The Money and Bond Markets in February

Short-term interest rates fell further in February, continuing the downtrend that began in the summer months of 1974. The declines in most cases were modest, particularly in comparison with the sharp drops registered in January. The Federal funds rate, however, fell substantially further in February. For the month as a whole, the effective rate averaged 6.24 percent, its lowest level since January 1973. In addition, early in February the Board of Governors of the Federal Reserve System approved a reduction in Federal Reserve Bank discount rates from 7¼ percent to 6¾ percent, the third reduction in three months. And, effective March 10, the discount rate was lowered from 6¾ percent to 6¼ percent at ten Reserve Banks, including New York.

Private demands for short-term credit were sluggish again in February. Business loans at major New York City banks, for example, fell sharply for the second consecutive month, despite several reductions in the banks' prime lending rates. At the same time, however, the Treasury borrowed heavily. Nevertheless, rates on United States Government securities moved irregularly lower on balance over the first three weeks of the period. Late in the month, the Treasury announced plans to raise $7 billion in new cash between mid-March and mid-April through sales of coupon-bearing issues. Rates rose significantly in response to this disclosure, finishing the month about unchanged from end-of-January levels. Yields in the corporate and tax-exempt bond markets initially declined but retraced their steps toward the close of the month, as indications that the Treasury would be borrowing substantial sums tempered the interest rate outlook. Moreover, participants in the tax-exempt bond market grew increasingly concerned about the financial difficulties confronting the New York State Urban Development Corporation (UDC).

Preliminary data indicate that the narrowly defined money stock (M_1) expanded at a moderate pace in February. M_1 had actually declined in January and registered only sluggish growth over the last six months of 1974. The recent sharp drop in short-term market interest rates has encouraged sizable flows into commercial bank consumer-type time and savings deposits in the last several months. These deposits advanced rapidly again in February and, as a result, the more broadly defined money stock (M_2) continued to expand at a faster pace than M_1.

THE MONEY MARKET, BANK RESERVES, AND THE MONETARY AGGREGATES

Money market rates continued to fall in February, but in most cases the declines were considerably smaller than those experienced in the previous month (see Chart I). The rate on 90- to 119-day dealer-placed commercial paper, for example, closed the period at 6¼ percent, a drop of ⅜ percentage point over the month as compared with the 2¾ percentage point decline registered in January. Similarly, after falling sharply in January, rates on other maturities of commercial paper, on bankers' acceptances, and on certificates of deposit (CDs) in the secondary market edged downward in February. In contrast, the Federal funds rate moved substantially lower, although the decline did not match January's steep drop. For the month as a whole, the effective rate on Federal funds averaged 6.24 percent, 89 basis points below the level of the preceding month.

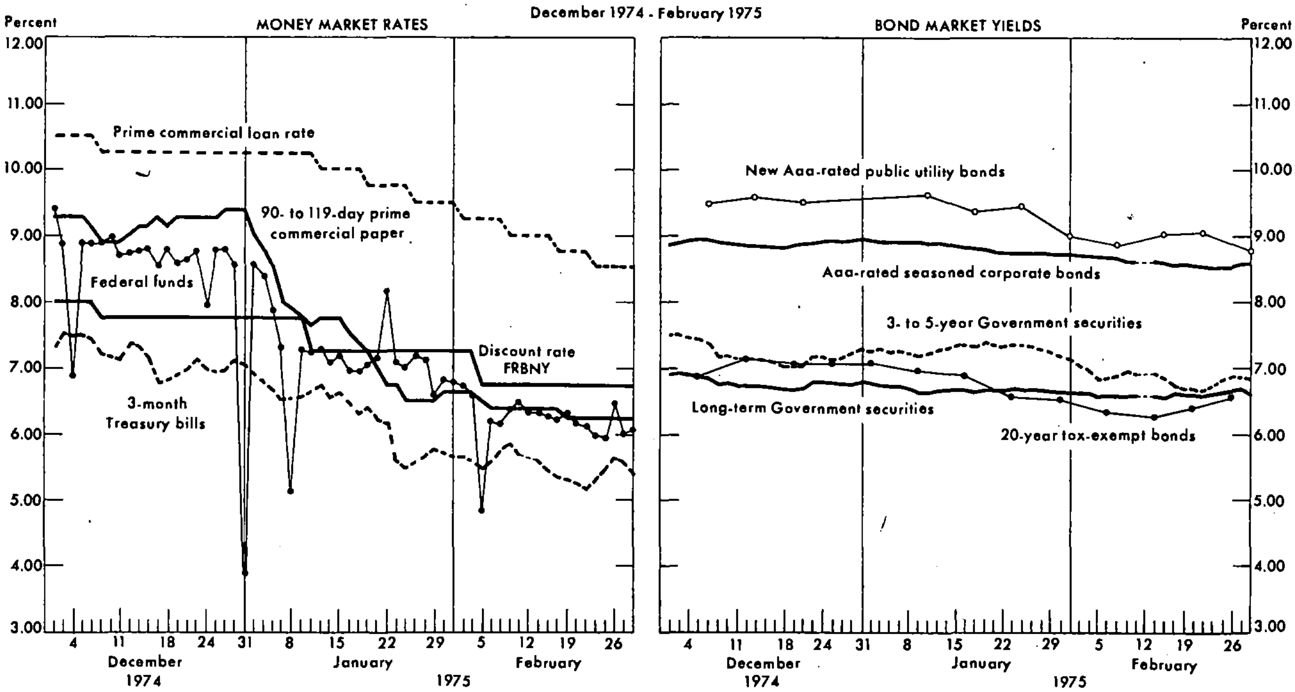
From a longer perspective, money market rates have fallen dramatically from the extraordinarily high levels reached in the summer of 1974. In general, rates on money market instruments have dropped by about 5 to 7 percentage points from their peaks. A decline in short-term rates is, of course, normal during an economic contraction when businesses and consumers curtail their borrowings in the short-term markets and the monetary authorities are pressing reserves on the banking system. In the current economic downturn, however, the declines thus far have been steeper than—and, except for the 1969-70 experience, have been nearly twice as steep as—in any previous contraction in the postwar period. In part, the sharper drop in short-term rates in the current episode reflects the relatively high level at which rates peaked in 1974, as well as the severity of the contraction in economic activity.

Duplicating the experience of previous postwar contractions, the declines in commercial banks' prime lending rates have lagged the fall in other short-term market rates. In February, most banks reduced their prime rates by ½

Chart I

SELECTED INTEREST RATES

December 1974 - February 1975



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.

to ¾ percentage point. By the close of the month, most were quoting a rate of 8½ percent, a substantial drop from the record high of 12 percent which prevailed over the July-September period. The decline in the commercial bank prime lending rate in February narrowed the spread between these and other money market rates, but the prime rate remained relatively high nevertheless. As a result, businesses continued to shift some of their borrowings from banks to the commercial paper market. Reflecting this shift, as well as the general weakness in short-term credit demands, commercial and industrial loans at weekly reporting banks fell by $956 million over the four weeks ended February 26. Meanwhile, the volume of nonfinancial commercial paper outstanding rose $557 million over the same period. With the weakness in business loan demand, banks withdrew from active bidding for CD funds, and the volume of CDs at New York City weekly reporting banks dropped over the four statement weeks of the month by $967 million. Member bank borrowings from the Federal Reserve rose by $38 million over the four weeks ended February 26, averaging $149 million for the period (see Table I).

In February, the Board of Governors announced revisions to the money stock and related measures to incorporate data obtained from nonmember banks in the October 1974 call reports and from reports from foreign agencies and branches. The revisions raised the levels of the money stock measures slightly beginning in May

1974 but did not change the overall pattern of growth. In particular, the new data for M_1—private demand deposits adjusted plus currency outside banks—still show a substantial deceleration in growth over the last six months of 1974 and a sharp decline in the level of M_1 in January of this year. In February, however, M_1 developed renewed strength, rising at a seasonally adjusted annual rate of 6.9 percent from the four weeks ended January 29 to the four weeks ended February 26. Notably, the demand deposit component of M_1 rose over this period at a moderate pace, after contracting sharply in January. The renewed growth of M_1 over the four statement weeks in February partly offset January's decline and left M_1 about unchanged from its level of thirteen weeks earlier (see Chart II).

Over the last several months, M_2—which adds to M_1 time deposits less large CDs—has been much more buoyant than M_1, as declines in market rates have encouraged flows into time and savings deposits. In February this pattern continued, with M_2 rising at a seasonally adjusted annual rate of 10.1 percent over the four statement weeks in February from its average level over the previous four weeks. However, the adjusted bank credit proxy—member bank deposits subject to reserve requirements plus certain nondeposit liabilities—remained unchanged over this period, in part reflecting a decline in CDs as well as a drop in member bank liabilities to their foreign branches.

THE GOVERNMENT SECURITIES MARKET

Interest rates on Government securities moved irregularly in February. Strong demand dominated the market as the month began, and rates on all maturities declined. Subsequently, concern over the potential size of Treasury borrowing led to upward pressure on rates, especially around midmonth. The downtrend later reemerged but was again interrupted toward the end of the month.

February was marked by unseasonably large Treasury sales of Government securities. A total of \$3.4 billion in new cash was raised by the Treasury. On February 19, \$3 billion in new cash was raised through the auction of two notes, \$1.5 billion of two-year maturity and \$1.5 billion maturing in eighteen months. The minimum denomination in each case was \$5,000. Competitive tenders of \$5.8 billion were received, and the average yield for the two-year issue was set at 6.09 percent, while a yield of 5.94 percent was established on the eighteen-month notes.

Late in the month the Treasury announced its intention to raise \$7 billion in new cash from mid-March to mid-April through the sale of coupon-bearing issues, while fur-

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, FEBRUARY 1975

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

Factors	Changes in daily averages—week ended				Net changes
	Feb. 5	Feb. 12	Feb. 19	Feb. 26	
"Market" factors					
Member bank required reserves	+ 528	+ 673	+1,015	+ 501	+2,717
Operating transactions (subtotal)	+ 51	+1,065	—1,209	—1,160	—1,253
Federal Reserve float	+ 178	— 164	+ 31	+ 273	+ 318
Treasury operations*	+ 392	+1,146	— 463	—1,502	— 427
Gold and foreign account	— 71	+ 66	— 98	+ 61	— 42
Currency outside banks	— 52	— 597	— 879	+ 177	—1,351
Other Federal Reserve liabilities and capital	— 396	+ 613	+ 202	— 168	+ 251
Total "market" factors	+ 579	+1,738	— 194	— 659	+1,464
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	— 690	—1,898	+ 470	+1,144	— 974
Outright holdings:					
Treasury securities	— 433	—1,866	+ 246	+ 803	—1,250
Bankers' acceptances	+ 10	— 24	— 15	+ 12	— 17
Federal agency obligations	— 16	— 22	—	— 12	— 50
Repurchase agreements:					
Treasury securities	— 248	+ 32	+ 186	+ 386	+ 356
Bankers' acceptances	+ 28	— 62	+ 31	+ 11	+ 8
Federal agency obligations	— 31	+ 44	+ 22	— 56	— 21
Member bank borrowings	— 46	— 7	+ 139	— 48	+ 38
Seasonal borrowings†	+ 1	— 1	+ 2	— 1	+ 1
Other Federal Reserve assets‡	+ 349	— 159	— 284	— 463	— 557
Total	— 387	—2,064	+ 325	+ 633	—1,493
Excess reserves‡	+ 192	— 326	+ 131	— 26	— 29

	Daily average levels				Monthly averages§
Member bank:					
Total reserves, including vault cash‡	37,044	36,045	35,161	34,634	35,721
Required reserves	36,646	35,973	34,958	34,457	35,509
Excess reserves	398	72	203	177	213
Total borrowings	97	90	229	180	149
Seasonal borrowings†	11	10	12	11	11
Nonborrowed reserves	36,947	35,955	34,932	34,454	35,572
Net carry-over, excess or deficit (—)‖	24	155	26	— 88	29

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 26, 1975.
‖ Not reflected in data above.

ther amounts might be raised in bills. An additional $1.2 billion in coupon issues would be raised to repay maturing debt. Of the $7 billion in new cash, $1.75 billion would consist of notes due November 15, 1981, $1.5 billion of notes maturing May 31, 1976, $1 billion of two-year notes maturing March 31, 1977, $1.25 billion of bonds maturing May 15, 1990, and $1.5 billion of notes due November 30, 1976. The $1.2 billion refunding will consist of two-year notes maturing March 31, 1977. There was some indication that an additional amount of new cash ranging between $11 billion and $21 billion would be required before the end of June.

The market was quick to react to the announcement of the Treasury's financing plans. The rate on three-month bills, for example, which had fallen about 38 basis points on balance over the first three weeks of the month, rose 10 basis points during the week following the announcement. Rates set at the fourth weekly Treasury auction of February were slightly higher, as well, than those set at the previous week's auction (see Table II). Similarly, after the Treasury's announcement, rates on intermediate-term coupon issues advanced from 5 to 15 basis points, while yields on long-term bonds rose 4 to 7 basis points. These increases appeared short-lived, however, as Treasury bill rates and yields on intermediate Government securities declined in the last two days of the month. For the month as a whole, rates on most Treasury issues changed little.

Yields in the market for Federal agency securities displayed the same pattern in February as those on Treasury securities, although movements were not so sharp. Sales of short-term notes by the Department of Housing and Urban Development for local public authorities were well received. First, early in the month, a 3.49 percent average interest rate was set on $680.2 million of tax-exempt notes with an average maturity of 8.3 months. Then, at midmonth an average interest rate of 3.57 percent was established for a $418 million tax-exempt issue of urban-renewal notes with an average maturity of 7½ months. The average yield on commitments to buy Government-backed mortgages auctioned by the Federal National Mortgage Association fell below 9 percent for the first time since last April and continued to fall at the second such auction in February. The Federal Home Loan Banks successfully sold at the start of the month $300 million of 8¾-year bonds partially to replace $1.2 billion maturing on February 25. A 7⅜ percent coupon was placed on this issue. The Federal Home Loan Mortgage Corporation (FHLMC) introduced a new type of security with a $300 million issue of guaranteed-mortgage certificates due March 15, 2005. It was offered to yield 8.20 percent. An option for the investor to resell the issue to the FHLMC at the issue price in fifteen years was included. The farm credit agencies entered the market at midmonth with a $391.6 million Banks for Cooperatives (BC) offering due September 2, 1975 and a $897 million Federal Intermediate Credit Banks (FICB) issue due December 1, 1975. The respective yields of 6.05 percent and 6.15 percent were substantially below the 7.05 percent paid in January on a similar issue. At the end of February, the BC and the FICB offered an additional $75 million of short-term bonds, with coupons ranging from 7.40 percent to 9.45 percent.

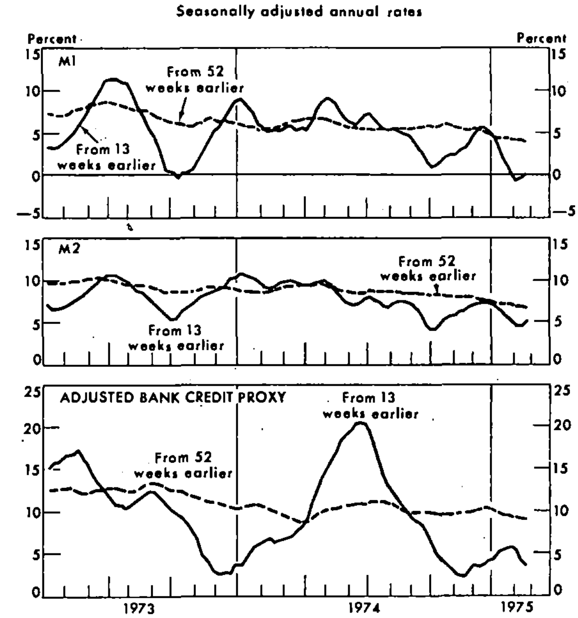
THE OTHER SECURITIES MARKETS

Yields in the corporate bond market continued to decline at the beginning of the month but began to stabilize soon afterward, partly as a result of dealers reducing

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 26, 1975.

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.

inventories that had built up in January. The calendar was heavy in February, but new issues were generally well received. As the yields of recently offered Aaa-rated bonds initially fell, investor interest spread to seasoned corporate bonds and those of less than top quality. In light of the strong demand for corporate bonds evidenced at the beginning of the month, some borrowers advanced the dates of their issues. Near the close of the period, however, yields backed up sharply, retracing some of their earlier declines, in response to the Treasury's announcement of future borrowing and the growing supplies of corporate and tax-exempt issues.

During the first week of February, a utility successfully sold $35 million of Aa-rated first-mortgage bonds yielding 8.67 percent in thirty years. This represented the lowest return on a new long-term high-grade utility bond in almost a year, significantly below the record 10.6 percent yield registered in late 1974. In the same vein, a second utility sold $100 million of A-rated thirty-year bonds at a yield of 9.55 percent, 3.45 percentage points lower than the yield associated with an issue it offered last September. By midmonth, however, the sharp decline in yields on utility bonds reduced their attractiveness relative to industrial bonds. This development was partly responsible for the slow-paced sale of $125 million of thirty-year first-mortgage bonds of Commonwealth Edison Company at that time. A $300 million issue of thirty-year Aaa-rated debentures by Mobile Alaska Pipeline Company, on the other hand, sold out at 8.45 percent.

The last several days of the month witnessed sharp price reductions among recently offered and seasoned corporate bonds while newly issued corporate bonds were accorded mixed receptions, in light of the Treasury announcement of large offerings of Government securities by mid-April. The announcement that the Treasury planned to sell $1.25 billion of long-term bonds to raise new cash weighed particularly heavily on the market. The yield on the Commonwealth Edison bonds jumped 23 basis points after being released from syndicate restrictions. However, a thirty-year Aaa-rated bond issue of Dallas Power and Light Company sold well at a yield of 8.78 percent, significantly lower than those of earlier issues.

Retail demand for tax-exempt issues was also strong as the month began, and both short- and long-term issues benefited. A $103.5 million offering of various maturities by the New York State Housing Finance Agency, priced to yield 4.5 percent in 1975 to 7.6 percent in 2006, quickly sold out. Reflecting the recent decline in short-term interest rates, the one-year bond yielded 2 percentage points less than it had in a similar offering in October while the longest maturity bond yielded only a 0.35 percentage point less. A $290 million issue of one-year notes by New York City offered in the first week of the month yielded 7.25 percent, substantially below the 9 percent obtained in the city's two previous note issues. The market became more cautious toward the end of February in expectation of a large volume of future offerings in addition to the large backlog of unsold municipals. A $125 million bond offering by Massachusetts required some price reduction before it was sold, with yields ranging from 3.6 percent in 1976 to 6.3 percent in 2025, while $40 million of an Illinois issue was released from syndicate restrictions and declined sharply in price, bringing it more closely in line with the Massachusetts issue.

The state and municipal markets were directly affected by the UDC's financial problems. The corporation was unable to raise the required money to redeem $104.5 million of maturing short-term notes. In reaction to this, yields rose considerably in the tax-exempt market during the last several days of the month, and there was heightened concern about the quality of issues. Yields on new issues of the states of Connecticut and Louisiana were set above prevailing market rates. The issues, Aaa- and Aa-rated, respectively, were well received at the higher yields, however.

The Bond Buyer index of twenty municipal bond yields fell 14 basis points over the first three weeks of the month but then rose 15 basis points in the final week to close at 6.55 percent. The Blue List of dealers' advertised inventories stood at $652 million at the month end, having risen by $91 million for the month as a whole.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—February 1975			
	Feb. 3	Feb. 10	Feb. 14	Feb. 24
Three-month	5.669	5.800	5.408	5.455
Six-month	5.736	5.800	5.483	5.075
	Monthly auction dates—December 1974-February 1975			
	Dec. 11	Jan. 8	Feb. 5	
Fifty-two weeks	6.825	6.378	5.313	

* 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.