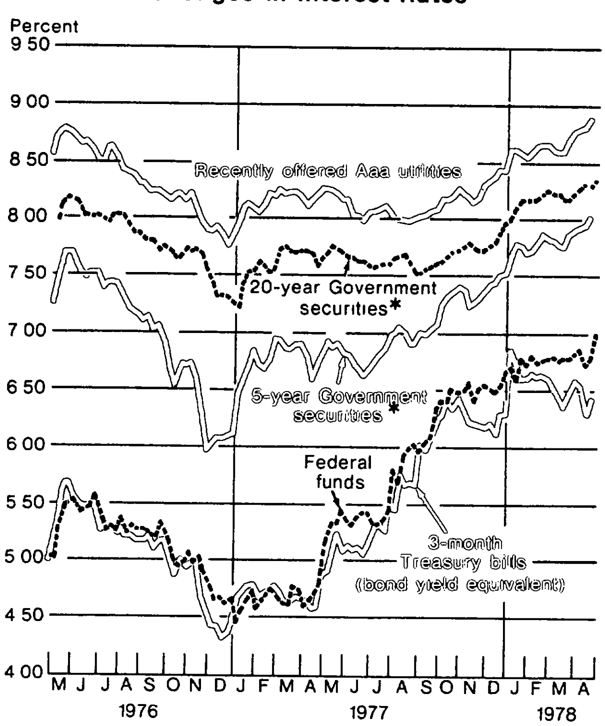
The financial markets

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

After remaining virtually flat for more than two months, interest rates began to rise in late March, as they had in early January and the latter part of 1977. Among the factors that contributed to the steadier environment during most of the winter were the slowing in the expansion of business activity and unexpectedly sluggish growth of the monetary aggregates. These developments tended to offset the concern over inflation and the weak performance of the dollar in foreign exchange markets. However, toward the end of March, investors became more apprehensive and rates once again began to rise.

Anchored by the stability of the Federal funds rate, most short-term market yields varied very little one way or the other from mid-January through the end of March. Some general upward pressure became apparent at that time as this key money market rate edged up, arousing concern over a possible firming of Federal Reserve policy. Late in April the Federal funds rate did increase from 6¾ percent to around 7¼ percent and most other short-term rates followed suit (Chart 1).

Interest rates on United States Treasury bills moved somewhat out of step with other money market rates. On January 4 the Board of Governors of the Federal Reserve System and the Treasury Department announced actions that would be taken to check speculation and reestablish order in the foreign exchange markets This led some observers to expect a decline in foreign central bank purchases of Treasury bills, and yields on these securities rose relative to those on other short-term instruments. However, as time passed, the demand for bills remained strong and the rate differential gradually returned to its earlier level.

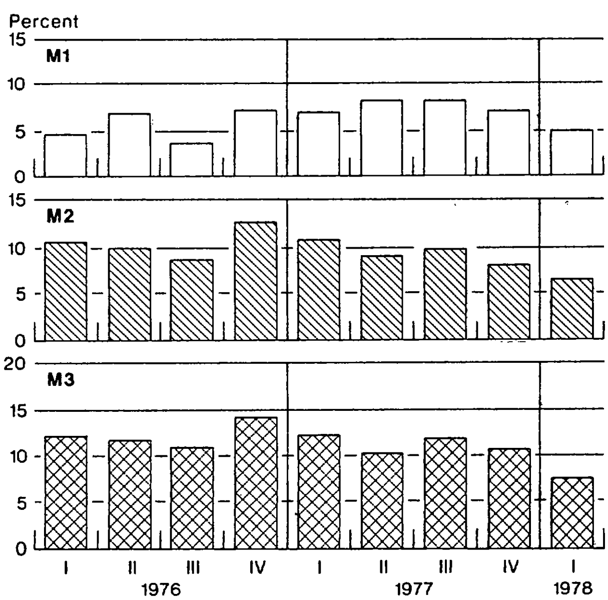
In the capital markets, yield fluctuations were also moderate during most of the first quarter, with little net change in the level of rates. The more relaxed atmosphere in these markets reflected a decline in new issues of both corporate and municipal securities. Although there was some pickup in March, gross offerings of corporate and municipal bonds in 1978 are running below their levels of last year.

Toward the end of March, long-term yields resumed their upward movement as the market reacted to signs that the economy was rebounding and that inflationary pressures were strong. The announcement of a record United States balance-of-trade deficit in February and the release of revised monetary aggregate data by the Board of Governors on March 23 strengthened expectations that a more restrictive policy stance was likely in the near term. The revisions in the monetary aggregates incorporated bench-mark adjustments for domestic nonmember banks, based on call reports for December 1976 and for March, June, and September 1977, as well as on revised seasonal factors. The bench-mark adjustments were somewhat larger than usual.

Chart 2

Growth of the Monetary Aggregates

Seasonally adjusted



The quarterly growth rates represent the percentage change from the preceding quarter, expressed at annual rates

The level of M_1 at the end of 1977 was increased by \$1.6 billion, while the growth of M_1 for 1977 was revised up from 7.4 percent to 7.8 percent. Of perhaps greater importance for bond market participants was the impact of the seasonal and bench-mark adjustments on recent monetary growth. They showed that M_1 rose at a 4.3 percent annual rate over the first two months of 1978, compared with the 1.6 percent rate of increase that had been previously reported for this period.

Despite the effects of the data revisions, M_1 growth did ease some in the first quarter, although there was a sharp rise in April. The first quarter's gain amounted to just over 5 percent at an annual rate, the lowest one-quarter advance in more than a year (Chart 2). Nevertheless, for the year ended in the first quarter, M_1 grew 7.3 percent, well above the 4½ to 6½ percent range that the Federal Open Market Committee (FOMC) had projected for the period. For the year ending in the first quarter of 1979 the projected range for M_1 is from 4 to 6½ percent, the same as the range projected for 1978.

Some of the first-quarter moderation in M_1 growth presumably reflects the temporary slowing of economic activity associated with the severe winter weather and the coal strike. But some may also reflect deficiencies in the seasonal adjustment techniques used by the Federal Reserve to adjust financial data.* The adequacy of these techniques has been a source of concern to the System for some time. On March 23 the Board of Governors announced the formation of a committee of experts to assess the applicability of various seasonal adjustment techniques to financial data, with a view to recommending the most appropriate methods to be used. Of particular interest to the Board is the adjustment of weekly and monthly series for the monetary aggregates, their components, and related bank reserve and credit flows.

Due partially to the easing in M_1 growth and partially to a noticeably weaker advance in savings and consumer-type time deposits at banks and thrift institutions, the broader monetary aggregates—M_2 and M_3—also rose more slowly during the first quarter than they did in 1977. These increases (expressed at annual rates) were 6.4 percent for M_2 and 7.4 percent for M_3. Both are just below the ranges projected by the FOMC for all of 1978. The projected growth of M_2 for 1978 is 6½ to 9 percent, while for M_3 it is 7½ to 10 percent. At its April meeting the FOMC voted to maintain the

* The March 23 data revisions substantially increased the slow first-quarter growth of M_1 in 1976 and 1977 For 1976 the increase was from 2 9 percent to 4 7 percent, while for 1977 it was from 4 3 percent to 6 9 percent

same ranges for both M_2 and M_3 for the year ending in the first quarter of 1979.

With market interest rates at or above the Federal interest rate ceilings on savings and small-denomination time deposits at banks and thrift institutions, some decline in the growth of these deposits was to be expected. Evidence of the enhanced attractiveness of other investment alternatives is provided by an increase in the volume of noncompetitive tenders in Treasury bill auctions and by the renewed growth of money market mutual funds. Money market mutual funds first attracted broad attention in 1974 when market yields exceeded deposit rate ceilings by wide margins. In little more than a year, assets of these funds rose from less than $200 million to nearly $4 billion. Thereafter, market rates declined and there was no further growth of the funds through the end of last year. In the three months since then, though, holdings of these deposit alternatives have expanded by $1.5 billion.

Net mortgage lending by thrift institutions has also moderated in recent months, but not so much as deposit growth. Under these circumstances, thrift institutions—particularly savings and loan associations—have added to their nondeposit liabilities in order to meet demands for mortgage credit Federal Home Loan Bank advances to these associations, the principal source of nondeposit funds, amounted to approximately $21 billion at the end of February. This is up from $14 billion in March 1977 and is very close to the record level established in December 1974. These changes in savings and loan association balance sheets have been associated with some deterioration in liquidity positions, as measured by the ratio of cash and investment securities to savings capital and total borrowings. However, this ratio remains well above the values reached in 1973-74, the previous period of sluggish deposit growth.

Commercial banks have experienced a similar tendency for inflows of consumer-type savings and time deposits to fall short of customer loan demands. To service their customers' needs, banks have sought to raise funds in the money market by selling Government securities, issuing large-denomination time deposits which are not subject to Regulation Q interest rate ceilings, and borrowing funds from nonbank sources in the markets for Federal funds and repurchase agreements. (The functioning of the latter markets is discussed in "Federal Funds and Repurchase Agreements", this *Quarterly Review,* Summer 1977.)

The sale of Government securities provided a considerable amount of financing for banks during the latter part of 1977. More recently, banks have focused on other means of raising funds. In particular, they have continued to issue substantial quantities of large-denomination time deposits. In recent months, most of the net new issues have been negotiable certificates of deposit at large banks (CDs). However, other large time deposits, which consist largely of nonnegotiable deposits in excess of $100,000 at weekly and nonweekly reporting banks, have also been an important source of financing. Indeed, as of March the outstanding volume of these other large time deposits was about 15 percent greater than that of negotiable CDs of large banks.

Over the last six months, weekly reporting banks in New York City have been as active in issuing CDs as banks outside the city, but the growth of CDs has been concentrated in a few very large banks. The moderate issuance of CDs by most city banks presumably reflects the fact that these banks have yet to participate in the rapid expansion in business loan demand that began in early 1977. Historically, the pickup in loan demand at New York City banks tends to lag behind the rest of the country, but the present temporal disparity is somewhat greater than normal.