The Money and Bond Markets in January

Interest rates continued to fall sharply during the first half of January. The declines were particularly pronounced in short-term rates, with some rates dropping to their lowest levels in more than three years. Forecasts of lower interest rates in the early months of 1976, optimism about the outlook for inflation, and a lower trading range for Federal funds strengthened market demand. At midmonth the rally faltered, amid signs of sustained economic recovery and reemergence of concern over financing the massive Federal deficit. The absence of further declines in the Federal funds rate also prompted a more cautious market tone. In this atmosphere, a reduction in the discount rate by Federal Reserve Banks at midmonth was viewed only as a necessary adjustment to recent declines in other short-term rates and provided only modest support to the market.

Late in the month the Treasury announced its plans for the February refunding operation. Market reaction was favorable, and a substantial amount of new cash was raised. In early February the Treasury sold $9.4 billion of securities to the public to retire $4.3 billion of maturing notes and to raise $5.1 billion in new funds.

Preliminary estimates, which reflect recent revisions, indicate that the narrowly defined money stock (M_1) increased modestly in January after declining in the previous month. At the same time, consumer-type time deposits at commercial banks advanced at a rapid pace and, thus, growth in the more broadly defined money stock (M_2) accelerated sharply. A sizable decrease in the outstanding volume of large negotiable certificates of deposit (CDs) held the bank credit proxy to a small gain.

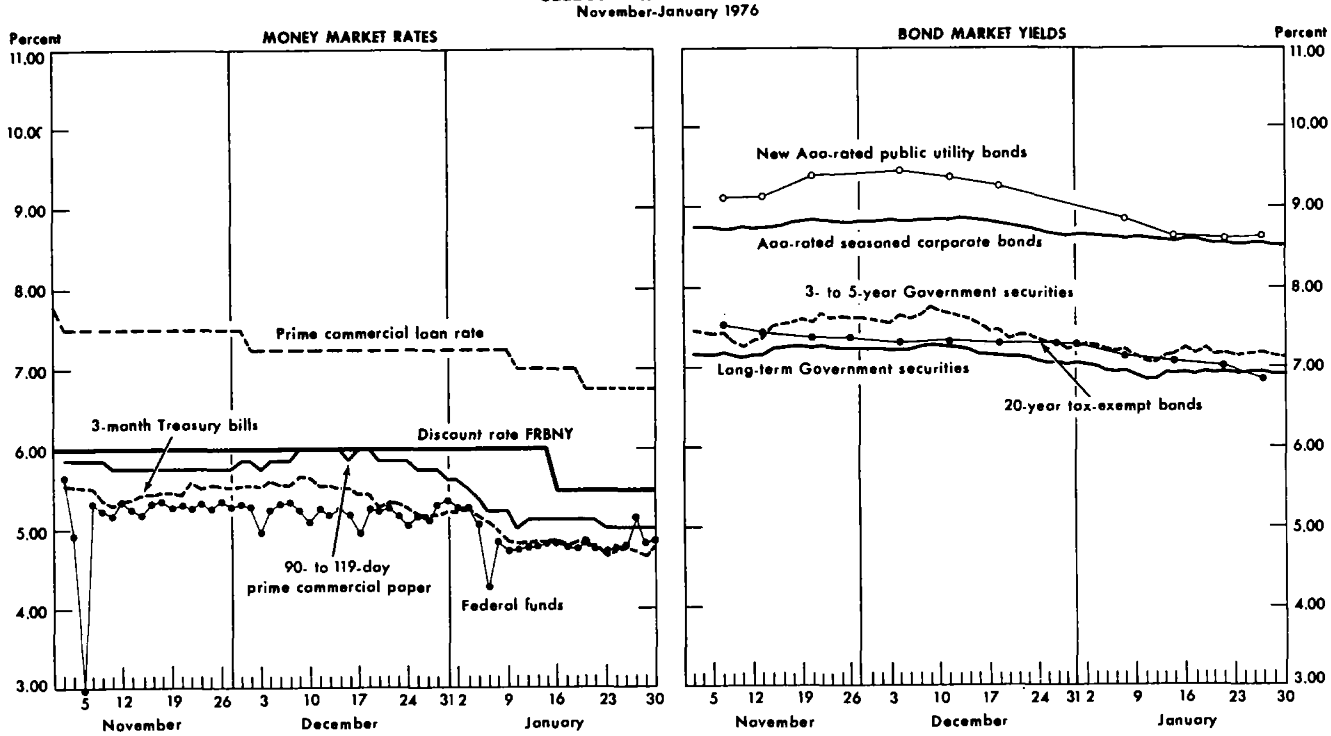
THE MONEY MARKET AND THE MONETARY AGGREGATES

Interest rates on most money market instruments declined sharply during the first half of January, then stabilized at new lower levels (see Chart I). Compared with its average in December, the effective rate on Federal funds fell 33 basis points in January to 4.87 percent, its lowest monthly level since September 1972. Most other short-term interest rates also posted substantial declines. Over the month, the rate on 90- to 119-day dealer-placed commercial paper dropped ⅝ percentage point to 5 percent, while the yield in the secondary market on ninety-day CDs declined about ⅝ percentage point to 5.02 percent. Effective January 19, the Board of Governors of the Federal Reserve System approved a reduction in the discount rate at eleven Federal Reserve Banks, including New York, from 6 percent to 5½ percent, and the remaining Reserve Bank joined in this move on January 22. The action was intended to bring the discount rate into closer alignment with other short-term rates. Even with the discount rate reduction, Federal funds traded at rates generally below the discount rate and the volume of borrowing was modest (see Table I).

Commercial and industrial loans at large commercial banks fell by $3,897 million in the four statement weeks ended January 28. A sharp reduction in bank holdings of bankers' acceptances accounted for part of this decline, however. Loans excluding acceptances showed a decrease of $2,698 million. Over comparable periods in the preceding two years, these loans excluding acceptances were down an average of $3,153 million. Reflecting the easing in other short-term interest rates and the continued sluggish loan demand, most major banks reduced their prime lending rate to 6¾ percent in two ¼ percentage point steps.

In January the Board of Governors announced revision of the money stock and related measures to incorporate data obtained from nonmember banks in the June and September call reports and to revise seasonal adjustment factors. The revisions also reflect adjustments for certain new data relating to cash items in the process of collection, a deduction item in the computation of the demand deposits adjusted series. The "cash items" adjustment affected the money stock measures back to 1966. The major effect of the revisions was to lower slightly the growth of the money stock measures in 1970

Chart I
SELECTED INTEREST RATES
November-January 1976



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.

and raise slightly the growth in 1972. In addition, changes in the seasonal adjustment factors were larger than usual, particularly for M_1, and resulted in higher levels of the money stock measures for January and lower levels for June. As a consequence, monthly changes in the money stock measures in 1975 are now somewhat smoother than previously estimated. All money stock data in this article reflect these revisions.

According to preliminary data, the monetary aggregates gave a mixed picture in January, with M_1 showing continued weakness and M_2 showing substantial strength. Over the four-week period ended January 28, M_1—private demand deposits adjusted plus currency outside commercial banks—rose 2.6 percent at an annual rate from its average level over the previous four weeks. This brought the growth in M_1 from the four weeks ended thirteen weeks earlier to 3 percent (see Chart II). M_2—M_1 plus time deposits other than large negotiable CDs—on the other hand, benefited from the lower interest rates on money market instruments. Both individual and corporate savers were attracted by the relatively higher rates generally available on small- to medium-size time and savings deposits. As a result, the growth in M_2 accelerated to a 10.4 percent annual rate in the four-week period ended January 28 from its level over the previous four weeks. Over the same period, the adjusted bank credit proxy—total member bank deposits subject to reserve requirements plus certain nondeposit sources of funds—increased

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JANUARY 1976

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

Factors	Changes in daily averages— week ended				Net changes
	Jan. 7	Jan. 14	Jan. 21	Jan. 28	
"Market" factors					
Member bank required reserves	— 44	— 395	— 359	+1,084	+ 286
Operating transactions (subtotal)	+ 176	+3,893	— 433	—3,851	— 215
Federal Reserve float	—1,209	— 620	— 443	—	—2,272
Treasury operations*	+ 854	+2,545	— 633	—4,256	—1,490
Gold and foreign account	+ 15	— 60	+ 34	+ 74	+ 63
Currency outside banks	+ 392	+1,854	+ 679	+ 319	+3,244
Other Federal Reserve liabilities and capital	+ 124	+ 174	— 71	+ 12	+ 239
Total "market" factors	+ 132	+3,498	— 792	—2,767	+ 71
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	— 257	—3,515	+ 773	+2,551	— 448
Outright holdings:					
Treasury securities	— 516	—1,522	+ 62	+ 238	—1,738
Bankers' acceptances	—	+ 1	— 6	+ 14	+ 9
Federal agency obligations	—	—	+ 68	+ 172	+ 240
Repurchase agreements:					
Treasury securities	+ 184	—1,553	+ 620	+1,727	+ 978
Bankers' acceptances	+ 60	— 305	+ 14	+ 202	— 29
Federal agency obligations	+ 15	— 136	+ 15	+ 198	+ 92
Member bank borrowings	— 186	— 27	+ 108	— 94	— 199
Seasonal borrowings†	— 2	— 1	—	— 1	— 4
Other Federal Reserve assets‡	+ 35	— 87	— 41	+ 249	+ 156
Total	— 408	—3,629	+ 840	+2,706	— 491
Excess reserves‡§	— 276	— 131	+ 48	— 61	— 420

	Daily average levels				Monthly averages‖
Member bank:					
Total reserves, including vault cash‡§	35,531	35,813	36,220	35,075	35,660
Required reserves	35,232	35,627	35,986	34,902	35,437
Excess reserves§	299	186	234	173	223
Total borrowings	71	44	152	58	81
Seasonal borrowings†	10	9	9	8	9
Nonborrowed reserves	35,460	35,769	36,068	35,017	35,579
Net carry-over, excess or deficit (—)¶	208	127	66	42	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.

§ Adjusted to include waivers of penalties for reserve deficiencies in accordance with the Regulation D change effective November 19, 1975.

‖ Average for four weeks ended January 28, 1976.

¶ Not reflected in data above.

at only a 1.3 percent rate, as CDs registered a substantial decline when banks allowed rates to drop in view of continued weak loan demand.

In mid-January, the Federal Reserve adopted a new long-term target range for M_1 growth, left the ranges for the broader monetary aggregates unchanged, and advanced by one quarter the yearly period over which the ranges apply. The M_1 range for the period from the fourth quarter of 1975 to the fourth quarter of 1976 was widened to 4½-7½ percent from the previous 5-7½ percent range for the period from the third quarter of 1974 to the third quarter of 1975. The change was prompted by the recent transfer of an estimated $2 billion of corporate funds from checking to savings accounts at commercial banks. These transfers followed the November change of banking regulations allowing partnerships and corporations to hold commercial savings accounts of up to $150,000.

THE GOVERNMENT SECURITIES MARKET

Interest rates on United States Treasury bills continued their recent sharp declines and ended January substantially lower on balance. The declines followed general reductions of other money market rates and continued despite sizable additions to outstanding bills through increases in the regular weekly auctions. Yields on coupon issues, however, reversed course before midmonth, partly retracing early-January declines. Market participants became wary that the rally might have been overdone, especially in view of renewed evidence that economic recovery was well under way and of the continued heavy borrowing needs anticipated by the Treasury. Competition from the enlarged corporate calendar and the normal hesitancy that precedes a refunding announcement may also have been factors.

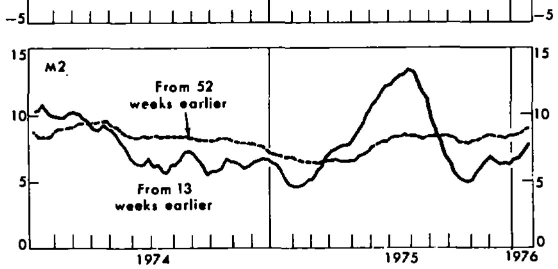
Prices of Treasury coupon issues rose early in January in line with the general improvement in the tone of the money and bond markets. However, the market accorded an unenthusiastic reception to $4.5 billion of Treasury notes during the second week of the month. In that financing, $2 billion of 64-month notes and $2.5 billion of 24-month notes were auctioned to replace $1.6 billion of maturing issues and to raise $2.9 billion of new cash. The average yields on the notes were 7.40 percent and 6.49 percent, respectively. Dealers made slow progress distributing the new notes, and with the February refunding on the horizon coupon prices moved downward.

On January 27 the Treasury announced its expected borrowing needs for the first half of 1976 and its offerings for the February refunding operation. The Treasury expects to borrow $35 billion to $40 billion in the market during the first six months of 1976, with $8.6 billion of this new cash having been raised in January. In its February refunding package, the Treasury made a larger than expected start on the balance of these funds by selling $9.4 billion of securities to retire $4.3 billion of publicly held notes maturing February 15 and to raise $5.1 billion in new cash. In auctions on February 5, the Treasury sold $3 billion of three-year notes at a 7.05 percent yield and $400 million of additional 8¼ percent 29-year 3-month bonds at an 8.09 percent return. In addition, the Treasury announced that it would accept subscriptions for at least $3.5 billion of seven-year notes with 8 percent coupons to be issued at par. The subscription technique, which had not been used in the past six years, caught the market by surprise. The response to it was favorable, however, since the coupon rate was set at an attractive level. Subscriptions were accepted through February 3. The issue turned out to be heavily oversubscribed, with requests totaling $29.2 billion. The Treasury originally announced that all orders up to $500,000 would be fully allotted. Because of the overwhelming response to the issue, orders of only $200,000 were actually met in full and subscriptions over that amount were also allotted $200,000. Even this restrictive approach to subscriptions resulted in an enlargement of the issue to $6 billion in sales to the public.

Chart II

GROWTH OF SELECTED MONEY STOCK MEASURES

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 January 28, 1976.

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.

Source: Board of Governors of the Federal Reserve System.

Following the Treasury's announcement, prices on outstanding coupon issues changed little, as most participants felt that the financing package was manageable. Over the month, the index of intermediate-term Government securities declined by 14 basis points to 7.14 percent while the index of long-term bond yields fell 13 basis points to 6.92 percent.

Treasury bill rates continued their sharp declines in January, buoyed by easier conditions in the Federal funds market. At the regular weekly bill auctions, rates on new three-month bills dropped almost steadily over the month (see Table II). On January 26, the average issuing rate was 4.76 percent, about 45 basis points below the rate set at the final auction in December and the lowest such rate since the auction of November 6, 1972. One-year bills were auctioned on January 7 at 5.58 percent, down 86 basis points from the yield at the December 10 auction. Rates on most issues ended the month 40 to 50 basis points below levels at the end of December.

In January, yields on Federal agency securities moved in a similar manner to those in the coupon market. A combined total of $1.42 billion of Federal Land Bank bonds was sold during the early part of the month and encountered an excellent reception. The offering consisted of $400 million of 6.60 percent 21-month bonds, $600 million of 7.35 percent 51-month bonds, and $420 million of 7.85 percent twelve-year bonds. These issues raised $347 million in new cash. Another series of agency bonds, involving $1,561 million of farm credit issues, was also sold during the month and raised $100 million in new cash. Investor response to these bonds was somewhat more modest. The issues were $399 million of 5.35 percent six-month Banks for Cooperatives (BC) bonds, $962 million of 5.65 percent nine-month Federal Intermediate Credit Bank bonds, and $200 million of 7.75 percent nine-year eleven-month BC bonds. On January 15, $126.1 million of 7.25 percent Government National Mortgage Association mortgage-backed bonds due in thirty years was priced to yield 8.22 percent on a corporate bond equivalent basis. This offering was immediately sold and traded at a small premium. Finally, on January 22 the Federal National Mortgage Association raised $300 million of new cash during the month through ten-year capital debentures yielding 8.15 percent.

OTHER SECURITIES MARKETS

The corporate bond market continued to rally during the first half of January. Low inventories, a slack forward calendar, and forecasts of lower interest rates in 1976 contributed to the optimistic atmosphere. However, by midmonth, the calendar of scheduled offerings had enlarged, massive Treasury borrowing loomed ahead, and sizable unsold balances of certain aggressively priced issues remained in dealer hands. Consequently, price gains halted, as market participants concentrated on the distribution of large new offerings.

A number of highly rated corporate issues came to market in January at yields appreciably below those available on similar issues in December. Three utilities sold thirty-year first-mortgage bonds, with yields of 8.50 percent on a $55 million Aa-rated issue, 8.83 percent on a $60 million Aa-rated issue, and 8.60 percent on a $100 million Aaa-rated issue. These yields were about 85 to 100 basis points below those on comparably rated securities offered during the previous month. In another major offering, $200 million of 25-year credit corporation debentures rated Aaa by Moody's and AA by Standard & Poor's was sold at a yield of 8.80 percent, about 100 basis points below a similar issue offered in December.

In the municipal market, yields on high quality issues also moved sharply lower over the month. Underwriters, however, continued to be wary of tax-exempt bond issues in view of the Federal legislation, passed the previous June, that holds them responsible for disclosure of information on the issuer. Hence, many state and local governments found it necessary to expand the data available on their financial condition before new issues could be floated. Over the month as a whole, The Bond Buyer index of twenty bond yields on twenty-year tax-exempt bonds fell 44 basis points to 6.85 percent. About a third of the decline, however, reflected a change in the composition of the index.

Prices on New York State-related tax-exempt bonds remained stable during the month in spite of the refinancing problems of certain agencies of New York State and Massachusetts and the suspension of Moody's rating of three New York State agencies. In New York, four agencies needed to raise $128 million by midmonth, mainly to refund maturing issues. However, several New York banks (on a rollover basis) and two state insurance reserve funds agreed to supply the necessary funds. The difficulties of one Massachusetts agency were overcome when the state purchased $60 million of notes that the Housing Finance Agency had been unable to market publicly. A possible solution to the financial problems of New York State agencies in the months to come was proposed during January, as state pension funds may consider buying "moral obligation" bonds of certain state agencies, contingent upon passage of a state constitutional amendment prohibiting further moral obligation borrowing and agreement by the private sector to underwrite the state's short-term borrowing in the spring.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—January 1976			
	Jan. 5	Jan. 12	Jan. 19	Jan. 26
Three-month	5.226	4.826	4.783	4.763
Six-month	5.521	5.066	5.046	5.052

Maturity	Monthly auction dates—November 1975-January 1976		
	Nov. 13	Dec. 10	Jan. 7
Fifty-two weeks	6.010	6.439	5.578

*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.