long-term Treasury securities market was tempered, however, by investor hesitancy about committing funds to long-term investments as several rallies faltered for lack of investor enthusiasm.

In the corporate and municipal bond markets, the gloom of August diminished somewhat, though the long-term markets were still beset with the problem of rapid inflation. Several new issues moved to substantial premiums in trading in the secondary markets. Also, electric utility offerings improved, as two Aa-rated companies were able to sell thirty-year bonds at rates slightly below those on a similar issue in August.

According to preliminary data, the sluggish growth of most of the monetary aggregates of the last few months continued in September. M_1—private demand deposits adjusted plus currency outside banks—actually declined in the four-week period ended September 25. The growth of M_2—M_1 plus commercial banks' time deposits other than large CDs—decelerated sharply in the same period. In contrast, the volume of CDs outstanding increased after falling in August.

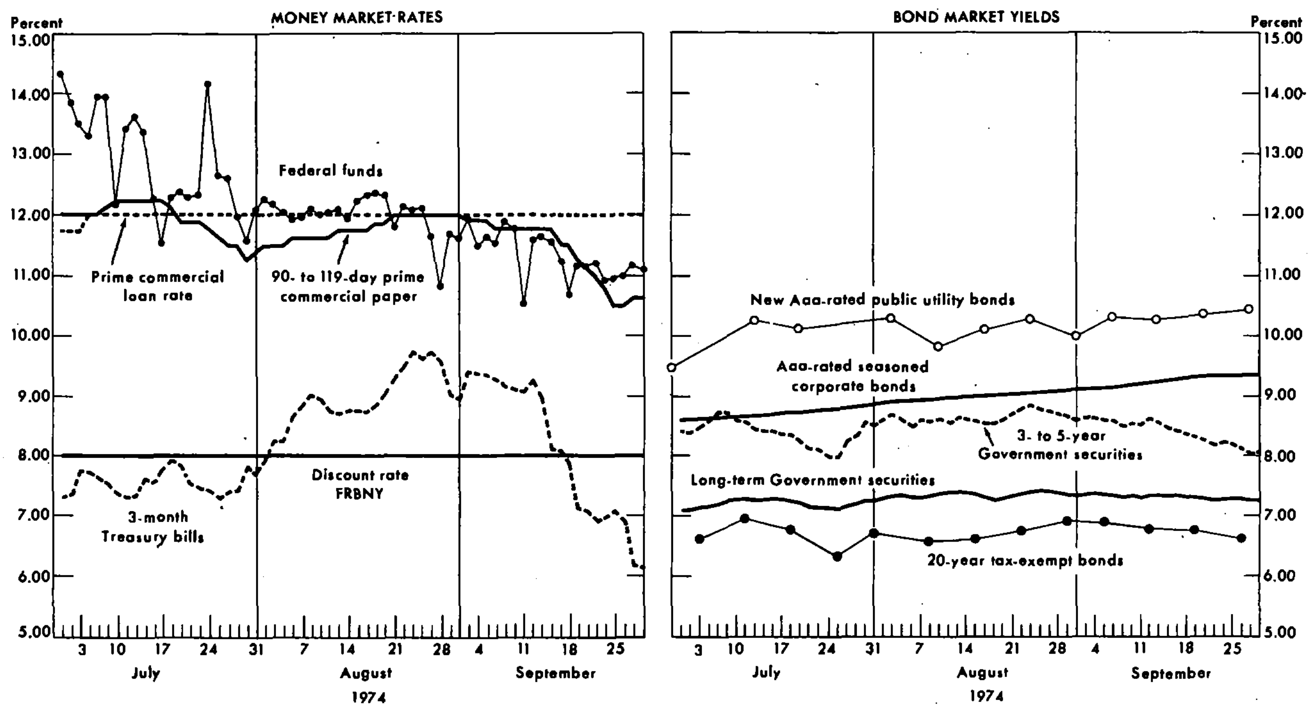
THE MONEY MARKET, BANK RESERVES, AND THE MONETARY AGGREGATES

Short-term interest rates declined across a wide front in September (see Chart I). The effective rate on Federal funds averaged 11.34 percent, 67 basis points below the August level and substantially below the record high of 12.92 percent reached in July. In the secondary market, the rate on three-month CDs fell during the month by about 1 percentage point to the 10¾ to 11 percent range. Similarly, rates on 90- to 119-day commercial paper declined from 12 percent at the end of August to 10⅝ percent at the end of September. At the same time, dealers' offering rates on bankers' acceptances showed a drop of 2 percentage points to the 9½ to 10½ percent range in generally heavy trading.

For most of September, the commercial bank prime lending rate remained at the record-high level of 12 percent reached in July. At the end of the month, however, two money market banks lowered their prime rate to 11¾ percent, owing in part to the declines in most short-term rates and the relatively modest business loan demand during the midmonth tax and international oil payment dates. Although many banks did not reduce their prime rate immediately, the 11¾ percent prime rate spread through much of the banking system in early October.

Member bank borrowings from the Federal Reserve continued relatively high in September, averaging $3.4 billion (see Table I). Late in the month, the Board of Governors of the Federal Reserve System announced that it had amended Regulation A which governs member bank borrowings. The amendment will allow Federal Reserve Banks to impose a special discount rate (higher than the regular discount rate) on member banks requiring exceptionally large, long-term assistance. The special rate

Chart I
SELECTED INTEREST RATES
July - September 1974



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Prime commercial loan rate at most major banks; 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.

will not exceed the rate established for emergency loans to nonmember banks (currently 10 percent). The special discount rate, which can be waived in individual cases, may be applied to a bank borrowing exceptionally large amounts (such as more than the bank's average required reserves) for prolonged periods (such as more than eight weeks).

According to preliminary estimates, most monetary aggregates displayed little, if any, growth in September. M_1 declined at a 1.4 percent seasonally adjusted annual rate from its average level over the four weeks ended August 28 to the average level for the four weeks ended September 25. With the growth of other time deposits advancing at a 3.6 percent rate over the same period, M_2 grew at a 1.3 percent rate. The growth of M_2 from the corresponding period ended thirteen weeks earlier to the four weeks ended September 25 fell to a 4.6 percent rate, the lowest such growth rate thus far this year (see Chart II). The adjusted bank credit proxy increased at a 4.3 percent annual rate in the four weeks ended September 25 over the four statement weeks in August, with CDs advancing at an 18.4 percent rate over the same period.

On September 4, the Federal Reserve Board revised Regulation D to remove the 3 percent marginal reserve requirement on large-denomination CDs with maturities of four months or longer. The action lowered the effective cost to the banks of the longer CDs by about 40 basis points and was designed primarily to encourage member banks to lengthen the maturities of their CDs. The removal applied to roughly one sixth of the large CDs outstanding and reduced required reserves by about $400 million in the statement week ended September 25. The regular 5 percent time deposit reserve requirement will still be placed on all CDs, while the marginal 3 percent will now apply to the shorter CDs in excess of the amount held in May 1973. In addition to CDs, Regulation D also covers bank-related commercial paper and finance bills.

THE GOVERNMENT SECURITIES MARKET

Yields on all maturities of Treasury securities fell during the month, with the largest declines occurring in the shortest maturities. Long-term interest rates edged down only slightly. Early in the month, Treasury bill rates declined moderately before dropping sharply at midmonth. Market participants concluded that the removal of the marginal reserve requirement on CDs with more than four months' maturity, together with the decline in the Federal funds rate, indicated that monetary policy was becoming less restrictive. In addition, the slow growth of M_1 prompted the hope that further easing of monetary policy would be possible. Also contributing to the midmonth decline in bill rates was the purchase of a sizable volume of Treasury securities in one week by the Federal Reserve for its customer accounts. By the month end, the drop in the three-month bill rate had exceeded by far the declines in rates on commercial paper and CDs with the same maturity.

The rates at the weekly auctions of Treasury bills fell in September by about 3 percentage points from the record-high rates set in late August. Contributing to this decline was the reduction in the Treasury's bill sales in September. At each of the last two weekly auctions in August, the Treasury raised an additional $400 million in new cash. In September, the Treasury merely refunded the maturing bills at the first and last weekly auctions and paid down $200 million in each of the two weekly auctions in the middle of the month. While the Treasury was reducing its demands, noncompetitive tenders from the public at the weekly auctions early in the month were unusually high. In addition, after allowing for the rolling-over of bills by the Federal Reserve for its own and its customer accounts, the supply of new bills for competitive bidding in September was only about half the amount available in August. At the first auction on September 9, noncompetitive bids from the public reached a total of $1 billion of the $4.4 billion of three- and six-month bills sold; these issues were auctioned at rates of 9.10 and 8.98 percent, respectively (see Table II). Demand was also high at the next weekly auction, when noncompetitive tenders

Table I

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

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

Factors	Changes in daily averages— week ended				Net changes
	Sept. 4	Sept. 11	Sept. 18	Sept. 25	
"Market" factors					
Member bank required reserves	− 26	+ 287	− 378	+ 126	+ 9
Operating transactions (subtotal)	− 336	+2,518	− 221	−2,121	− 160
Federal Reserve float	− 62	+1,007	− 213	− 363	+ 369
Treasury operations*	+ 64	+1,263	+ 422	−1,674	+ 75
Gold and foreign account	− 64	+ 9	− 163	− 87	− 305
Currency outside banks	− 142	− 203	− 125	+ 351	− 119
Other Federal Reserve liabilities and capital	− 132	+ 442	− 142	− 348	− 180
Total "market" factors	− 362	+2,805	− 599	−1,995	− 151
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 57	−2,223	+ 702	+1,273	− 191
Outright holdings:					
Treasury securities	+ 181	−1,923	+ 96	+1,335	− 311
Bankers' acceptances	+ 7	− 8	− 18	+ 35	+ 16
Federal agency obligations	+ 234	− 12	—	+ 59	+ 281
Repurchase agreements:					
Treasury securities	− 116	− 186	+ 434	− 174	− 42
Bankers' acceptances	− 78	− 37	+ 55	+ 47	− 13
Federal agency obligations	− 171	− 57	+ 135	− 29	− 122
Member bank borrowings	+ 373	− 821	− 164	+ 610	− 2
Seasonal borrowings†	− 9	− 20	+ 2	+ 7	− 20
Other Federal Reserve assets‡	+ 92	+ 40	+ 33	+ 90	+ 255
Total	+ 522	−3,004	+ 571	+1,974	+ 63
Excess reserves‡	+ 160	− 199	− 28	− 21	− 88
	Daily average levels				Monthly averages§
Member bank:					
Total reserves, including vault cash‡	37,255	36,769	37,119	36,972	37,029
Required reserves	36,919	36,632	37,010	36,884	36,861
Excess reserves	336	137	109	88	168
Total borrowings	3,906	3,085	2,921	3,531	3,361
Seasonal borrowings†	152	132	134	141	140
Nonborrowed reserves	33,349	33,684	34,198	33,441	33,668
Net carry-over, excess or deficit (−)‖	155	144	102	55	114

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 September 25, 1974.
‖ Not reflected in data above.

amounted to nearly $900 million and the rates on the auctioned bills were well below those on outstanding issues of comparable maturity. By the last auction of the month, the rate for three-month bills had dropped to the lowest level since May 1973. In the auction of the 52-week bill on September 18, the average issuing rate was set at 8.34 percent, 122 basis points below the record rate established at the preceding monthly auction.

Yields on Treasury coupon securities also fell over the month in response to the sharp rate declines in the short end of the market. However, the market for Treasury notes and bonds continued to be somewhat depressed by the high rate of inflation, and the market sagged after the report of the surge in wholesale prices in August. By the end of the month, most other developments had strengthened the market, and yields on intermediate-term securities were 31 to 62 basis points lower, while yields on longer term securities declined by about 7 to 33 basis points. On September 24, the Treasury auctioned $2 billion of two-year notes to replace a like amount maturing at the end of the month. The bidding was on a yield basis and the minimum denomination on the notes was increased to $10,000 from the usual $1,000 to reduce the likelihood of a shift of funds from the nation's thrift institutions. The auction attracted good interest from both dealers and investors, and the average yield was set at 8.34 percent.

Prices of United States Government agency securities moved up during the month, and new issues were generally well received. In the first offering of the month, the Federal Home Loan Banks raised $1.7 billion of new capital. The bonds due in August 1976 carried a yield of 9.55 percent, the bonds maturing in February 1978 returned 9.38 percent, and the February 1979 bonds paid 9.45 percent. The monthly offering of Banks for Cooperatives six-month and the Federal Intermediate Credit Bank nine-month issues produced rates that were 30 and 20 basis points lower, respectively, than those on comparable issues sold in August. At the end of the month, the Tennessee Valley Authority (TVA) resumed its monthly note auction after a two-month absence because of high interest rates. The TVA sold $50 million of four-month notes at an average interest cost of 9.07 percent, about 1 percentage point below the rate paid on similar notes in June.

THE OTHER SECURITIES MARKETS

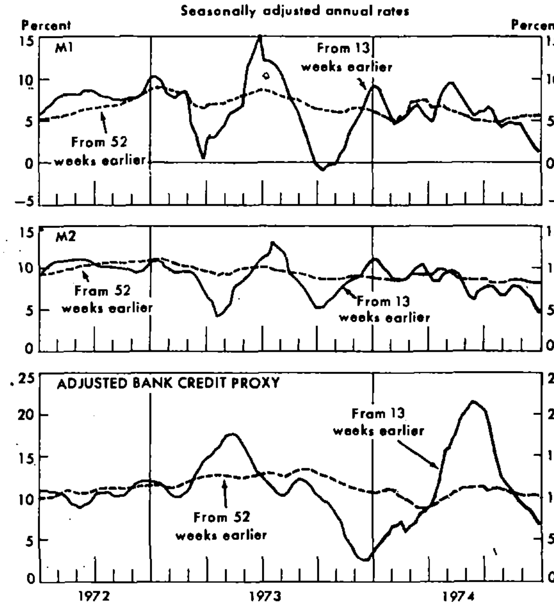
The atmosphere in the corporate and municipal bond markets improved somewhat in September in response to the sharp drop in short-term interest rates. A relatively modest volume of new issue activity during the month also served to bolster the market. However, the continuing high rate of inflation as well as an unusually heavy calendar of new offerings scheduled for October provided a sobering influence.

Early in the month, the corporate calendar was dominated by electric utility issues. During the first two weeks, two electric utilities each marketed $50 million of thirty-year Aa-rated first-mortgage bonds. Both issues were well received; one issue was priced to yield 10½ percent, and the other was priced to yield 10.40 percent. These yields were 25 to 35 basis points lower, respectively, than on a similar long-term Aa-rated utility issue sold in August. In the middle of the month, Duke Power Company marketed $100 million of Baa-rated five-year notes, which were priced to yield a very high 13 percent and proved attractive to individual investors. The issue sold out on the first day and traded at a premium in the secondary market.

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 September 25, 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.

The largest corporate bond issue of the month was the $225 million of South Central Bell Telephone Company debentures. In a negotiated sale in mid-September, the Aaa-rated forty-year debentures were priced to yield 10.05 percent, 5 basis points above a Bell issue in August and a new record-high interest rate for Bell System debt. The issue sold only moderately well at first, but was down to tag ends at the end of the second day. Three non-Bell telephone-utility issues, all of which were A-rated thirty-year first-mortgage bonds, were also sold at midmonth. The range of yields on these securities was 10.82 to 11.25 percent, and the issues generally received only fair receptions. The yield spread of roughly 100 basis points between the Aaa-rated and the A-rated utility issues was still wider than usual—although the spreads were far wider this summer—reflecting investors' lingering preference for high-quality debt.

In the tax-exempt sector, the bulk of new financing was concentrated in the short-term area, with two of the largest short-term offerings being sold by New York City. On September 9, New York City awarded $600 million of revenue anticipation notes at a net interest cost of 8.43 percent. Near the end of the month, after short-term rates had dropped sharply, a second note issue of $800 million sold at a net interest cost of 7.31 percent, more than 100 basis points lower than the earlier issue.

The volume of long-term tax-exempt securities was rather light early in the month, but became heavier as the month progressed. Toward the end of the month a sharp drop in the net interest costs of some new issues prompted apprehension that the heavy fourth-quarter calendar might become even larger. Consequently, the aggressively priced issues of the states of Oregon and California sold fairly slowly during the last week of the month. The Oregon bonds, rated Aaa by Moody's and AA by Standard and Poor's, were reoffered at yields of 5.25 percent for the five-year bonds to 5.95 percent for the sixteen-year bonds. The Aaa-rated California issue was reoffered at yields of 5.10 percent for bonds due in 1975-76 to 6.10 percent for bonds due in 1993-94. On September 26, The Bond Buyer index of twenty municipal bond yields stood at 6.62 percent, 29 basis points below the level at the end of August. The Blue List of dealers' advertised inventories rose by $221 million to $580 million.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—September 1974			
	Sept. 9	Sept. 16	Sept. 23	Sept. 30
Three-month	9.099	8.185	7.002	6.385
Six-month	8.980	8.203	7.928	7.430
	Monthly auction dates—July-September 1974			
	July 24	Aug. 21	Sept. 18	
Fifty-two weeks	7.836	9.564	8.341	

* 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.