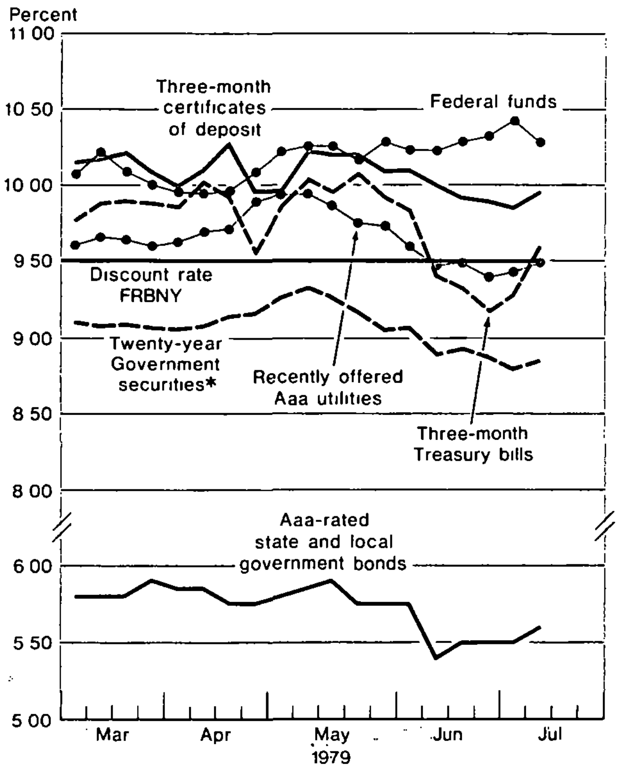
The financial markets
Current developments

Chart 1

Recent Changes in Interest Rates



*This yield is adjusted to twenty-year maturities and excludes 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

Financial market developments in the spring and early summer reflected the unsettled conditions in the economy Interest rates, particularly those on longer term securities, rose at first as concern over inflation intensified However, as signs of a slowing in the pace of economic expansion accumulated, the earlier increases were reversed The July 20 increase in the Federal Reserve discount rate to a record 10 percent was followed by an upward adjustment in short-term interest rates. The long-term debt markets, in contrast, rallied in response to the determination shown by the monetary authorities to strengthen the dollar.

During the spring, interest rates on most money market instruments extended the period of relative stability that had begun early in the year (Chart 1) Following an April surge in the growth of the monetary aggregates the Federal funds rate rose from around 10 percent or slightly higher to about 10¼ percent and then remained at that level through mid-July Other short-term rates moved in a similarly narrow band but showed little net change for the entire period For example, three-month certificates of deposit (CDs) were trading at around 10 percent in the secondary market in mid-July, essentially the same as their level in early April.

Yields on United States Treasury bills moved in line with those on other short-term securities for a while but then fell dramatically in early June Professional demand was heavy, amid speculation of collateral shortages and strong reinvestment demand as outstanding cash management bills began to mature. Later in June a weakening of the dollar in the foreign exchange markets led to increased purchases of Treasury bills by foreign central banks, which helped maintain the relatively low yields on these securities At times, steep rate declines in the Treasury bill futures market added impetus to the downward pressure in the cash market, particularly for bills closely related to the June and September contracts

Trading in the Treasury bill futures market was quite active over the period Open interest in the June 21, 1979 futures contract remained high throughout the latter stages of its life Indeed, on the last day of trading, the contract closed with a record high open interest of 706 contracts, resulting in the delivery of $706 million of September 20 bills on the next day. This delivery represented a substantial fraction of the September 20 bills outstanding, after excluding those held by the Federal Reserve, those held in foreign official accounts, and awards to noncompetitive bidders (The previous high delivery which occurred last December amounted to $442 million of bills)

In contrast to the short-term sector of the fixed income securities market, yields on long-term instruments fluctuated widely during the spring and early summer Initially, concern over inflation as well as a pessimistic long-run outlook for interest rates weighed heavily on the market Subsequently, large increases in the weekly money stock figures, together with a lack of retail follow-through demand for the Treasury's May refunding issues, also served to depress market sentiment. In this atmosphere, yields on long-term taxable bonds rose by up to 35 basis points, with the largest increases occurring in the corporate sector

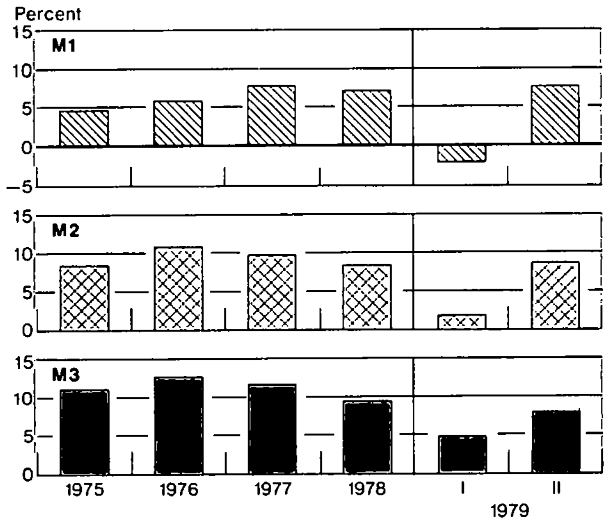
Toward the middle of May there was a major shift in sentiment Government statistics released at the time presented a softer picture for business activity than had previously been anticipated In particular, market participants were surprised by a small downward revision in first-quarter gross national product A series of reports for April added to the view of a weakening economy and helped turn rates lower In the changing investment climate a consensus began to take shape that bond yields might be near, or perhaps even beyond, a cyclical peak As a result, the market rallied strongly While yields backed up somewhat in early July, amid the weakening of the dollar in the foreign exchange markets and concern over energy policy, they remained below the early-April levels

In the tax-exempt market, the net change in yields was similar to that for other long-term securities but the pattern of movement was different Here, rates varied little through most of the spring but then dropped markedly in early June The initial strength in this area was largely technical as new issue activity was light The supply of new issues was curtailed further following the introduction in the Congress of legislation designed to end the tax-exempt status of home mortgage revenue bonds sold after April 24 While

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

Source Board of Governors of the Federal Reserve System

final action on the legislation is still pending, it forced postponement of virtually all such offerings, except for a few that were close to completion

Some of the volatility in the capital markets reflected the sharp but irregular rebound in the growth of the monetary aggregates. The behavior of M_1 is particularly noteworthy After remaining virtually unchanged since last summer this aggregate surged to a 7 5 percent rate of advance in the second quarter (Chart 2) Not only was the increase larger than those in the recent past but it was more uneven, with the entire change occurring in two months—April and June.

The second-quarter rise in M_1 more than offset a small first-quarter decline and brought the advance over the first half of the year to just below a 3 percent annual rate, which is at the middle of the 1½ to 4½ percent growth range specified by the Federal Open Market Committee (FOMC) for all of 1979. This range was originally set by the FOMC in February and was reaffirmed at its July meeting

Growth of the broader monetary aggregates (M_2 and M_3) also recovered from its modest pace early in the year, but in these cases the acceleration was not so sharp. A pickup in commercial bank time and savings deposits (other than large CDs), combined with the renewed strength in M_1, raised the second-quarter growth rate of M_2 to approximately 8.5 percent. Although this is well above the advance during the winter, it leaves the growth of M_2 for the first half of 1979 near the lower end of the 5-8 percent range projected for the year as a whole. As in the case of M_1, the FOMC voted at its July meeting to retain its original 1979 projections for the broader monetary aggregates and for bank credit.

Unlike time and savings deposits at commercial banks, thrift institution deposit inflows were weaker in the spring than in the winter. This turnabout in relative growth rates was due largely to the elimination of the higher ceiling interest rate that thrift institutions are allowed to pay on six-month money market certificates of deposit. (New regulations that became effective in mid-March reduce or eliminate the higher rate payable by thrift institutions whenever the rate on six-month United States Treasury bills is above certain levels.)[1] As a result, the recent uptick in M_3 growth was small, and for the year to date it remains at the bottom of the 6-9 percent range projected by the FOMC.

Total commercial bank credit expanded at about a 13 percent rate in the second quarter, bringing its growth for the first half of 1979 to a rapid 14 percent rate. In contrast to the experience with the monetary aggregates, the latter figure is well above the 7½ to 10½ percent growth range set by the FOMC for this year. As the pace of business activity weakened and inventories continued to mount, loans to commercial and industrial firms remained one of the strongest components of bank credit. After rising by 14 percent in 1978, the growth of business loans accelerated to nearly a 21 percent pace over the first half of this year.

At its July meeting the FOMC formulated preliminary growth ranges for the monetary aggregates and bank credit for 1980. The Committee tentatively decided that the ranges for 1980 should be the same as those for 1979, with the understanding that adjustments might be necessary in light of emerging economic conditions and in response to legal or legislative developments affecting M_1. (In April a United States Court of Appeals ruled that automatic transfer accounts—ATS—and certain other payments services are illegal under current laws and will be prohibited as of January 1, 1980 unless the Congress explicitly enacts new legislation authorizing these services.) In any event, the Committee noted that the current reexamination of the definitions of the monetary aggregates might in the near future lead to a new and improved set of money stock measures.

The second quarter witnessed a continuation of a number of ongoing changes in the balance sheets of financial market participants. Total investments in money market mutual funds rose by approximately \$9 billion, surpassing the previous record increase of \$7 billion set during the winter months. At the same time, while households added further to their stock of outstanding debt, there were indications of some moderation from the unprecedented borrowing pace of the previous two years. An analysis of household indebtedness is presented in the article beginning on page 9. As mentioned above, business firms placed strong credit demands on banks during the second quarter. An article beginning on page 35 looks at another important source of business credit that has grown over the past few years, namely, finance companies.

Commercial banks in the United States also made important changes in their portfolios in recent months. Specifically, they cut back on their domestic money market liabilities and instead drew heavily on the Eurodollar market. Since early this year, United States banks have permitted a \$22 billion runoff in deposits with denominations of over \$100,000—\$17 billion in negotiable CDs and \$5 billion in other large time deposits. With total bank credit continuing to advance at a rapid pace, banks offset this decline by increasing the net balances due to their own foreign branches by \$16 billion and the net balances due to nonaffiliated foreign banks by an additional \$5 billion. The increase in indebtedness of United States banks to their own foreign branches during the first half of this year is exceptionally large. Indeed, over the preceding eighteen months, United States banks had maintained a virtually constant level of \$10 billion in net claims *against* their foreign branches. Among the factors contributing to this dramatic turnaround were a 2 percentage point increase in reserve requirements on large-denomination time deposits (effective November 1, 1978) and some narrowing in the differential between interest rates on Eurodollars and on CDs. An April 13 proposal by the Board of Governors of the Federal Reserve System to impose a 3 percent reserve requirement on certain domestic nondeposit bank liabilities also may have provided some inducement for banks to borrow in Euromarkets.

[1] Effective March 15, 1979, the Board of Governors of the Federal Reserve System, the Federal Home Loan Bank Board, and the Federal Deposit Insurance Corporation took joint action to eliminate the ¼ percentage point differential on money market certificates issued by thrift institutions and commercial banks when the rate on six-month United States Treasury bills is 9 percent or more. The full differential is in effect when the ceiling rate is 8¾ percent or less. When the six-month bill rate is between 8¾ and 9 percent, thrift institutions may pay a maximum 9 percent while commercial banks may pay up to the actual discount rate on the bills. Except for the last two weeks in June and the first week in July, the six-month bill rate has not fallen below 9 percent.