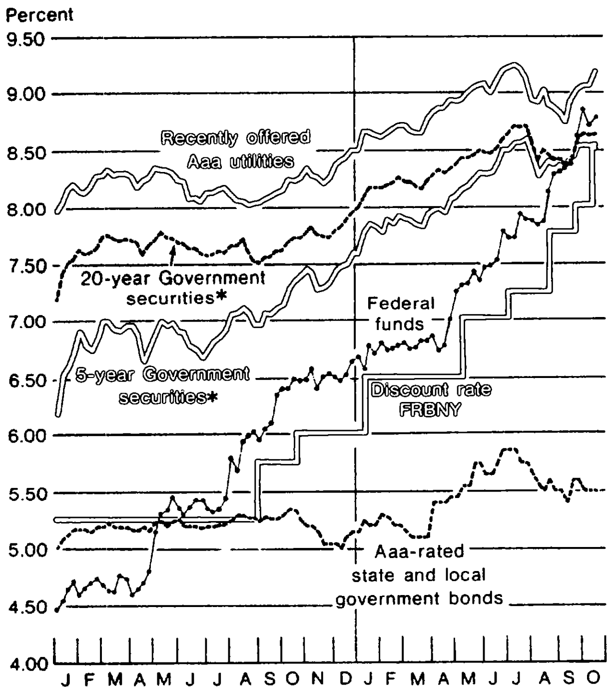
The financial markets

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, and Moody's Investors Service, Inc.

The summer was a volatile period in the financial markets. Interest rates, particularly those on longer term securities, fluctuated more widely than they had in some time. Growth of the monetary aggregates, which for a while showed signs of moderating, was again quite rapid. Indeed, the broader monetary aggregates—M_2 and M_3—advanced at a faster pace than they had in nearly a year. An important contributing factor to this resurgence was the introduction of a new savings instrument—the six-month money market certificate of deposit—by commercial banks and thrift institutions.

As the summer began, interest rates across the maturity spectrum extended the rise that had resumed in April (Chart 1). Following the June 20 Federal Open Market Committee (FOMC) meeting the Federal funds rate increased from about 7½ percent to 7¾ percent, and during the next month it rose a further notch to 7⅞ percent, as the Federal Reserve pursued its efforts to moderate monetary growth. Over this period, other short-term rates generally moved up in line with the funds rate.

Toward the end of July there was a shift in market sentiment. Two successive weekly declines in the money supply data led market participants to believe that an additional firming move by the Federal Reserve could occur later than had been expected. Furthermore, a series of Government reports suggested that, after the sharp rebound from the weather- and strike-plagued winter, business activity was returning to a more sustainable pace. The adjustment to the new outlook caused rates on many money market instruments to decline by around 20 to 30 basis points within ten days, and they then remained relatively steady.

In mid-August, short-term interest rates turned upward again. As it became evident that monetary growth was continuing above the Federal Reserve's longer run objectives, the System steadily tightened its policy stance and by the middle part of October Federal funds were trading around 9 percent. Other short-term rates advanced by a similar 1⅛ percentage points or a bit more during this interval.

The rise in money market rates, together with other domestic and international financial developments, led the Federal Reserve Banks to raise the discount rate on four separate occasions during the summer and early fall. The cumulative effect of these actions was to increase the rate by 1½ percentage points to a record level of 8½ percent. In announcing its approval of the latest change at nearly all Reserve Banks on October 13, the Board of Governors of the Federal Reserve System stated that the action was taken to bring the discount rate into closer alignment with increased short-term market interest rates and in recognition of continued high inflation, the recent rapid rate of monetary expansion, and current international financial conditions.

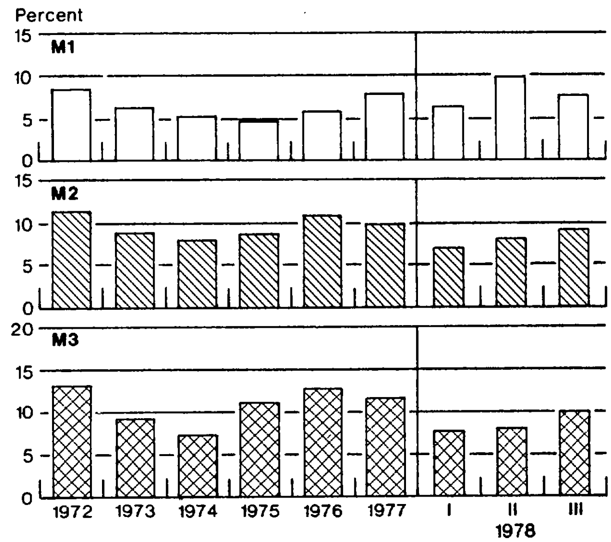
Yields on longer term instruments also varied widely during the summer, but for these securities there was little net change in the level of rates for the period as a whole. Evidence of a firmer Federal Reserve policy initially depressed the capital markets, but they soon recovered on the realization that the firming moves had been more modest than expected. Subsequently, a strong rally developed as there was a view in some quarters that bond yields might be nearing a cyclical peak The buying rush gathered momentum as some investors sought to capture current high yields, while many participants scrambled to cover short positions. The effects of the improved market atmosphere were widespread In the corporate sector, where the supply of new securities was light, yields on recently offered Aaa-rated utility bonds fell by approximately 50 basis points in the two-month period beginning in mid-July.

Slightly smaller, but still substantial, declines were recorded in the Treasury and tax-exempt markets. For example, over the same two-month interval Moody's index of yields on high-grade municipal bonds dropped from 5 85 percent to 5.40 percent. This decrease was particularly noteworthy, as a record volume of nearly $6 billion of new municipal securities was sold in August. The surge reflected an effort by state and local governments to bring issues to market in advance of rulings, effective September 1, tightening the regulations on the interest-arbitrage operations of borrowers in the tax-exempt bond market. These regulations were originally published by the Treasury in 1973 and have been amended several times since then.

Chart 2

Growth of 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

Not only did interest rates fall further in the capital markets than in the money markets, but the rally lasted somewhat longer—until the middle of September. For a while, the increases in the Federal funds rate during the latter part of August were compatible with the view that bond yields were close to a cyclical peak. In addition, investor sentiment was bolstered by a reduction in estimates of the Treasury's future borrowings in the market, partly reflecting sales of securities to state and local governments and foreign central banks. However, in the face of a continuing rise in short-term rates and the prospect that still higher rates might be necessary to slow money growth and contain inflation, bond market participants began to reassess their interest rate outlook. The end of the rally came suddenly, and by mid-October most of the gains, particularly those in the corporate and Treasury sectors, were erased.

Unexpectedly rapid growth of the monetary aggregates contributed to the turnaround in the bond markets. Growth of the narrow money stock, M_1, did ease some from its record second-quarter pace (Chart 2). Nevertheless, the slackening was less than some observers had expected and was at least partially offset by an upward revision in previously reported data.

Moreover, it came at a time when the broader money measures—M_2 and M_3—were accelerating.

On September 21 the Board of Governors announced revisions in the monetary aggregate data to incorporate benchmark adjustments based on the March 1978 call report for domestic nonmember banks and to correct for a cash items bias. The adjustment for the cash items bias related to certain transfers of funds by some agencies and branches of foreign banks in New York City. The principal effect of the revisions was to raise the growth rate of M_1 over the first two quarters of this year from 7.6 percent to 8.1 percent, which represents a slight acceleration from 1977. Initially M_1 growth appeared to be moderating significantly during the third quarter, but it picked up sharply near the end and for the period as a whole came to a 7.6 percent rate. While this is slightly less than the average growth rate for the previous six quarters, it remains above the 4 to 6½ percent range that the FOMC had projected for all of 1978 and for the year ending in 1979-II.

The September revisions also produced slight reductions in previous estimates of the growth of M_2 and M_3. However, any favorable impact this might have had on the credit markets was overshadowed by the third quarter's surge in these aggregates. During that period M_2 rose at a 9.0 percent rate, up 1½ percentage points from the advance over the first half of the year and at the top of the 6½ to 9 percent range projected by the FOMC for 1978 and for the year ending in the second quarter of 1979. The acceleration in M_3 was even sharper. The growth rate of this aggregate jumped from 7.7 percent in the first half of the year to 10.0 percent in the third quarter, which is at the upper end of the 7½ to 10 percent range projected by the FOMC for 1978 and for the 1978-II to 1979-II period.

With the growth of M_1 slowing somewhat, the pickup in the broader aggregates reflected a strong gain in time and savings deposits (other than large CDs) at banks and thrift institutions. The increase was particularly sizable at thrift institutions and to a very important extent was due to the favorable reception of the new six-month money market certificates of deposit. Effective June 1, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board authorized their member institutions to begin issuing these certificates with ceiling interest rates on new deposits that vary with the average rate on new issues of six-month Treasury bills. In keeping with the existing differentials in deposit ceiling rates, savings and loan associations and mutual savings banks are allowed to pay ¼ percentage point more on the certificates than commercial banks.

At the time of their introduction, there was a question as to how effective the new instruments would be in maintaining the growth of consumer-type time and savings deposits. The available data indicate that thus far they have, indeed, contributed to this objective. In the four months before the money market certificates were available, deposits at savings and loan associations and mutual savings banks increased at an almost constant 6½ percent annual rate. In each of the four subsequent months, deposit growth steadily accelerated and by September was approaching a 16 percent rate.

One means of judging the attractiveness of the new certificates is to compare their growth with that of investments in money market mutual funds, which have been important substitutes for consumer-type time and savings deposits for some time. In the more than four years that shares in the money market funds have been actively sold, total assets of the funds have risen to about \$8.5 billion. In contrast, sales of the six-month certificates have averaged \$8.5 billion a month since their introduction.

Most of the certificates have been issued by thrift institutions where, as noted above, the ceiling interest rate is ¼ percentage point above that at commercial banks. In fact, savings and loan associations and mutual savings banks are estimated to have issued more than 70 percent of the nearly \$34 billion of money market certificates outstanding at the end of September. So far it appears that the certificates have helped to maintain the flow of credit into housing. It remains to be seen, however, whether this effect will persist.