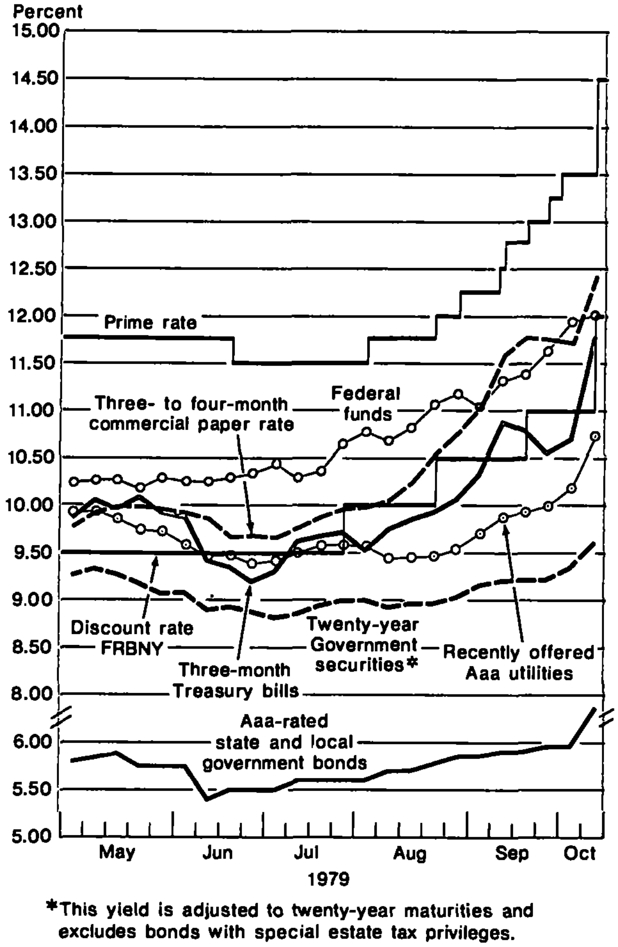
The financial markets

Current developments

Chart 1

Interest Rates Rose Sharply in the Third Quarter Following Declines in June



*This yield is adjusted to twenty-year maturities and excludes bonds with special estate tax privileges.

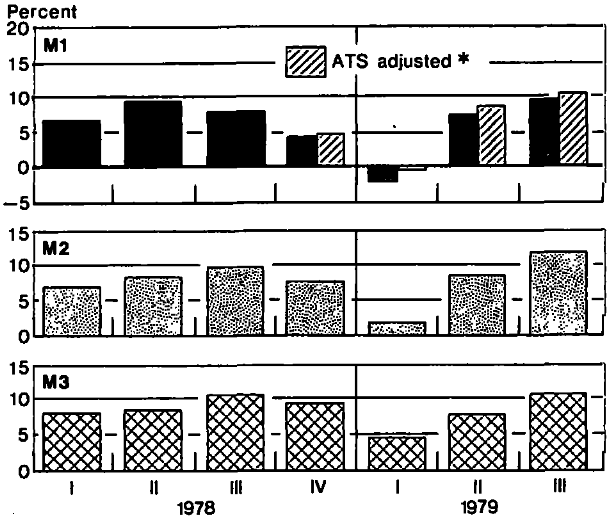
Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, and Moody's Investors Service, Inc.

With interest rates rising to record or near-record levels in the summer and early fall, the financial markets became increasingly cautious and uneasy. The markets were further unsettled by the economic uncertainties arising from several factors including continued high rates of inflation, rapid growth of the monetary aggregates, and bouts of severe weakness of the dollar in foreign exchange markets. On October 6 the Federal Reserve announced a series of policy actions aimed at gaining better control over the growth of money and bank credit, curbing speculative forces in foreign exchange and commodity markets, and thereby serving to dampen inflationary forces. These actions, all approved in unanimous votes, included: (1) a full percentage-point increase in the discount rate, (2) a marginal reserve requirement of 8 percent on certain managed liabilities of member banks, United States agencies and branches of foreign banks, and Edge Act corporations, and (3) a change in the method used to conduct monetary policy to support the goal of containing the growth of the monetary aggregates over the remainder of 1979 within the ranges previously established by the Federal Reserve. This action involves placing greater emphasis in day-to-day operations on the supply of reserves and less emphasis on confining short-run movements in the Federal funds rate.

Throughout the third quarter, heavy demand for short-term credit by businesses put strong upward pressure on interest rates. While the markets had rallied in June, when it appeared for a brief period of time that a peak in yields might be imminent because of emerging signs of an economic slowdown, short-term rates rose sharply during the third quarter and into early October. The movement toward greater restraint was spurred by increases in the Federal funds rate as the Federal Open Market Committee

Chart 2

Growth of the Monetary Aggregates Accelerated During the Third Quarter



* The growth rates are percentage changes from the previous quarter expressed at annual rates. The M1 growth rates are shown with and without an estimated adjustment for the impact of automatic transfers (ATS) between savings deposits and demand deposits introduced on November 1, 1978.

Source: Board of Governors of the Federal Reserve System.

(FOMC) acted to contain the very rapid growth of the monetary aggregates. The discount rate was raised three times during the third quarter, each time by ½ percentage point. In early October, as part of the broad plan aimed at gaining better control over the monetary and credit aggregates and slowing the rate of inflation, the discount rate was increased an additional percentage point. In turn, each of these increases brought the discount rate to a new record level, reaching 12 percent by October 8 and far surpassing the pre-1978 record of 8 percent set in 1974.

Other short-term rates generally paralleled the course of the Federal funds rate and the discount rate, and by mid-September the three-month Treasury bill rate had risen to just over 10.75 percent, an increase in excess of 150 basis points from the end of June (Chart 1). Near the end of the third quarter the financial markets rallied briefly when investors construed the four to three vote by the Board of Governors, approving an increase in the discount rate to 11 percent, as signaling that a peak in short-term rates was near. However, when the Federal Reserve announced its series of anti-inflationary policy actions on October 6, yields rose very sharply in an unsettled market as investors retreated to the sidelines.

In contrast to the short-term markets, the longer term sectors experienced only modest yield increases in the first six weeks of the third quarter, after participating in the June rally. Although inflation continued to be the primary focus of attention in the long-term markets, the weaker than expected performance of gross national product (GNP) in the second quarter helped to improve market sentiment. Expectations concerning inflation also improved during this period because of Paul Volcker's nomination as Chairman of the Board of Governors of the Federal Reserve System, and during the first half of the third quarter the long-term markets were also buoyed by the more restrictive monetary policy signaled by the increases in the discount rate and the Federal funds rate. However, by late August sentiment shifted as concern mounted that monetary policy might not ease for some time to come despite the evidence of weakening economic activity. The increase in the prime rate to a record 12¼ percent during the last week of August, along with a statement by Chairman Volcker that short-term interest rates are not likely to decline as long as the inflation rate continues high, added impetus to this change in sentiment in the long-term markets. As a result, investor interest in long-term issues declined, putting upward pressure on long-term yields during late August and early September. The same factors affecting the long-term markets contributed to a weakening in Treasury bill futures beginning in mid-August. Yields on the near-term contracts began the upward adjustment, and the rates on the late-1980 contracts followed one week later, as market participants reassessed the prospects of a more restrictive monetary policy through 1980 and into 1981 than had been anticipated only a few weeks earlier. And both the long-term securities market and the Treasury bill futures market reacted strongly to the Federal Reserve's policy moves on October 6 with prices initially moving sharply downward.

The prospects for any immediate easing in monetary policy were further dimmed by continued strength in the monetary aggregates during the third quarter (Chart 2). In part, the more rapid growth of M_1 in the second and third quarters as compared with the first quarter is due to a slower rate of expansion of savings accounts subject to automatic transfer service (ATS). After reducing M_1 growth an estimated 2 percentage points in the first quarter of 1979, the impact from ATS declined to about 1 percentage point in the second quarter and to about ½ percentage point in the third quarter. Uncertainty concerning the future legal status of ATS has undoubtedly led to reduced promotion of this service by commercial banks following a ruling in April by a United States Court of Appeals that ATS and certain other payment services are illegal under current laws and would be prohibited as of January 1, 1980 in the absence of Congressional action. However, even after allowing for the reduced impact from ATS, M_1 growth accelerated markedly in both the second and third quarters of 1979.

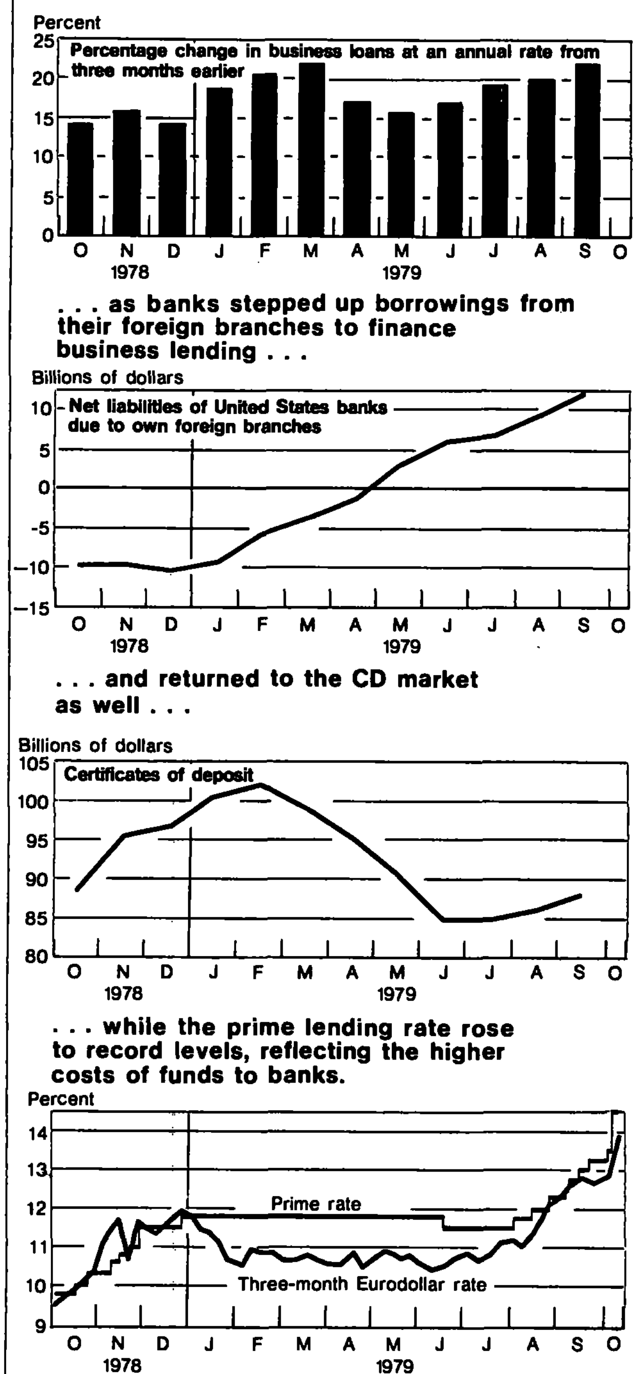
Reflecting not only the additional strength in M_1 but also very rapid expansion of time and savings deposits other than large negotiable CDs (certificates of deposit), M_2 growth accelerated to an annual rate of 12 percent in the third quarter from 8.6 percent in the second quarter. Savings deposits at commercial banks expanded at an annual rate of 5.5 percent in the third quarter, after declining $9.5 billion from October 1978 to May 1979. In contrast, sales of six-month money market certificates at commercial banks slowed in the three-month period from June to August to an average monthly gain of $5.2 billion, compared with an average of $6.8 billion per month in the March to May period.

Sales of six-month certificates at thrift institutions tapered off more sharply than at commercial banks during June, July, and August. These six-month certificates have added to the ability of thrift institutions to continue making mortgages even as market rates exceed the ceiling rates on other categories of time and savings deposits. The housing market has been further supported by the growing secondary mortgage market which now supplies one out of every four dollars of mortgage lending. A further development in the market for mortgage-backed securities was introduced during the third quarter when three firms announced plans to sell pass-through securities backed by a pool of mortgages serviced by a variety of mortgage lenders. This will provide a more diversified instrument for investors, since other publicly issued pass-through securities contain the assets of only one mortgage lender. And, for the lender, this new instrument means that smaller lenders can participate, since the entire mortgage pool need not be originated by a single institution. A more detailed analysis of this innovation and the mortgage-backed securities market in general is presented in an article beginning on page 1.

As was the case with commercial banks, total time deposits at thrift institutions accelerated in the third quarter—despite the slowing in the sales of six-month certificates—because of strength in other categories of time and savings deposits. Moreover, the strength in the monetary aggregates occurred even while the assets of money market mutual funds were expanding at a very rapid pace. These funds serve as close substitutes for savings deposits and, to a lesser extent, demand deposits. It is also possible that the rapid growth

Chart 3

The demand for bank loans by business remained very strong into the third quarter . . .



Source: Board of Governors of the Federal Reserve System.

of these money market funds has contributed to the slower sales of six-month certificates, with some investors placing the proceeds of maturing six-month certificates into money market funds to gain increased liquidity as well as market yields. As of September 1979, the assets of money market mutual funds amounted to about $35 billion, or 9.2 percent of M_1 and 3.7 percent of M_2.

In the context of the longer run trends in the monetary aggregates relative to the FOMC's annual targets, M_1, M_2, and M_3 all remain within their respective target ranges. The FOMC targets for 1978-QIV to 1979-QIV for these aggregates are 3 to 6 percent for M_1 (adjusted for a reduced impact from ATS), 5 to 8 percent for M_2, and 6 to 9 percent for M_3.

The target for M_1 has been adjusted from a range of 1½ to 4½ percent to a range of 3 to 6 percent because ATS has not been reducing M_1 growth by the amount originally incorporated in setting the target. It had been estimated at the beginning of the year that nationwide ATS along with NOW (negotiable order of withdrawal) accounts in New York State would reduce M_1 growth 3 percentage points from 1978-QIV to 1979-QIV. Thus far, however, the impact appears to have amounted to only about half that amount. In response to the difficulties encountered in analyzing the monetary aggregates in our changing financial structure, an alternative definition of M_1 has been proposed by the staff of the Board of Governors, which would include ATS and NOW accounts. This proposed definition of M_1 would eliminate the need to adjust the M_1 targets in the future because of differences between the estimated and realized impacts from ATS and NOW accounts. The new M_1 measure is expected to be ready fairly soon, possibly as early as February 1980 along with redefinitions of the broader monetary aggregates.

While the monetary aggregates have been growing at rates within the upper limits of the annual ranges set by the FOMC, bank credit (loans and investments plus loans sold to affiliates) has expanded thus far in 1979 at an estimated annual rate of 13 percent, a rate well above the 7.5 to 10.5 percent range. Much of the strength in bank credit stemmed from heavy demand for short-term business loans, as corporations financed increased levels of inventories. The demand for business loans has strengthened somewhat more at the weekly reporting banks in New York City than for those outside New York City. In the first quarter of 1979, the New York banks posted virtually no gain in business loans, while business lending continued strong outside New York. In the second and third quarters, however, the New York banks accounted for about 40 percent of the $16.4 billion increase in business lending by all weekly reporting banks.

A large volume of corporate financing needs is being met in the commercial paper market as well. Business loans have expanded at about a 22 percent rate from June to September, while business loans plus short-term commercial paper increased at an annual rate of 24 percent for the same period. Banks continue to finance these loans largely through nondeposit sources of funds, primarily borrowings from foreign branches, although in the third quarter banks also increased slightly the outstanding levels of CDs and large other time deposits of $100,000 or more after several months of running off these liabilities (Chart 3). To slow the growth of bank credit financed by CDs, Eurodollar borrowings, repurchase agreements (RPs), and Federal funds purchased from nonmember institutions, the Federal Reserve announced on October 6 an 8 percent marginal reserve requirement on the total amount of these liabilities outstanding in excess of the total level outstanding on average for the fourteen-day period ended September 26 or $100 million, whichever is larger.