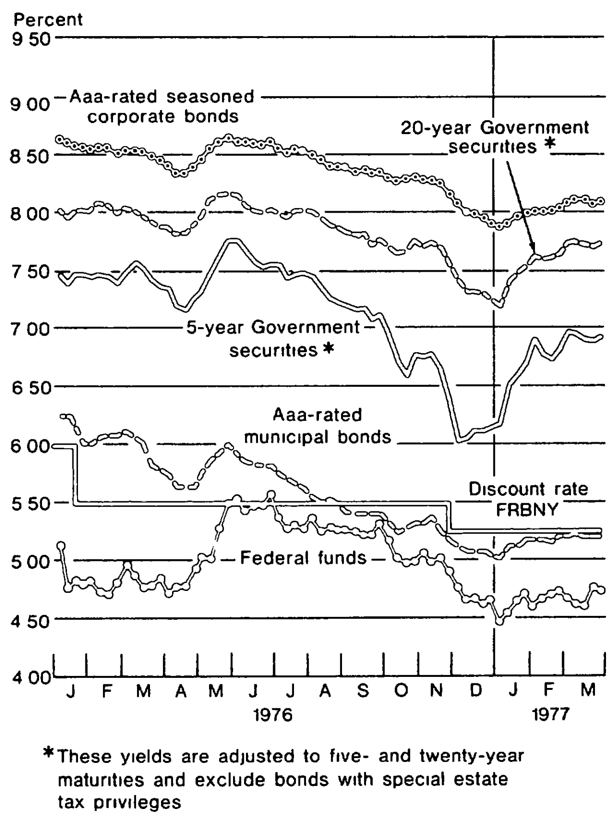
The financial markets
Current developments

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

A significant change took place in the financial markets near the turn of the year. At the end of 1976, a buoyant, practically euphoric, atmosphere pervaded the stock market and the various sectors of the bond market. The pace of the economy had been somewhat subdued in the last half of the year, and inflationary pressures seemed to have abated. Underwriters and investors alike were therefore expecting the kind of moderate and restrained economic growth that would limit both inflation and upward pressure on interest rates.

Developments early in the first quarter of 1977, however, caused a rapid, almost overnight, change in expectations. Prior expectations proved to be wrong on several counts. Underwriters had anticipated a further decline in the Federal funds rate which would spur demand by investors, but the rate did not decline. The slower growth in economic activity came to be recognized as having been only temporary. And the behavior of the various price indexes—consumer, wholesale, and spot commodity—raised the possibility of more inflation than had generally been forecast for 1977 and beyond.

The reaction to these changed perceptions had its major effect very soon after the year opened. Securities underwriters and dealers began unloading the excessive inventories they were carrying. Underwriters and dealers also began to believe that investors would demand higher interest rates to compensate for the possible increase in inflation. In addition, investors started to focus on the likelihood that the new administration's budget deficit could be too stimulating for the economy and could also enlarge Government borrowing in the credit markets. All these factors caused prices of debt instruments to fall sharply during most of January; only near the month's end did prices become steady, and they have remained fairly stable ever since. The drop in prices, of course, meant a rise in interest rates.

The abrupt change in the atmosphere of the financial markets occurred in the absence of any change in the thrust of monetary policy. Indeed, the Federal funds rate was steady throughout the first quarter, fluctuating narrowly around December's average of 4.65 percent. Beyond the shortest term sector of the money market, however, the change was pervasive. For example, the monthly average of rates on three-month Treasury bills reached 4.60 percent in March after they had fallen to 4.35 percent in December. Interest rates in other short-term markets followed much the same pattern. The advance in yields on intermediate-term Government securities was particularly sharp (see chart). This reflected the adverse swing in sentiment about the medium-term outlook for inflation and the prospect of sales in this maturity range by banks to accommodate greater loan demand. Accordingly, the yield on a five-year Government issue climbed to a 6.93 percent average in March from the recent low of 6.10 percent in December.

Interest rates on long-term Government and corporate bonds also declined before the year-end and then rebounded sharply. When yields moved down, more corporate issues to raise new funds and to refinance appeared. When yields went up again, some corporate issues were postponed to await better market conditions.

Rates in the municipal bond market did not reverse course as much as those in other long-term markets. There has been a general downward movement in municipal yields over the past eighteen months, reflecting the improved financial conditions in New York and other cities. Another event important to the municipal market was a court decision in November that prohibited New York City from continuing its moratorium on repayments of principal to holders of certain of the city's notes This prompted a considerable improvement in the status of lower rated municipals generally, and their yield spreads from prime-rated municipals consequently fell. The spread between Baa and Aaa municipal yields, as reported by Moody's, was 187 basis points at the end of November and narrowed to 115 basis points at the end of March.

Because of the trend to lower yields on tax-exempt issues, commercial banks on the whole limited their accumulation of these securities. Banks did choose, however, to increase their holdings of bankers' acceptances by sizable amounts before their end-of-year financial statements were due. They ran off most of these acceptances as the new year began. (Banks did much the same around the previous year-end.)

During the first quarter of this year, commercial banks added substantially to their Government securities portfolios—rather more than they usually do in that quarter. Lending to businesses, however, continued to rise only very slowly, with demand for these loans at money market banks lagging demand elsewhere, as is typical in a cyclical upswing. Corporations have on the whole reduced their bank borrowings substantially over the past two years, and they have bought a considerable volume of liquid assets. Their stronger cash position allowed them to make sizable income tax payments in March without borrowing a great deal from commercial banks.

The recent improvement in corporate liquidity is one of the determinants governing the outlook for the credit markets over the balance of 1977. The fundamentals indicate some cyclical upturn in private demand for credit, and the Federal deficit may add more to credit demands than is usual for this stage of the cycle. With economic activity and income growing strongly, however, the level of private saving will rise and thereby increase the already ample supply of investable funds. The outlook for inflation will be important to the credit markets this year, and these markets will remain very sensitive to any change in perceptions about how well inflation is being kept in check.