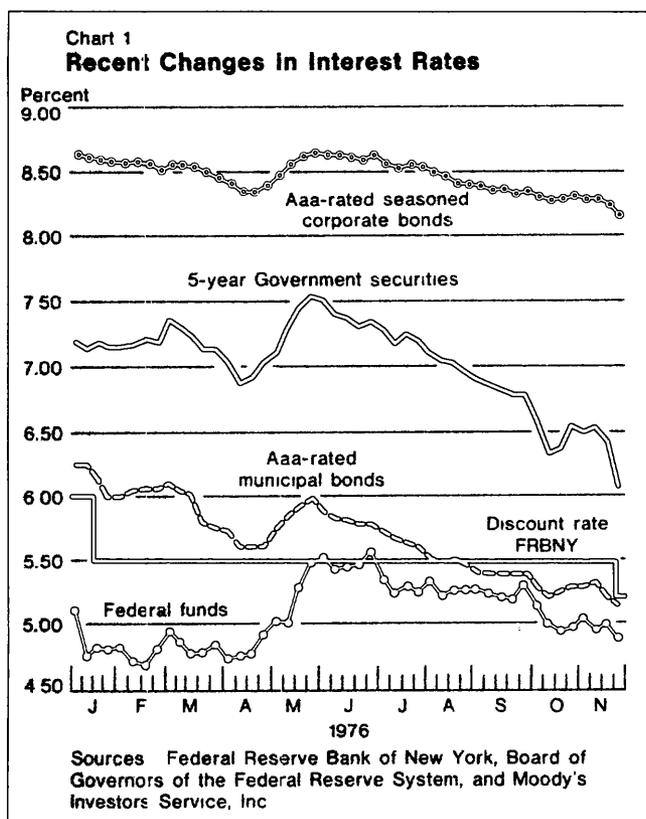
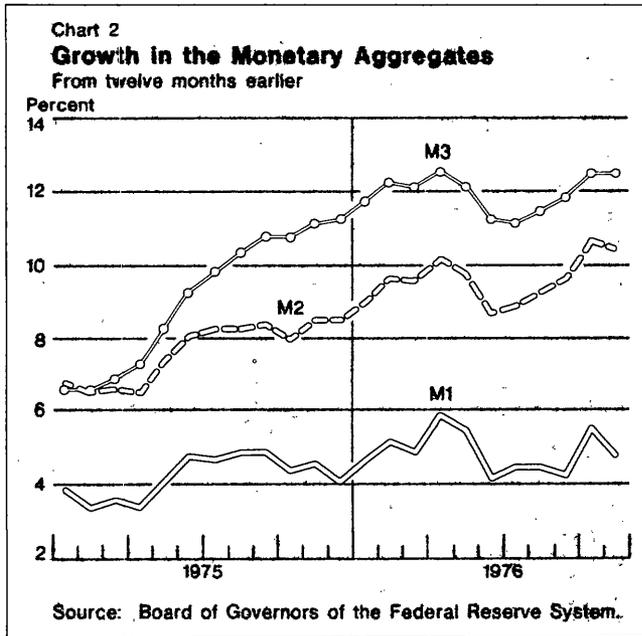


The financial markets Current developments

The broad decline in interest rates which began early in the summer extended into the fall. Growth in economic activity has remained modest in recent months and, under these circumstances, the Federal Reserve accommodated a further easing in interest rates without fundamentally altering the basic thrust of monetary policy. While the debt markets were somewhat hesitant in October, perhaps because of uncertainty associated with the outcome of the election, interest rates across the maturity spectrum moved down after the voting. Long- and intermediate-term yields declined to their lowest levels in more than two years despite both exceptionally heavy new issue activity in the municipal bond market and continuation of the Treasury effort to lengthen the maturity of its outstanding debt. Short-term market rates of interest, too, dropped further and, at the end of November, reached their lowest levels since late 1972. The Federal Reserve discount rate was reduced late in November by $\frac{1}{4}$ percentage point. The change to 5 $\frac{1}{4}$ percent was the first lowering of this rate since January. The action was taken to bring the discount rate into better alignment with short-term rates generally.

The persistent decline in most long-term interest rates through the summer and fall (see Chart 1) may have come as something of a surprise. Earlier, considerable pessimism had been expressed about the outlook for long-term yields. The view that such rates would rise over the balance of the year apparently was premised on the strong first-quarter performance of the economy and the spring bulge in the monetary aggregates. With the prolonged sluggishness in economic growth over the second and third quarters, however, concern that capacity problems would soon lead to an acceleration in inflation diminished. Moreover, the relatively modest expansion in the monetary aggregates, particularly M_1 , over the summer





helped to allay fears of another inflationary burst.

The prolonged drop in intermediate- and longer term yields came as the Treasury was in the process of lengthening the maturity of its marketable interest-bearing debt outstanding. Indeed, the average maturity of privately held debt, which stood at slightly over five years in mid-1967, fell consistently to a low of twenty-nine months at the end of 1975. It then held at about this level until the spring of this year, when it started to rise. By the end of November, the Treasury had succeeded in raising the average maturity to about three years. This increase was accomplished through heavy reliance on coupon offerings, especially intermediate-term issues, and a concomitant reduction in the use of Treasury bill auctions as a vehicle for raising new cash. In the first three refunding operations of the year, for example, the Treasury sold intermediate-term issues at par on a subscription basis. Demand for these issues proved in general to be far stronger than anticipated, with the Treasury ultimately selling considerably more of the securities than it had originally planned. Overall, through the first eleven months of this year, the Treasury raised \$49 billion of new cash through coupon offerings but less than \$6 billion in the bill market.

In recent months, the slower rate of economic expansion has continued. At the same time, evidence has accumulated suggesting that business loans at large weekly reporting commercial banks finally may have bottomed out. Over the thirteen-week period

ended December 1, business loans at these banks, including loan sales to affiliates, rose \$4.4 billion, whereas they had fallen by more than \$21 billion from their peak at the end of 1974 to August of this year. While some of the latest increase reflects bank purchases of bankers' acceptances, there nevertheless has been some growth in business loans exclusive of acceptances. The pickup appears to be concentrated in major money center institutions, where such loans previously had been particularly weak. It should also be noted that, despite recent signs of some firming, overall business demand for short-term credit has still been unusually soft thus far in the economic recovery. And, with short-term market interest rates continuing to move lower, a few commercial banks reduced their prime lending rate $\frac{1}{4}$ percentage point to $6\frac{1}{4}$ percent in late November, following a $\frac{1}{4}$ percentage point reduction which became general early in the month.

The complete absence of a normal cyclical rise in short-term interest rates at this stage in the business cycle has preserved the competitiveness of time and savings deposits at commercial banks and thrift institutions at a point when such deposits might typically be feeling the effects of Regulation Q ceilings.¹ This factor, together with legal and institutional changes such as NOW accounts, corporate and local government savings accounts, and telephone transfers of funds from savings to checking accounts, has enhanced the attractiveness of savings relative to demand deposits and has contributed to divergent growth in the monetary aggregates over much of the year.² Indeed, over the first eleven months of the year, growth of M_2 generally was running about 4-5 percentage points above that of M_1 , and the gap between the expansion of M_3 and of M_1 was even wider (see Chart 2). In testimony before the Congress in November, Federal Reserve Board Chairman Burns indicated that the long-run objectives for growth in the monetary aggregates had been modified to take these factors into account. The upper boundary of the desired growth-rate range for M_1 was reduced $\frac{1}{2}$ percentage point, with the range set at $4\frac{1}{2}$ to $6\frac{1}{2}$ percent for the period extending from the third quarter of 1976 through the third quarter of 1977. In contrast, the growth path ceilings for the broader M_2 and M_3 measures were raised $\frac{1}{2}$ percentage point, establishing new ranges of $7\frac{1}{2}$ to 10 percent and 9 to $11\frac{1}{2}$ percent, respectively.

¹ For an explanation of the recent behavior of short-term interest rates, see the article on pages 33-39 of this *Review*

² For further discussion of these developments, see Laurence H. Meyer, "Alternative Definitions of the Money Stock and the Demand for Money", *Monthly Review* (Federal Reserve Bank of New York, October 1976), pages 266-74