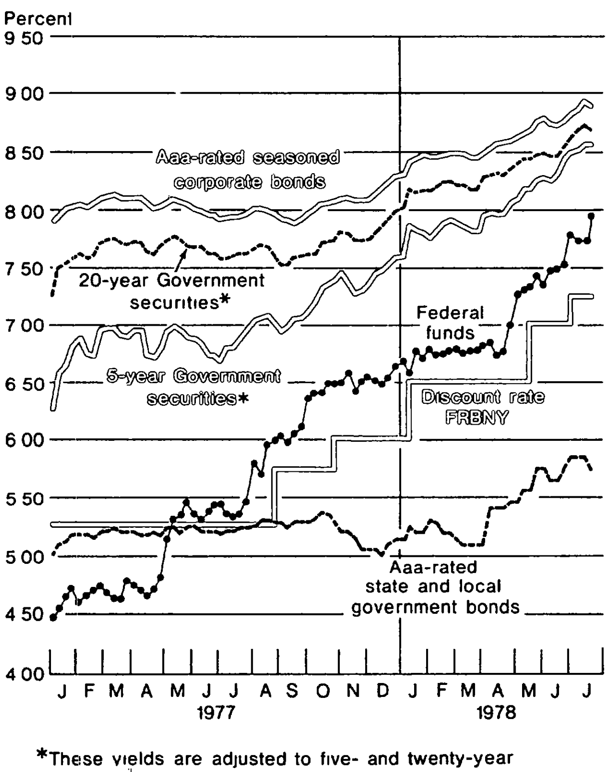
The financial markets
Current developments

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

The combination of vigorous growth in economic activity, rising prices, and continued brisk credit demands put strong upward pressure on the monetary aggregates in the spring and early summer. As the Federal Reserve resisted those pressures on the money stock, virtually all interest rates moved up noticeably over the April-July period, after changing little on balance since the start of the year

Money market instruments experienced the largest increases in rates in recent months (Chart 1). The Federal funds rate, which had hovered close to the 6¾ percent level since early January, started to rise in late April, when the Federal Reserve began to limit the availability of reserves relative to demand in response to sharp increases in the monetary aggregates. As monetary growth continued above the Federal Reserve's longer run objectives, the System gradually tightened its provision of reserves further, and toward the end of July Federal funds were trading around 7⅞ percent At times, the advance in other short-term rates moved out of step with the upturn in the Federal funds rate, but near the close of July most other money market rates were also about 1⅛ percentage points or so above their early-April levels. On two occasions during the second quarter, the Board of Governors of the Federal Reserve System eventually approved actions by the Federal Reserve Banks to raise the discount rate Increases were approved for the majority of the Reserve Banks, including New York, of ½ percentage point to 7 percent on May 11, and an additional ¼ percentage point to 7¼ percent on June 30 (The remaining Federal Reserve Banks quickly followed suit) In announcing its approval, the Board stated that the actions were taken in recognition of increases that had already occurred in other short-term rates.

The advance in money market rates over the spring and early summer has been spurred in part by strong demands for short-term credit. Reflecting the second-quarter rebound in the economy and increased purchases of automobiles and other consumer durables, consumer instalment loans have shown unusually large gains over the past several months. To service their consumer as well as business customers, finance companies, in turn, have stepped up their borrowing in the commercial paper market, and bank holding companies and their subsidiaries have been issuing sizable amounts of commercial paper to finance their nonbanking operations. Nonfinancial firms have also begun to show renewed interest in the commercial paper market as a source of short-term credit. Indeed, after remaining virtually flat since the summer of last year, the volume of nonfinancial commercial paper outstanding in the second quarter posted its largest increase in nearly four years.

The rise in business borrowing at commercial banks so far this year has also been unusually brisk. Over the first half of 1978, bank lending (excluding bankers' acceptances) to commercial and industrial firms advanced at an annual rate of more than 20 percent, up from the already rapid increase of 14 percent registered in 1977. Even business loan demand at the major New York City banks, which has been abnormally weak in the current recovery, has shown some signs of a modest pickup over the past several months, although recent gains remain well below those experienced at other commercial banks. To help finance strong loan demand in 1978, banks in general have been issuing substantial amounts of large-denomination time deposits, which are not subject to Regulation Q interest rate ceilings, while borrowing more heavily from nonbank sources in the markets for Federal funds and repurchase agreements. As the cost of raising short-term funds increased over the spring and early summer, most major banks boosted their prime lending rate in four ¼ percentage point steps to 9 percent by early July.

While rates on most short-term market instruments advanced by more than a percentage point over the April-July period, increases in long-term yields ranged from about 30 to 75 basis points. Within the long-term sector, municipal yields posted the largest gains. Unusually heavy borrowing by state and local governments—in part attributable to a surge in advance refundings prior to a Treasury ruling restricting these political units from setting up sinking funds invested in higher yielding taxable securities—put upward pressure on yields in that market. The smaller increases in long-term versus short-term rates over recent months largely reflect the fact that market participants had previously come to expect some gradual rise in money market rates over the spring and summer, and so these expectations were already incorporated into the yield structure at the start of the second quarter. But, subsequently, investors in long-term securities began to revise upward their expectations of the future course of interest rates in response to strong credit demands and continued sharp increases in prices.

The acceleration in monetary growth in the second quarter, coupled with several recent upward revisions to the monetary aggregates data, also weighed on market sentiment in the long-term sectors. Although each revision by itself was modest, the cumulative effect was to add significantly to the pace of monetary expansion from what was reported originally In late March, the Board of Governors announced revisions to incorporate bench-mark adjustments for domestic nonmember banks, based on call reports for December 1976 and for March, June, and September 1977, as well as revised seasonal factors. The effect of these revisions was to raise slightly the level of M_1 in 1977 and the first two months of 1978. Then in mid-June, the Board announced further revisions incorporating new estimates of nonmember bank deposits based on the December 1977 call reports, which boosted the level of M_1 from October 1977 through May 1978 Finally, the correction of a processing error in the computation of the cash item adjustments to the demand deposit component, announced by the Board in late June, had the effect of raising the level of M_1 over the May-June period.

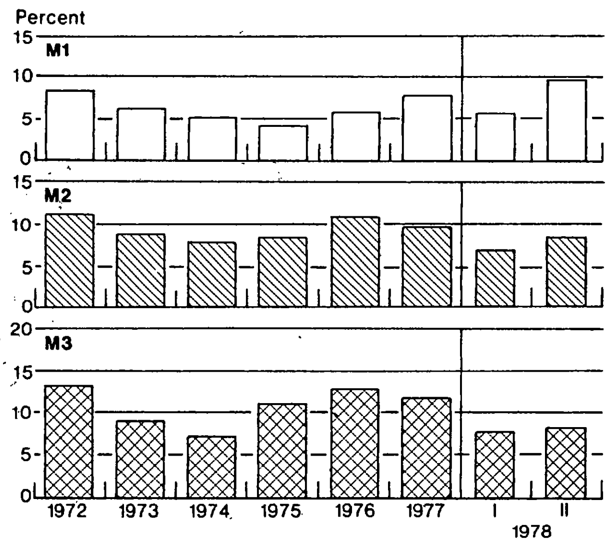
As a result of these revisions, M_1 is now estimated to have increased by 7 9 percent in 1977, compared with the 7.4 percent advance reported originally for that period. Although data available in early March of this year had suggested that M_1 would rise only sluggishly in the first quarter, revised figures show a moderate gain of 5.6 percent at an annual rate (Chart 2). Over the second quarter, the growth of M_1 accelerated to an annual rate of 9.5 percent—a record quarterly advance for the postwar period—resulting in a gain over the first half of 1978 as a whole little changed from that of 1977. By comparison, the FOMC's projected growth of M_1 for all of 1978 was a range of 4 to 6½ percent, and the same range was extended to cover the period from the second quarter of 1978 to the second quarter of 1979.

Although revisions to the broader monetary aggregates have also had the effect of boosting their growth from previous estimates, the recent expansion of these aggregates has remained well within the FOMC's longer run objectives. Over the first half of this year,

Chart 2

Growth of 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

M_2 advanced at an annual rate of 7.7 percent, while M_3 rose by 7.9 percent. These compare with the FOMC's yearly growth ranges for M_2 and M_3 for 1978 (and also for the four-quarter period ending in the second quarter of 1979) of 6½ to 9 percent and 7½ to 10 percent, respectively. Like M_1, the broader monetary aggregates expanded more rapidly in the second quarter than in the first, but this was accounted for entirely by the acceleration in growth of the M_1 component. With market rates generally above regulatory ceiling levels on comparable maturities of savings and small-denomination time deposits at banks and thrift institutions, inflows into these deposits over the quarter as a whole continued at a moderate pace.

To provide more flexibility for banks and thrift institutions to compete for funds so as to assure an adequate flow of credit into housing and to meet other borrowing needs, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board in a joint action, effective June 1, allowed their member institutions to begin offering two new types of time certificates. The new instruments are: a six-month money market certificate with a ceiling interest rate for new deposits that changes weekly with changes in the average rate on new issues of six-month Treasury bills and an eight-year certificate with a fixed maximum rate of interest. Both new certificates allow banks and thrift institutions to offer higher yields on deposits with comparable maturities than previously permitted. Maximum rates on the money market certificates, which must be issued in denominations of $10,000 or more and are nonnegotiable, are determined by the average auction rate on new six-month Treasury bills at the regularly weekly auction, normally held on a Monday. Commercial banks may pay a rate starting on the issue date of the bills, normally the following Thursday, not to exceed the most recent auction average on a discount basis (*e.g.*, 7.425 percent in the week beginning Thursday, July 27), while savings and loan associations and mutual savings banks may pay up to ¼ percentage point more[1] By comparison, the highest rates permitted on other time deposits with maturities of ninety days to one year are 5½ percent at commercial banks and 5¾ percent at thrift institutions On the eight-year certificate, which must be issued in denominations of $1,000 or more, commercial banks can offer a maximum rate of 7¾ percent, while thrift institutions can pay up to 8 percent Under previous regulations, yields on certificates with maturities of six years or more at banks and thrift institutions were limited to 7½ percent and 7¾ percent, respectively.

So far the money market certificates appear to be attracting considerable buying interest, while the new long-term certificates seem to be less popular. Insured commercial banks issued an estimated $2.1 billion in money market certificates over the first twenty-eight days of June. Thrift institution sales were apparently even stronger, reflecting the rate ceiling differential and their more intense promotion Data collected by the Federal Home Loan Bank Board from a sample of large savings and loan associations (holding among them 40 percent of industry-wide deposits) show that these institutions issued about $2.5 billion of money market certificates in June and an additional $1.3 billion over the first ten days of July. As of July 10, the volume of money market certificates at these institutions comprised about 2.3 percent of their total outstanding deposits. Surveys conducted by the National Association of Mutual Savings Banks of large mutual savings banks (holding more than 90 percent of total savings bank deposits) show sales of about $1.5 billion over the first twenty-eight days of June and $700 million more over the subsequent week. By July 5,

[1] Compounding the return on a daily basis, as is done by many banks and thrift institutions, results in higher annual rates

the amount of money market certificates at these institutions represented about 1.5 percent of their total deposits.[2] Respondents to the savings and loan association survey estimate that about 40 percent of the dollar volume of money market certificates issued so far represents new funds raised, with the balance coming from transfers from existing savings and time deposits within the same institution. Mutual savings bank respondents estimate a smaller proportion—about 25 percent—of new funds raised, probably because these institutions have a much higher percentage of their deposits in passbook accounts which can be shifted quickly without any interest rate penalty.

The surveys by themselves do not provide very strong evidence on whether the new money market certificates have enabled thrift institutions as a whole to attract more deposits than they would otherwise. On the one hand, even new funds raised at one institution could represent transfers from existing accounts at others; on the other hand, deposits transferred from an existing account to a money market certificate might otherwise have been withdrawn in the absence of the availability of the new certificate. Other information, however, suggests that the new money market certificates have indeed enabled thrift institutions to attract or to retain deposits. First, inflows of total deposits to thrift institutions strengthened somewhat in June from May's pace, despite a further rise in market yields. Also, investments in money market mutual funds, an increasingly important substitute for thrift deposits, showed less growth in June than in earlier months.

[2] Data on sales of the new eight-year certificates are available only for large mutual savings banks They show an estimated $357 million of these certificates was outstanding as of July 5

In addition to establishing new types of time certificates, the Board of Governors recently announced two other actions designed to improve the functioning of the financial system. In May, the Board amended its regulations to facilitate the participation of member banks in a newly announced Treasury program for the handling of its funds in commercial banks and other depositaries. Under the program, the Treasury will invest funds in interest-bearing notes of commercial banks and will compensate banks directly through fees for certain services rendered to the Treasury. It is hoped that the new procedure, which will be implemented following appropriations by the Congress of funds to cover the fee payments, will enable the Treasury to maintain reasonably stable balances at the Reserve Banks, thereby reducing the need for frequent and massive intervention by the Federal Reserve's open market Trading Desk (see the following article). Also in May, the Board announced that it had approved a plan permitting member banks, beginning November 1, to offer their nonbusiness customers arrangements whereby funds could be transferred automatically from savings to checking accounts. The new service can be used to cover checking overdrafts or to maintain a minimum checking account balance, provided that arrangements by the bank and its customers are made in advance. In explaining the desirability of the move, the Board cited the resulting greater convenience and efficiency of savings accounts and the benefits due to a reduction in the number of checks written on accounts with insufficient funds. Depending on the charges imposed by banks and the degree of public participation, the new service could also have important implications for the interpretation of the monetary aggregates by further blurring the distinction between demand and savings deposits.