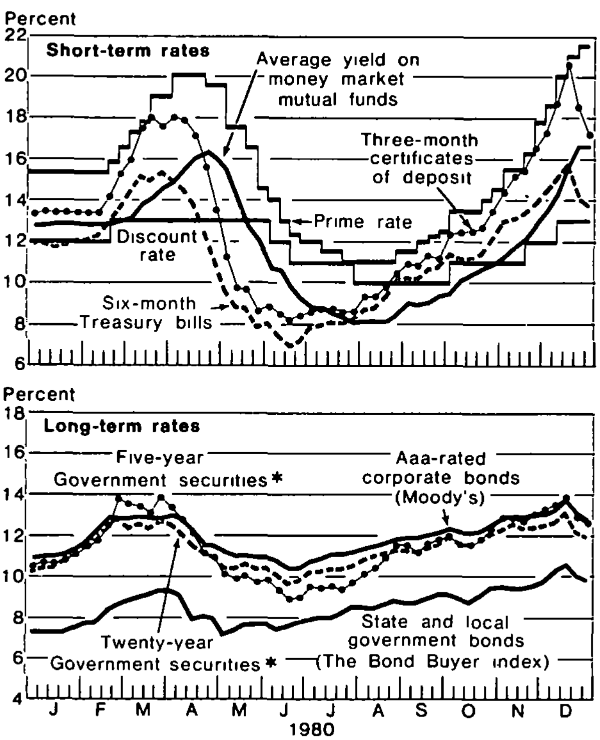
The financial markets
Current developments

Chart 1

After rising sharply for several months, interest rates declined in the final weeks of the year.



* These yields are adjusted to five-year 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, Moody's Investors Service, The Bond Buyer, and Donoghue's Money Fund Report of Holliston, Massachusetts

Financial markets tightened throughout most of the fourth quarter as interest rates approached and in many cases exceeded the record highs of last spring. But, in the final weeks of the year, interest rates declined (Chart 1) as the market reacted to slower money supply growth and indications that the economy would be weakening For most of the fourth quarter, however, the financial markets were responding to news of a much stronger than expected economy and very rapid money supply growth As a result, the three-month bill rate rose from about 11 percent at the end of September to 16 7 percent in the week of December 17. To keep the discount rate in line with other market rates and to restrain the rapid growth of money and credit, the Federal Reserve raised the discount rate twice during the fourth quarter to a level of 13 percent and imposed a surcharge on frequent borrowers from the discount window [1]

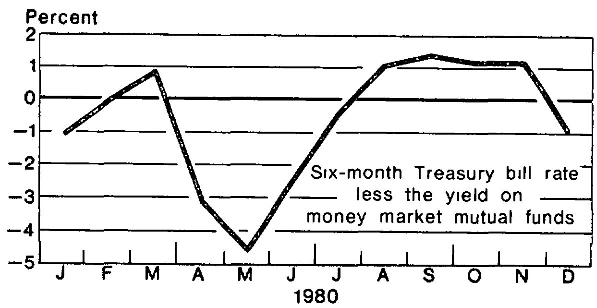
Partly as a result of the strengthening in economic activity in the second half of the year, M-1B rose at a 10 5 percent annual rate, compared with 2 3 percent in the first half of the year But the rapid growth of M-1B did not stem only from the strengthening in economic activity A considerable volume of funds were shifted from savings deposits, which are not part of M-1B, into automatic transfer accounts (ATS) which are a component of M-1B, ATS accounts, negotiable order of withdrawal accounts (NOWs), and credit union share drafts comprise the "other checkable deposit" component of M-1B The inflow of funds from savings

[1] The surcharge above the basic discount rate, which was set at 2 percentage points on November 17 and increased to 3 percentage points on December 5, applies only to borrowings for "adjustment purposes" by institutions with deposits of $500 million or more and is charged when such borrowings occur in two or more successive weeks in a calendar quarter or when borrowings take place in more than four weeks in a calendar quarter

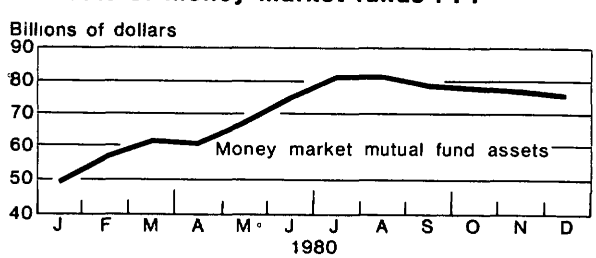
accounts into ATS accounts during the latter half of 1980 was concentrated at commercial banks outside the New York, New Jersey, and New England geographic area. Apparently, these banks were promoting ATS accounts aggressively in advance of the introduction of nationwide NOW accounts for all financial institutions as of December 31 to solidify in advance market shares for interest-bearing checkable deposits. Furthermore, to the extent that these ATS accounts replace prospective NOW accounts, reserve require-

Chart 2

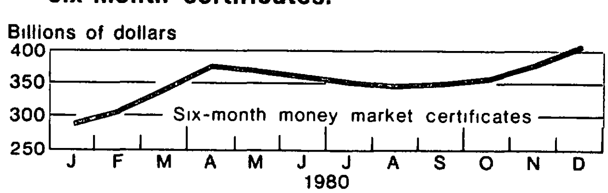
With short-term interest rates rising, the spread between market rates and the return on money market funds became positive after July . . .



. . . leading to a decline in the assets of money market funds . . .



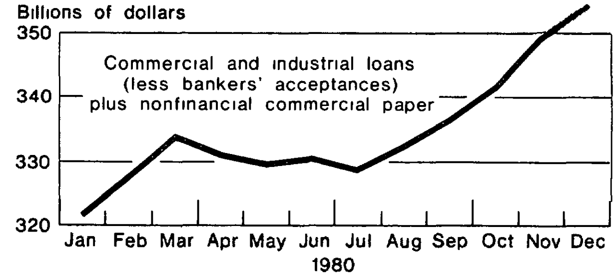
. . . and encouraging growth of six-month certificates.



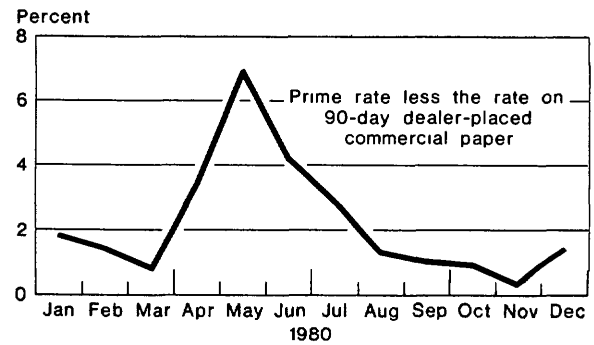
Sources Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, and Donoghue's Money Fund Report of Holliston, Massachusetts.

Chart 3

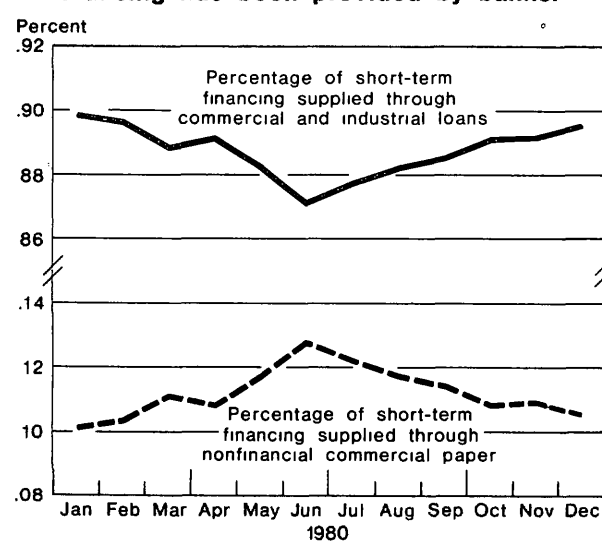
While the demand for short-term business credit has increased sharply since July . . .



. . . the spread between the prime rate and the commercial paper rate has narrowed . . .



. . . and a larger share of short-term financing has been provided by banks.



Sources Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System.

ments of these banks will be reduced for a while, since requirements on ATS accounts will be phased in from the previous ratio required against savings deposits (3 percent) to the higher level required against transaction accounts (12 percent for deposits in excess of $25 million). On the other hand, reserve requirements on NOW accounts outside New York, New Jersey, and New England will be at the level for transaction accounts immediately.

The rapid growth of other checkable deposits during the second half of 1980 makes it difficult to interpret the growth of the narrow monetary aggregates —M-1A and M-1B—relative to the annual targets for 1980 that were set by the Federal Open Market Committee (FOMC) last February. From the fourth quarter of 1979 to the fourth quarter of 1980, M-1B increased at an annual rate of 7.3 percent, about ¾ percentage point above the 6.5 percent upper limit set for 1980, while M-1A advanced at a 5.0 percent rate, well within the 6.0 percent upper limit of its annual range. The upper limits of the M-1A and M-1B targets were set with a ½ percentage point spread, assuming only negligible effects from ATS and NOW accounts. As it turned out, however, the spread between the annual growth rates of M-1A and M-1B was 2.3 percentage points as the public shifted a larger than expected volume of funds from demand deposits and savings deposits into other checkable deposits. After allowing for these unexpected shifts, both M-1A and M-1B increased at rates roughly equal to the upper limits of their respective annual ranges. The broad aggregates—M-2 and M-3—also showed strong growth during the second half of the year and recorded growth rates of 9.9 percent and 10.0 percent, respectively, slightly above the 1980 targets.

The introduction of nationwide NOW accounts on December 31, 1980 will continue to complicate the interpretation of the narrow monetary aggregates during 1981. As funds shift from demand deposits into NOW accounts, the growth of M-1A will continue to be reduced. This particular shift will not affect M-1B growth because both components are included in the definition of M-1B. However, other funds, primarily savings deposits, will also be moved into NOW accounts, which will add to M-1B growth in the same way that shifts of savings deposits into ATS accounts added to M-1B growth in 1980. As a result of funds shifting from demand and savings deposits into NOW accounts, M-1B growth is likely to be considerably stronger than M-1A growth during 1981.

Reflecting the strong demand for money during the fourth quarter, short-term interest rates increased sharply. The rate on six-month Treasury bills rose from about 11.5 percent at the end of September to 15.7 percent in mid-December. As a result of the higher yields which were consequently available on six-month money market certificates, the public invested a large volume of funds in these certificates at banks and thrift institutions during the latter part of the year (Chart 2). At the same time, the average yield on the assets of money market mutual funds increased from a low of about 8 percent during the summer months to 16.6 percent at the year-end. However, since the yield on money market mutual funds rises only gradually as portions of the existing portfolio of money market instruments mature and are reinvested, the return tends to lag behind other market rates. Consequently, the assets of money market funds declined during the fourth quarter. In contrast, during a period of declining interest rates, money market mutual funds should be more attractive than other market instruments because the yield would not fall so quickly.

The rapid increase in interest rates occurred during a period of strong demand for short-term business credit. Commercial and industrial loans exclusive of bankers' acceptances plus commercial paper issued by nonfinancial corporations expanded at an 18.7 percent annual rate between July and December (Chart 3). In part, this overall strength stems from the increased cost of borrowing in the long-term debt market. During the fourth quarter, rates on long-term corporate bonds were as much as 3¼ percentage points above the trough level recorded last summer. Many corporations became reluctant to incur such high borrowing costs on a long-term basis and turned instead to short-term sources of credit to meet their financing needs. As a result, new corporate bond offerings averaged only about $2.8 billion per month during the fourth quarter, compared with $5.6 billion during the spring and summer months.

As corporations turned to the short-term market, the interest rate spread between commercial paper and the prime rate was an important factor contributing to the composition of their short-term borrowing. Even though the prime rate rose to a record 21½ percent by the end of December, commercial paper rates rose by a greater amount and, as a result, corporations raised a larger proportion of their short-term credit needs at banks rather than in the commercial paper market. Another factor contributing to greater reliance on bank loans was the downgrading of several large issuers of commercial paper.