The Money and Bond Markets in August

A cautious atmosphere prevailed in the financial markets in August. The large financing needs of the Treasury continued to be a major source of concern. Investor uncertainty was heightened by reports of recent sharp increases in both consumer and wholesale prices and the surprising drop in July's unemployment rate. Money market participants interpreted these developments as indicating that economic activity was perhaps recovering faster than expected and that underlying inflationary pressures might be building. In addition, the continuing financial crisis of New York City weighed heavily on the municipal sector. The city was able to meet its commitments in August with funds provided from several sources, including loans by the Municipal Assistance Corporation (MAC) and by the major New York City banks. Legislation to provide additional revenues for the city and to establish an Emergency Financial Control Board to oversee the city's fiscal operations was passed by the New York State legislature early in September.

In this problematical environment, most interest rates continued to advance in August until late in the month, when they retraced part of their upward movement. In the money market the increases were generally mild, compared with those of recent months. The Federal funds rate changed little over the period from its average level in July, and the rates on Treasury bills rose by 14 to 25 basis points, less than half the increase in bill rates from June to July. However, as dealers acted to distribute $4 billion of new notes and $2 billion of additional bills issued by the Treasury during the month, sizable increases were registered in yields on intermediate- and long-term Government securities. The heavy volume of borrowing by the Treasury was even larger than had been anticipated by investors as a result of unexpected redemptions of nonmarketable issues and from outlays running ahead of projections. Toward the close of the month, yields on Treasury coupon issues receded somewhat, partly in response to an anticipated lull in borrowing during the remainder of September. Yields in the corporate and municipal sectors also experienced strong upward pressure over most of the month, but the pressure eased late in the period in sympathy with the improved tone in the Treasury market. In reaction to the adverse market conditions that prevailed over most of the month, many planned corporate and municipal issues were reduced in size, canceled, or postponed. Nonetheless, a number of new issues sold well at higher yields.

According to preliminary data, the growth rate of the narrow money stock (M_1) showed a moderate increase in August from the very modest growth registered in July. At the same time, consumer-type time deposits at commercial banks advanced more slowly than in the previous month; thus, growth in the more broadly defined money stock (M_2) was essentially unchanged. Largely because of a further drop in the volume of large negotiable certificates of deposit (CDs), the bank credit proxy continued to decline.

THE MONEY MARKET AND THE MONETARY AGGREGATES

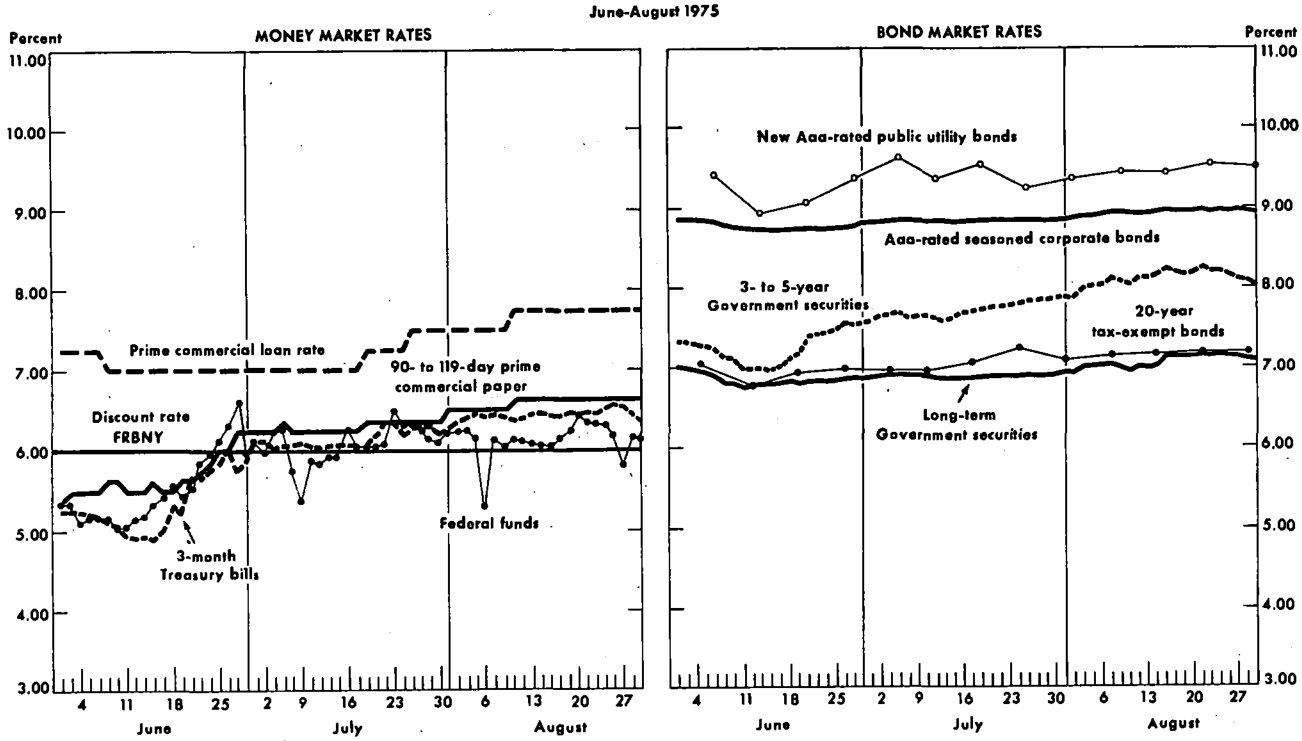
Interest rates on most money market instruments rose in August for the third consecutive month, but the increases were generally mild (see Chart I). The rate on 90- to 119-day dealer-placed commercial paper, for example, advanced only ⅛ percentage point over the period, while rates on bankers' acceptances rose about ⅛ to ⅝ percentage point. The average rate on ninety-day CDs in the secondary market continued to show considerable fluctuation and closed the month up 28 basis points from its end-of-July level. Most money-center banks boosted their prime lending rate ¼ percentage point to 7¾ percent, following an increase of ½ percentage point by most banks in the previous month. In contrast to other money market rates, the Federal funds rate showed no uptrend in August. For the month as a whole, the effective rate on Federal funds averaged 6.14 percent, compared with 6.10 percent in July.

Weakness was still quite evident in business demand for short-term credit in August. At large commercial banks, commercial and industrial loans declined by $1,527 million over the four statement weeks of the month. This contrasted with an average increase of $325 million during comparable periods in the previous four years. Thus far in 1975, business loans at large banks have

Chart I

SELECTED INTEREST RATES

June-August 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.

dropped by \$12.3 billion. In the last two months, however, after allowance for normal seasonal variations, the declines have been much smaller than in earlier months of the year. This may indicate that a turning point in business demand for short-term credit is close at hand.

In response to the continued weakness in business loan demand at banks, major commercial banks allowed a further large runoff of CDs in August. The volume of CDs outstanding has paralleled movements in business loans all year. Over the eight months ended in August, CDs dropped \$11.8 billion. In recent months, however, as in the case of business borrowing from banks, the declines in CDs have been comparatively small.

Preliminary data indicate that the growth rate of M_1—private demand deposits adjusted plus currency outside commercial banks—rose moderately in August from its very low growth rate in July. In the four-week period ended August 27, seasonally adjusted M_1 averaged 5.3 percent at an annual rate above its average during the four weeks ended July 30. The change from June to July had been much smaller. Indeed, the fluctuation in monthly M_1 growth has been particularly sharp this year, ranging from double-digit growth in May and June to negative or near-zero growth in January and July. Changes in M_1 over longer periods are shown in Chart II.

The expansion of consumer-type time deposits at commercial banks slowed considerably in August, compared with its growth over recent months. The deceleration probably reflected, at least in part, the rise in interest rates on competing market instruments relative to rates on consumer-type time deposits. The latter are of course constrained by the legally set rate ceilings. As a result of the slowdown, the expansion of M_2—which includes these time deposits plus M_1—was little changed in August from its growth in July. The adjusted bank credit proxy—a measure which encompasses all deposits at member banks subject to reserve requirements plus certain nondeposit sources of funds—declined in August for the second consecutive month. The drop was largely due to the decline in the volume of CDs outstanding. This decline offset demand and consumer-type time deposit growth. Member banks continued to make little use of the discount window in August, when borrowings averaged $208 million (see Table I) as compared with the revised figure of $326 million for July.

THE GOVERNMENT SECURITIES MARKET

Yields on Treasury securities rose sharply during August. Investor uneasiness was heightened by growing concern about renewed inflationary pressures. This concern was nurtured by substantial increases during July in both wholesale and consumer prices as well as by a sharp, unexpected drop that month in the unemployment rate. The large financing needs of the Treasury also contributed to the cautious tone in the market for Treasury securities. On August 6 the Treasury announced plans for meeting the bulk of its cash needs through early September. The level of borrowings, even larger than had been anticipated, called for $6 billion in new cash. The package of new money included the immediate sale of $1 billion in eighteen-day bills, which were subsequently to be added to the auction on August 20 of the outstanding 52-week bill issue. Also included in the package were the addition of $1 billion to the auction of three- and six-month bill issues on August 18 and the auction of $2 billion of new two-year notes on August 14 and of $2 billion of new 49-month notes on August 21.

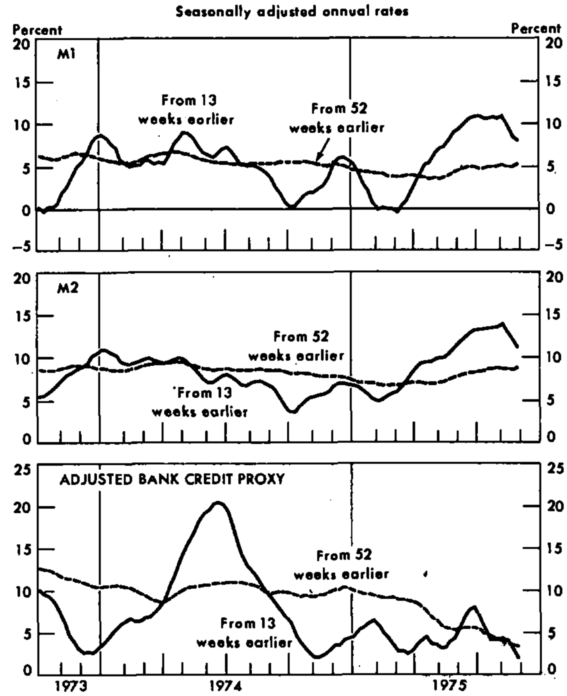
The large supply of Treasury securities, as well as expectations that the supply would continue heavy throughout the year, reduced the incentive for investors to bid aggressively. Each of the auctions for coupon securities was characterized by investor wariness and the need for the Treasury to offer substantially higher yields than it had during June and July. Much attention was focused on the auction of $2 billion of two-year notes on August 14. Looking ahead to large auctions in almost every week of August and early September, investors held back, and the average yield on the securities at the August 14 auction rose to 8.25 percent; this was 75 basis points above the average yield at the July auction of securities of comparable maturity. The auction of $2 billion of 49-month notes on August 21 encountered similar investor resistance, resulting in an average yield of 8.54 percent, the highest rate on a Treasury-backed note in over a year.

At the close of the month, yields on coupon issues declined as dealers found their inventories to be modest, given the expected reduction in Treasury borrowing. Market participants were also encouraged by Chairman Burns's comment in a letter to Henry S. Reuss, Chairman of the House Banking Committee, that the Federal Reserve would continue purchasing coupon securities in coming months. Over the month as a whole, the index of yields on intermediate-term Government securities rose

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 August 27, 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.

14 basis points to 8.02 percent. The yield on the 8½ percent Treasury bond of 1994-99 rose to 8.43 percent at the end of August, up 9 basis points from its level at the end of July.

Movements in Treasury bill rates paralleled movements in rates on coupon securities. During early and mid-August, rates on bills rose. The average yield on 52-week bills at the monthly auction on August 20 was 7.33 percent (see Table II), up 55 basis points from the average yield at the July auction. At the weekly auction of three- and six-month bills on August 25, the average yields on three- and six-month bills were 6.59 percent and 7.09 percent, the highest rates on three- and six-month bills since January of this year. But, as in the case of coupon securities, rates declined during the final week of August, and the average rates on three- and six-month bills at the August 29 auction were 6.38 percent and 6.87 percent, 14 and 15 basis points above the rates on these bills at the final auction in July. Over the month as a whole, yields on most bills rose 14 to 25 basis points.

Rates on agency securities also rose during August. On August 7, the Federal Home Loan Banks issued $500 million of seven-year bonds at 8⅝ percent. These bonds traded near par during most of the month. Later in the month the Federal National Mortgage Corporation issued $650 million of five-year debentures at 8¾ percent. These rates compare with a yield of 8.20 percent on 7½-year bonds issued by the Federal Land Banks early in July. During the month, the Banks for Cooperatives issued $505.6 million of 7.4 percent bonds due March 1, 1976, and the Federal Intermediate Credit Banks issued $725.2 million of 7.6 percent bonds due June 1, 1976. Both issues were reasonably well received.

THE OTHER SECURITIES MARKETS

Investor uncertainty over the financing needs of the Treasury as well as increased concern over inflation affected the corporate and municipal bond markets in August. The tax-exempt sector was additionally troubled by the financial problems of New York City. Yields came under strong upward pressure throughout the month, although a number of cancellations and postponements of new issues served to limit the advance.

Throughout the year, corporations have been issuing bonds in order to lengthen the maturity structure of their liabilities. Since corporations can postpone the issuance of bonds that are used to restructure their liabilities, several corporations, including the New Jersey Bell Telephone Co., postponed bond offerings indefinitely because of adverse market conditions. Analysts estimated that at

Table I

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

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

Factors	Changes in daily averages— week ended				Net changes
	Aug. 6	Aug. 13	Aug. 20	Aug. 27	
"Market" factors					
Member bank required reserves	+ 373	+ 190	— 267	+ 241	+ 537
Operating transactions (subtotal)	+ 811	+1,102	— 828	— 858	+ 227
Federal Reserve float	+ 105	+ 300	+ 101	— 348	+ 158
Treasury operations*	+ 667	+1,017	— 79	— 879	+ 726
Gold and foreign account	— 18	— 8	— 32	+ 60	+ 2
Currency outside banks	— 119	— 433	— 731	+ 577	— 706
Other Federal Reserve liabilities and capital	+ 176	+ 226	— 87	— 268	+ 47
Total "market" factors	+1,184	+1,292	—1,095	— 617	+ 764
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	—1,155	—1,522	+1,866	+ 575	— 236
Outright holdings:					
Treasury securities	—1,113	—1,506	+1,496	— 207	—1,330
Special certificates	+ 231	—	— 25	— 206	—
Bankers' acceptances	— 1	— 16	+ 2	+ 7	— 8
Federal agency obligations	—	—	—	+ 336	+ 336
Repurchase agreements:					
Treasury securities	— 243	—	+ 368	+ 568	+ 693
Bankers' acceptances	— 13	—	+ 10	+ 71	+ 68
Federal agency obligations	— 16	—	+ 15	+ 6	+ 5
Member bank borrowings	— 77	+ 2	+ 25	+ 68	+ 18
Seasonal borrowings†	+ 9	+ 6	—	+ 5	+ 20
Other Federal Reserve assets‡	— 29	+ 5	— 541	+ 23	— 542
Total	—1,261	—1,515	+1,350	+ 666	— 760
Excess reserves‡	— 77	— 223	+ 255	+ 49	+ 4

	Daily average levels				Monthly averages§
Member bank:					
Total reserves, including vault cash‡	34,563	34,150	34,672	34,480	34,466
Required reserves	34,345	34,155	34,422	34,181	34,276
Excess reserves	218	— 5	250	299	191
Total borrowings	176	178	204	272	208
Seasonal borrowings†	29	35	35	40	35
Nonborrowed reserves	34,387	33,972	34,468	34,208	34,259
Net carry-over, excess or deficit (—)‖	180	141	25	96	111

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 August 27, 1975.
‖ Not reflected in data above.

the time of the postponement on August 6 the yield on the $75 million Aaa-rated issue of New Jersey Bell bonds would have been about 35 basis points higher than the yield of 8.80 percent on approximately comparable bonds issued by the Bell Telephone Co. of Pennsylvania on July 15. Other postponements of Aaa-rated issues included $150 million of seven-year notes of J. P. Morgan & Co. Incorporated. A lesser rated issue of $80 million of Consolidated Edison Co. of New York, Inc. bonds was also postponed on two separate occasions during the month.

A number of corporate issues brought to market during the month at relatively high rates sold fairly well. On August 4, the Chicago-based Commonwealth Edison Co. sold $125 million of Aaa-rated eight-year bonds at 8.85 percent. During that same week, Public Service Co. of Indiana, Inc., an Aa utility, sold out an $80 million issue of thirty-year bonds at 9.6 percent, compared with a yield of 9.43 percent on a comparably rated thirty-year issue in late July. On August 12, British Petroleum North American Finance Corporation successfully negotiated a two-part sale of Aa-rated securities, guaranteed by the British Petroleum Co. Ltd.: $50 million of five-year notes yielding 9 percent and $100 million of 25-year debentures yielding 10 percent. On August 19, Pfizer Inc. sold $100 million each of ten-year notes and 25-year debentures. The Aa-rated securities were priced to yield 8⅞ percent and 9.30 percent, respectively, and were quickly sold out. In comparison with the yields of 9 percent and 8⅞ percent on the intermediate-term Aa-rated issues of British Petroleum and Pfizer, a similarly rated issue of eight-year bonds had been sold by Arco Pipe Line Company to yield 8.46 percent in mid-July. Over the month, the Federal Reserve Board index of yields on recently offered Aaa-rated corporate securities rose 7 basis points to close the period at 8.94 percent.

During most of August, attention in the tax-exempt sector was centered on the need for New York City to raise $960 million to meet current expenses and to pay $791 million on notes and interest due on August 22. The $960 million aid plan for New York City arranged by MAC consisted of the placement of $350 million of bonds with New York City banks (including $100 million in exchange for maturing New York City notes), purchases of $215 million of bonds by various city and state pension funds, $120 million in advance aid from the state, and the negotiated public sale of $275 million of bonds on August 14. After a one-day delay because of insufficient presale demand, the negotiated sale, consisting of $70 million of 10 percent bonds due in five years, $65 million of 10½ percent bonds due in six years, and $140 million of 11 percent bonds due in eight years, was completed on August 15. The success of this second public offering of A-rated MAC bonds was assured when a group of underwriters agreed to take any unsold bonds. Subsequently, prices on outstanding MAC issues weakened as market participants focused on the city's September cash needs.

The problems faced by New York City, and earlier in the year by New York State's Urban Development Corporation, have had a particularly adverse effect on the market for state agency issues. During the month, the Massachusetts Housing Finance Agency was forced to reject all bids on a $63.8 million issue of bond anticipation notes maturing in 1976 and 1977. The New York State Housing Finance Agency twice postponed its $110 million note offering and finally scaled it down to $92 million. The net interest cost to the agency on these notes was 10.848 percent, compared with an 8.87 percent cost on a similar sale in July.

In the municipal sector, the largest issue of the month (except for MAC)—$180 million of Commonwealth of Pennsylvania bonds—was well received. These A-1 (Moody's) bonds sold out on August 7, with yields ranging from 4.80 percent for the 1977 maturities to 7.25 percent for those maturing in 1995 or about 10 to 40 basis points higher than a similar sale by Pennsylvania last May. The Bond Buyer index of twenty bond yields on twenty-year tax-exempt bonds on August 28 was 7.18 percent, up from its level of 7.09 percent on July 31. The Blue List of dealers' advertised inventories rose by $84 million and closed the month at $631 million.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—August 1975				
	Aug. 4	Aug. 11	Aug. 18	Aug. 25	Aug. 29
Three-month	6.456	6.349	6.452	6.593	6.381
Six-month	6.864	6.809	7.000	7.085	6.866

Maturity	Monthly auction dates—June-August 1975		
	June 24	July 24	Aug. 20
Fifty-two weeks	6.292	6.782	7.331

* 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.