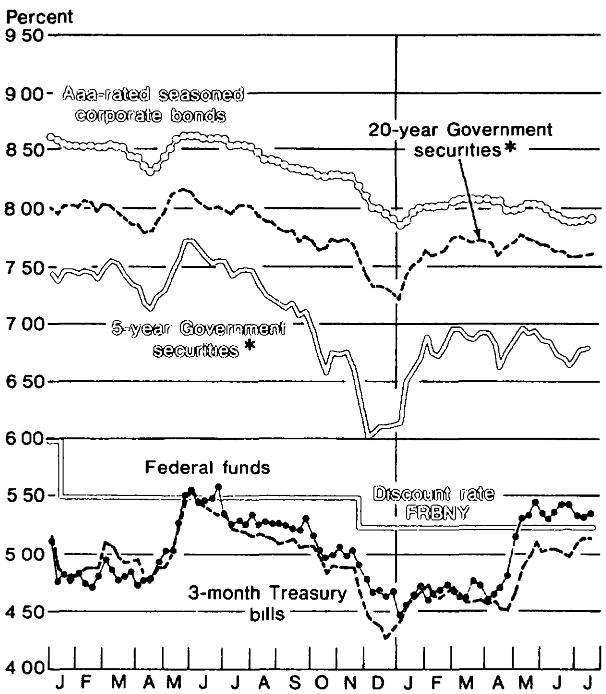
The financial markets
Current developments

Chart 1

Recent Changes in Interest Rates



*These yields are adjusted to five- and twenty-year maturities and exclude bonds with special estate tax privileges

Sources Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, and Moody's Investors Service, Inc

Short- and long-term interest rates moved in opposite directions during the spring and early summer. Rates on short-term instruments started to rise in late April when the Federal Reserve began to supply reserves less generously in response to sharply higher growth in the monetary aggregates. The Federal funds rate, which had been in the area of 4⅝ to 4¾ percent since December 1976, moved up to 5⅜ percent by the end of May and then fluctuated narrowly around that level into July (Chart 1). The advance in other short-term rates at first lagged the upturn in the funds rate, but most rates soon moved into line.

In the meantime, yields in the long-term debt markets were generally declining from April through the middle of July, after a steep upswing in the early months of the year. The capital markets rallied briefly in mid-April when President Carter announced his decision to eliminate the tax rebate program from the Administration's fiscal stimulus package. The announcement had a positive effect on the markets by allaying fears that fiscal policy might prove too stimulative and that enlarged Treasury borrowing would put upward pressure on yields. Increasing concern over inflation and reports of rapid growth in the monetary aggregates halted the rally by late April. But, when inflationary pressures appeared to be ebbing and the spurt in money stock growth subsided, yields began to edge down again. While there was some upward movement in yields early in July, at midmonth yields on most long-term securities were close to their January levels.

The Federal Reserve's decision to tighten its provision of reserves starting in late April did not represent any fundamental change in the overall thrust of monetary policy. However, the rapid expansion in the monetary aggregates in the spring (the increase for M_1

reached nearly 20 percent at an annual rate in April) was clearly inconsistent with the Federal Reserve's longer run objectives While money stock growth did slow to a modest pace over the May-June period, as was expected, the rate for the second quarter as a whole was nevertheless still rapid, with M_1 rising by 8½ percent (Chart 2). The Federal Reserve's decision to seek a higher trading range for rates on Federal funds during this period, a time of rather strong advance in business activity, was designed to insure that growth in the money stock would not exceed the System's long-term targets for too long a time. Continued rapid expansion in the monetary aggregates would risk exacerbating inflationary expectations—expectations that could in turn both push up long-term yields and undermine the sustainability of the continuing recovery.

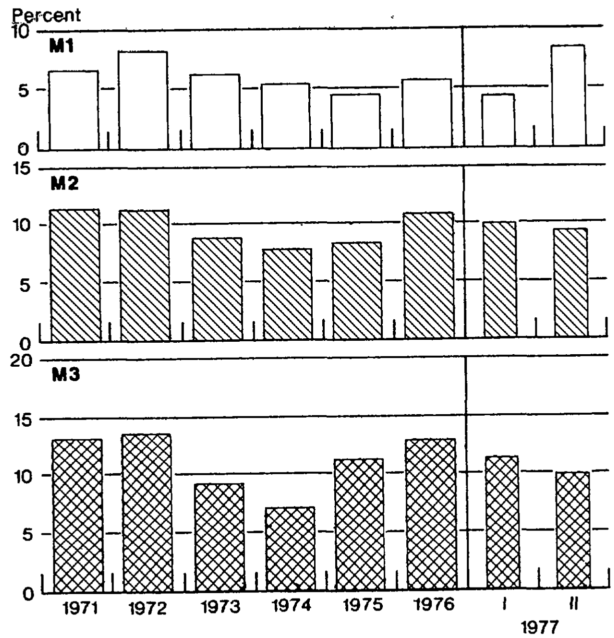
A better way of gauging the thrust of monetary policy is to look at the Federal Reserve's one-year target ranges for various monetary aggregates, which the Federal Open Market Committee began to announce publicly in mid-1975 At that time, the FOMC indicated its intention to lower these targets to levels consistent with noninflationary growth of the economy. The approach toward that objective has been gradual, however, in recognition of the need to sustain advances in business activity when inflationary momentum remains strong. Since then, Federal Reserve officials have reaffirmed this approach on many occasions. Consistent with this general policy, the FOMC voted to reduce the upper boundaries of the growth ranges for M_2 and M_3 by ½ percentage point at its April meeting, when it set the one-year targets applying to the first quarter of 1977 through the first quarter of 1978. This brought the M_2 and M_3 ranges to 7 to 9½ percent and 8½ to 11 percent, respectively. At the same time, the FOMC left the M_1 target range unchanged at 4½ to 6½ percent.

Since the beginning of the year, the economy has expanded briskly, and short-term credit demands have finally begun to show some of the strength normally associated with a cyclical upswing Reflecting and supporting sharply higher sales of automobiles and other consumer goods, consumer instalment loans have registered unusually large gains all year To service customers, finance companies, in turn, have stepped up their borrowing by raising substantial amounts of funds in the commercial paper market Nonfinancial corporations have also been very heavy borrowers in the commercial paper market so far in 1977. Indeed, while monthly movements were erratic, commercial paper issued by nonfinancial corporations over the January-June period advanced at an annual rate of nearly 40 percent

Chart 2

Growth of the Monetary Aggregates

Seasonally adjusted



The annual growth rates represent the percentage change from the fourth quarter of one year to the fourth quarter of the next The quarterly growth rates represent the percentage change from the preceding quarter, expressed at annual rates

Business borrowing at commercial banks, although less robust, also picked up substantially in the first half of 1977. Commercial and industrial loans (excluding bankers' acceptances) at all commercial banks rose at a 14 percent annual rate over the January-June period, compared with an increase of less than 4 percent in the last half of 1976. Not all banks have shared in this gain; in particuar, from data available for major New York City banks, it appears that business borrowing at money-center banks has shown little growth on balance this year In previous upswings, business borrowing at the larger banks also generally lagged borrowing at other banks. This time, however, the lag appears to be somewhat more prolonged, partly reflecting the ample liquidity of large corporations

The relative weakness in business loan demand experienced by major commercial banks was probably an important reason why they did not raise their prime lending rates by as much as the advances registered in many other short-term interest rates during the spring Most banks did boost their prime rates in May by ½ percentage point to 6¾ percent, but other short-term rates generally rose by ¾ percentage point over the April-May period. In June, one major bank refrained from increasing its prime rate to 7 percent, as was indicated by its guideline tied to commercial paper rates; instead, it altered the guideline formula and kept its rate at 6¾ percent. Later in the month, still another major bank reduced its prime rate to 6½ percent, but most other banks did not join in the move.

While private credit demands in the short-term markets have been strengthening in recent months, the Federal Government's budget in the second quarter moved into surplus The surplus in part reflected seasonal influences, which always tend to swell revenues in the April-June quarter But it also resulted from the President's decision to drop the tax rebate In line with its efforts to lengthen the maturity of its outstanding debt, the Treasury used the surplus to redeem large amounts of maturing bills at its regular weekly and monthly auctions, while raising some new cash through coupon issues. Over the second quarter as a whole, the net paydown of bills came to over $9 billion, while the amount of marketable coupon securities outstanding rose $5 billion.

The reduction in the Treasury's demand for funds in the second quarter helped to alleviate upward pressure on short-term rates at a time when private credit demands were building. The net paydown of maturing bills served especially to temper the rise in Treasury bill rates While rates on three-month bills advanced about 50 basis points in May, for example, rates on private money market instruments of the same maturity increased about 75 basis points. The modest amount of funds raised by the Treasury through coupon issues also had a beneficial effect on the long-term debt markets.

Private credit demands in the capital markets have varied considerably among sectors in recent months. In the corporate sector, the volume of new offerings so far this year has been running well below the levels of the past two years, a period when corporations were rebuilding their liquidity positions by reducing their reliance on short-term sources of funds. The volume of new equity issues has also been at a modest level in recent months, partly reflecting the general decline in stock prices this year.

In contrast, state and local governments have been borrowing heavily in the long-term debt markets. Indeed, the volume of new municipal offerings was at a record pace in the first half of 1977. In part, the huge volume of offerings represents advanced refundings of outstanding issues which were offered when rates were relatively high but are not yet eligible to be called. Even when this portion is excluded, however, the volume of new municipal issues has been unusually large this year.

Property-casualty insurance companies and open-end mutual funds have provided strong buying support for new municipal bond issues in 1977, while commercial banks have stepped up their purchases in recent months. In addition, investors in general have been attracted to municipal securities by the improvement in the financial condition of municipalities and by several recent court decisions protecting sources of revenue earmarked for bond repayment and prohibiting state legislatures from violating covenants on outstanding securities. These latter developments have led to sharp declines in the yields on lower quality issues and to the upgrading of quality ratings on securities of a number of municipalities, including those of New York City and New York State. As a result, spreads between yields on high- and lower quality municipal securities have continued to narrow from the record high levels reached in the summer of 1976 (For a further discussion of recent movements in the risk structure of yields in the municipal as well as other sectors of the bond market, see the following article.)