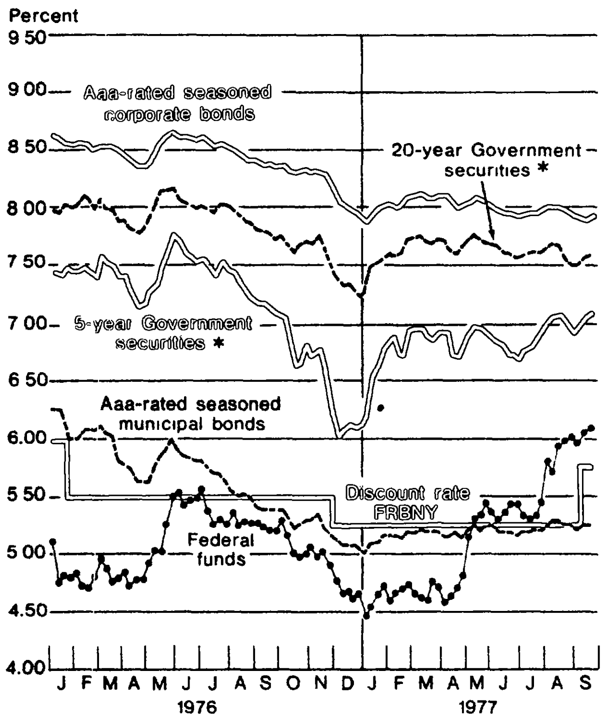
The financial markets
Current developments

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

Although short-term interest rates rose further during the summer, long-term yields continued to decline. Rates on short-term instruments moved upward in late July, when the Federal Reserve boosted its target range for rates on Federal funds in response to indications of rapid expansion in the monetary aggregates. The System moved cautiously, since it was not clear whether the monetary bulge that emerged in July reflected only temporary phenomena and would soon be reversed. When the monetary aggregates continued to rise above the Federal Reserve's longer run objectives, the System sought a further tightening of money market conditions in August and September. By the second half of September, the funds rate had risen to around 6¼ percent, compared with June's level of 5⅜ percent and the 4⅝ to 4¾ percent range that had prevailed in the early months of the year (see chart). Rates on other short- and intermediate-term instruments increased along with the funds rate, but the rise did not extend to the longer term sectors of the debt markets. Indeed, most long-term yields moved several basis points lower over the summer, after declining 10 to 15 basis points in the spring.

The advance in short-term market rates brought them to levels substantially above the Federal Reserve discount rate by August for the first time in nearly three years. The result was a surge in member bank borrowing at the discount window, which reached a daily average level of nearly $1.7 billion in the statement week of August 24. To reduce the incentive for member banks to borrow at the window, the Board of Governors of the Federal Reserve System approved actions by the Federal Reserve Banks that raised the discount rate from 5¼ to 5¾ percent in late August and early September. The Board emphasized that the increase did not signal a change in monetary policy; rather, it was intended as a technical move to bring the discount rate into better alignment with other short-term rates. The action had been widely anticipated, and market effects were minimal. Following the discount rate increase, member bank borrowing receded considerably from its August level.

Both the strength and the pattern of growth of the monetary aggregates during the July-September period closely resembled that of the second quarter. M_1 again surged in the opening month of the period; July's increase came to over 18 percent at an annual rate, nearly matching the extraordinary gain registered in April. Growth slowed over the succeeding weeks, as it had following April's bulge, but picked up again beginning in late August. As a result, it appears likely that the expansion of M_1 over the July-September period as a whole will prove to be even higher than the 8½ percent gain recorded in the second quarter.

Special factors may have contributed to sharp increases in M_1 during certain weeks in July, but they do not account for the sustained growth in this aggregate. An early disbursement of social security checks appears to have played a role in the sizable advance registered in the first statement week of the month. A similar timing for social security payments occurred in October 1976 and April 1977, periods when the money stock also displayed unusually large gains. However, the biggest increase took place in the third statement week. Deposit balances may have been boosted during that time, when normal check clearings were disrupted somewhat by the New York City power failure. But together these transitory influences probably can explain no more than 4 or 5 percentage points of the growth of M_1 for July as a whole. Moreover, they do not account for the fact that M_1 levels remained high and even expanded further in August and September.

So far, the rise in short-term interest rates has had only a modest effect on the ability of banks and thrift institutions to attract savings and consumer-type time deposits. Consequently, the broader monetary aggregates have also increased at fairly high rates in recent months, although their growth has not accelerated sharply as in the case of M_1. Both groups of financial institutions have been maintaining their offering rates on savings and short-term time deposits at regulatory ceilings and have recently boosted rates on longer term deposits to such levels At the same time, they have been advertising heavily and actively promoting long-term certificates in an effort to retain or attract funds from maturing "wild card" deposits. These are certificates with maturities of four years or more that were issued during a brief period in 1973, when rate ceilings on them were temporarily suspended.

The expansion of the monetary aggregates—particularly M_1—since the spring has clearly exceeded the Federal Reserve's longer run objectives. In fact, the Federal Open Market Committee (FOMC) voted to reduce the lower boundary of its M_1 growth range by ½ percentage point at its July meeting, when it set ranges applying to the second quarter of 1977 through the second quarter of 1978. This brought the M_1 range to 4 to 6½ percent. At the same time, the FOMC left the M_2 and M_3 ranges at 7 to 9½ percent and 8½ to 11 percent, respectively.

While short-term interest rates were rising over the spring and summer, yields in the capital markets fluctuated within a very narrow range and moved slightly lower, on balance. Yields on high quality corporate securities as measured by Moody's Aaa bond yield index, for example, have hovered near 8 percent during the past six months In the first three weeks of September, they averaged 7.90 percent, about 20 basis points below March's level. Yields on Government and high quality municipal securities behaved similarly. At the same time, lower quality corporate and municipal securities experienced further sizable yield declines, a reflection of increasing investor confidence as the recovery has proceeded. As a result, spreads between yields on low and high quality securities in both sectors have continued to drop in recent months and are now far below their 1976 peaks and close to their pre-recession levels.

The general stability of long-term yields in the face of sharply rising short-term rates appears to have stemmed from a variety of factors. In the first place, the restructuring of corporate balance sheets toward longer term debt that characterized much of the 1975-76 period seems to have abated considerably since the beginning of the year. Corporations have been borrowing more heavily in the short-term markets, while their offerings of long-term securities have fallen below the levels of the past two years. At the same time, the municipal sector has received strong buying support from fire and casualty insurance companies as well as from individuals, both directly and through tax-exempt bond funds This support has enabled state and local governments to borrow record amounts of funds in the bond markets, partly to refund in advance securities that were issued when rates were relatively high. Finally, the Federal Reserve's policy of announcing long-term targets for the monetary aggregates and its resolve to bring money stock growth down eventually to levels consistent with general price stability have helped to temper inflationary expectations. In this respect, the Federal Reserve's actions to restrain monetary growth in the spring and summer appear to have had a calming effect on investors in long-term securities by indicating that the System will act to prevent the monetary aggregates from expanding at excessive rates for too long a time.

In recent months, there have been a number of signs indicating a slowdown in the pace of the economic recovery from the unsustainably rapid advance registered in the first half of 1977. While such a development would not be surprising and indeed would be expected judging from past experience, a minority of analysts on the basis of this evidence are predicting an extended period of little or no economic growth. A few are even forecasting a recession.

Overall, recent financial developments do not support such pessimistic views. Previous slowdowns in economic activity, for example, were generally preceded by substantial declines in the rate of monetary expansion or else by dramatic shocks, such as the fourfold increase in petroleum prices imposed by the major oil-exporting nations in 1973. Clearly, the recent behavior of the money stock is not consistent with the view that the economy is likely to experience little growth, let alone head into a recession. To be sure, stock prices have dropped sharply in recent months, but the behavior of stock prices has not always been a reliable economic barometer.

Moreover, other financial indicators have been pointing to increasing confidence and underlying economic strength. The continued drop in spreads between yields on low and high quality securities in the bond markets is certainly an important sign that investors are more confident of the ability of firms and municipalities to service their debt obligations. In addition, consumers have shown a great willingness to take on substantial sums of mortgage and consumer debt. While this has generated some concern that households are becoming financially overextended, various debt measures relative to income are currently not out of line with the experience of the past decade (see the following article). Finally, businesses, governmental units, and financial institutions have greatly improved their liquidity positions in the past year or so and are now in excellent financial shape to sustain and support continued economic expansion