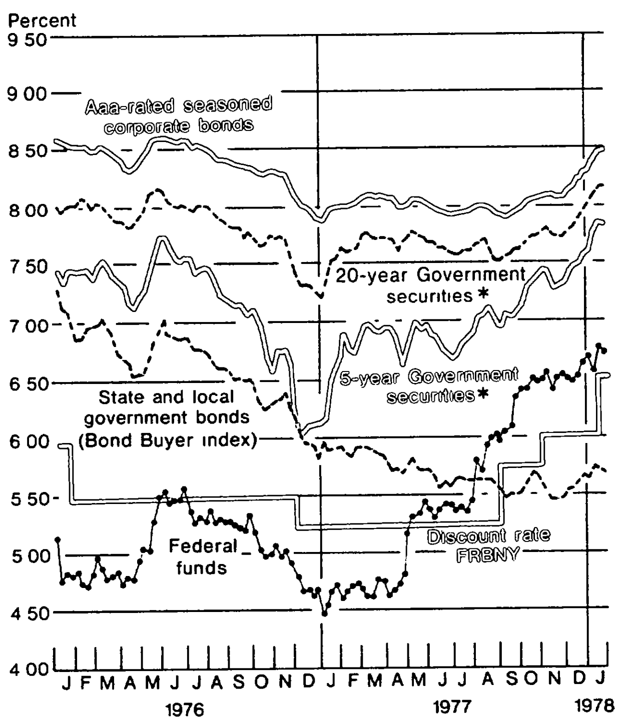
The financial markets
Current developments

Chart 1

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, Moody's Investors Service, Inc, and The Weekly Bond Buyer

In an environment of brisk credit demands, interest rates have moved up over recent months both in the money markets, where rates had been rising since the spring, and in the bond markets, where yields had been relatively stable during most of 1977. After the turn of the year, the markets reacted promptly to several actions by the Federal Reserve System that were designed to check speculation and reestablish order in the foreign exchange markets.

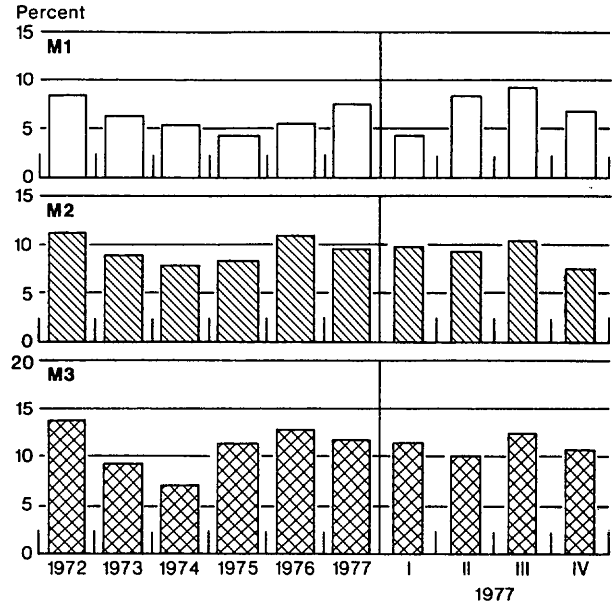
On January 4, the Board of Governors of the Federal Reserve System and the Treasury Department issued a joint statement announcing that the Exchange Stabilization Fund of the United States Treasury would be utilized actively, together with the $20 billion swap network operated by the Federal Reserve System. (The monetary effects of Federal Reserve swap operations are discussed in the following article.) On January 6, the Board approved ½ percentage point increases in the discount rate to 6½ percent by this Bank and the Federal Reserve Bank of Chicago. (The other Federal Reserve Banks followed suit shortly thereafter.) In announcing its approval, the Board cited recent disorders in foreign exchange markets as a threat to the orderly expansion of the domestic and international economy. The Board expressed the hope that the need for the increase would prove temporary and indicated that domestic business conditions were sound and that credit supplies to sustain economic expansion should remain ample. A few days later, the System began to seek firmer money market conditions, and by mid-January Federal funds were trading at around 6¾ percent, up from the 6½ percent level that had generally prevailed since mid-October.

Interest rates across the maturity spectrum rose quickly following the boost in the discount rate and the increase in the Federal funds rate (Chart 1). The largest advances were registered in the money market —where some rates jumped by almost 40 basis points on January 9—but long-term yields moved upward as well. Subsequently, most money market rates retraced some of the increases, as market participants came to feel that the Federal funds rate would stabilize at its higher level rather than advance further over the near term.

Even before the System's most recent moves, most short-term interest rates had been gradually rising for almost a month. The prime lending rate, which typically lags movements in money market rates, rose ¼ percentage point to 8 percent in early January, with major banks beginning to announce the increase prior to the Board's announcement of the higher discount rate. Long-term interest rates also began advancing in December after little change on balance since March. Contributing importantly to the higher rates in the latter part of the fourth quarter were expectations of continued strong credit demands.

System actions did influence money market rates near the start of the fall In early October, the System sought to dampen a persistent pattern of stronger than desired monetary growth by fostering a modest tightening of money market conditions. The Federal funds rate firmed from around 6¼ percent to 6½ percent. Toward the end of that month a further slight firming was sought for a short period, when it appeared that growth of the monetary aggregates was again becoming too rapid. Later on, information showed that the aggregates were advancing within the desired ranges and the objective for the Federal funds rate was returned to 6½ percent. The commercial bank prime lending rate increased in October in two separate steps by a total of ½ percentage point to 7¾ percent following similar advances in commercial paper rates in late September and early October. With money market rates increasing relative to the Federal Reserve discount rate, member bank borrowing from the discount window began to rise in mid-October. On October 25, the Board approved actions by the Reserve Banks to raise the discount rate from 5¾ percent to 6 percent.

Chart 2
Growth of the 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

The increases in short-term interest rates over 1977 were widely expected to reduce monetary expansion and, in the fourth quarter, M_1 growth did slow to a 6.8 percent annual rate (Chart 2). Over the previous two quarters, M_1 had advanced at an average annual rate of around 9 percent. Such a lag between a firming in money market conditions and a reduction in the pace of monetary expansion is not unusual.

While M_1 growth finally slowed in the fourth quarter, for the year as a whole its increase of 7.4 percent exceeded the FOMC's range of 4½ to 6½ percent projected for that period a year before. In contrast, over the four quarters ended in the last quarter of 1976, M_1 had advanced at a 5.6 percent rate which was slightly below the midpoint of its corresponding projected annual growth range. One of the main factors accounting for the acceleration of M_1 growth in 1977 was a slowdown in the rate at which the public substituted income-earning assets for demand deposit balances. During 1975 and 1976, demand deposit growth was dampened partly because of such switching to newly allowed interest-earning deposit substitutes, including negotiable order of withdrawal (NOW) accounts in New England and savings accounts of businesses and state and local governments. Over 1977, corporate savings accounts showed much reduced growth while state and local government savings accounts actually declined. Available data for the first three quarters of 1977 indicate less NOW account growth as well.

Reflecting both the slower fourth-quarter advance in M_1 and a moderate reduction in the growth of commercial bank time and savings deposits, the expansion of M_2 in the final quarter eased to a 7.5 percent annual rate. Small consumer-type accounts registered markedly slower growth, partly because of the advance in market interest rates to levels above ceiling rates on most maturities of commercial bank time and saving deposits. This was somewhat offset by a pickup in the expansion of the large time deposit component of M_2, which includes all large time deposits (over $100,000) at commercial banks except negotiable certificates of deposit at large banks. These deposits are not subject to rate ceilings.

M_3 growth also slowed in the fourth quarter. Deposits at thrift institutions, which are added to M_2 in deriving M_3, registered about the same expansion on a quarterly average basis, but monthly growth rates were successively lower. Despite rising market interest rates, thrift deposit growth was strong over the July-October period, when commercial banks—which have ceiling rates that are generally ¼ percentage point lower than those at thrift institutions—may have had difficulty competing with the thrift institutions for maturing "wild card" deposits. (These certificates with maturities of four years or more were issued by banks and thrift institutions in the July-October period of 1973 when rate ceilings on them were temporarily suspended.) In the final two months of the year, thrift deposit growth diminished somewhat but was still not much below the pace recorded over the first half of the year when market rates of interest were lower. This suggests that thrift institutions did not experience significant disintermediation—that is, the substitution of money market instruments for thrift deposits—before the end of the year. More recently, though, deposit inflows to thrift institutions have slowed further.

During the fourth quarter, the Federal Open Market Committee (FOMC) continued its policy of gradually reducing the long-term growth ranges for the monetary aggregates. For the four quarters ending in the third quarter of 1978, both the upper and lower bounds of the projected growth ranges of M_2 and M_3 were lowered by ½ percentage point. For M_2 the projected growth range covering this period was set at 6½ to 9 percent, while the range for M_3 was set at 8 to 10½ percent. The new M_3 range is consistent with a substantial inflow of savings to thrift institutions in the year ahead. In view of the uncertainties surrounding the recent behavior of M_1, the FOMC decided to maintain the 4 to 6½ percent growth range for this aggregate.

When the FOMC evaluates the financial health of the economy, the rate of credit expansion is always an important consideration. In 1977, credit demands were vigorous in most markets and at financial institutions, including commercial banks, finance companies, and thrift institutions. In the final quarter bank loan growth continued strong, although it remained somewhat below the peak rates of expansion during the preceding business recovery. In the closely watched business loan area, where activity throughout 1975 and most of 1976 was much weaker than at similar stages of past economic upturns, growth over the final quarter was also strong. However, business loans have yet to show any sustained growth at the large New York City banks, where they were essentially flat throughout 1977.

With strong overall loan demand and some slowing in the growth of consumer-type savings and time deposits, banks have met their needs for funds by liquidating United States Government securities and issuing large time deposits. Still, various measures of bank liquidity appear quite comfortable relative to past periods of strong credit demands. Among such indexes are ratios of loans to deposits and of liquid assets to liabilities. Loan-deposit ratios rose moderately at banks outside New York City in 1977 but were about unchanged at large New York City banks, where loan growth has been weaker. Ratios of liquid assets to liabilities actually increased quite strongly at the large banks in New York City while declining slightly on balance over the course of the year at weekly reporting banks outside New York City.

Borrowing in the capital markets also continued brisk in the fourth quarter. After remaining relatively stable during most of 1977, longer term interest rates began firming somewhat in early December. In the Government sector, yields on twenty-year securities rose about 25 basis points from the beginning of December through January 6 (when the Board announced the boost in the discount rate) and subsequently increased further by around 15 basis points by late January. Over the same two time spans the rate on seasoned Aaa-rated corporate bonds rose by similar amounts. After falling throughout most of 1977, tax-exempt yields also started to firm in December. The Bond Buyer index of twenty municipal bond yields rose 17 basis points from the end of November through early January and around 6 more basis points through late January. Even with these increases, yields on corporate and municipal securities were still below their levels reached at the start of the economic recovery almost three years ago, although long-term Government yields were a bit higher. In contrast, long-term yields had risen substantially during comparable periods of most previous economic recoveries.