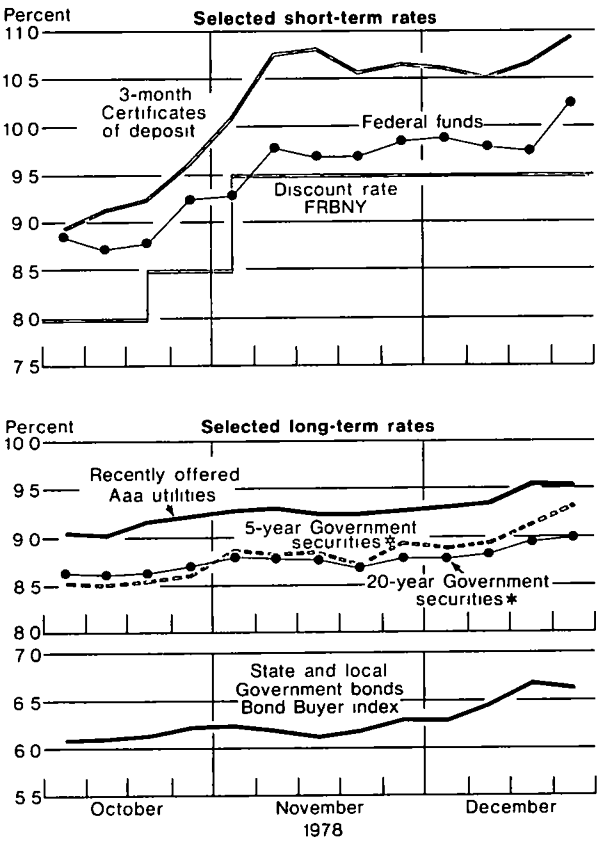
The financial markets
Current developments

Recent Interest Rates
Weekly



* 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 Bond Buyer

Financial market developments in the closing months of 1978 were dominated by United States initiatives aimed at strengthening the foreign exchange value of the dollar The initial reaction in the domestic markets was quite positive as the large uncertainties prevailing in the markets about inflation and the future of the dollar were alleviated Subsequently, however, long-term bond yields ratcheted upward and, with short-term interest rates continuing to rise, by the close of the year most Treasury issues were at record-level yields. The rise in interest rates was accompanied by a marked slowing in the rate of growth of the monetary aggregates While a slowing in the growth of M_1 was widely expected because of the introduction of automatic transfer accounts, growth of the more broadly defined aggregates also slackened

On November 1, 1978, President Carter, the Federal Reserve, and the Treasury announced a series of actions aimed at correcting the excessive decline of the dollar in the foreign exchange markets The program included a number of domestic monetary policy actions (for further discussion of this program, see the article beginning on page 63) Among the announced actions were a 1 percentage point increase in this Bank's discount rate—the largest increase since 1920 —to a record level of 9½ percent (chart) The other Reserve Banks raised their discount rates shortly thereafter In addition, a 2 percentage point increase in reserve requirements was imposed on large-denomination time deposits The increase in reserve requirements was intended to help moderate the expansion in bank credit and to raise the incentive for member banks to borrow abroad, thereby strengthening the dollar by improving the demand in Euro-markets for dollar-denominated assets Finally, in accordance with these measures, the Federal Open Market Committee (FOMC) raised the upper end of its range for the Federal funds rate and instructed the Trading Desk to seek a higher rate. By the end of the year, Federal funds were trading around 10 percent.

Prior to the November 1 initiatives, short-term interest rates had already been steadily rising, after a brief period of stability that ended in mid-August. By the close of October, the rate on Federal funds had risen to around 9¼ percent. Other short-term interest rates had also risen, responding to the further tightening in the Federal Reserve policy stance, to increased concern over the falling foreign exchange value of the dollar, and to inflation. In November and December, the rise in rates continued. Rates on commercial paper and bankers' acceptances generally closed the year around 150 basis points higher than in mid-October. Sharp increases in CD rates had started to occur toward the end of October and initially were more pronounced than for other short-term interest rates as banks aggressively issued certificates of deposit (CDs). By mid-November, secondary market rates on three-month CDs had risen 158 basis points over their level four weeks earlier. Subsequently, however, these rates declined slightly before rising in the closing weeks of 1978. The volume of large negotiable CDs outstanding at weekly reporting banks jumped by more than $5 billion in November, substantially above the $1.6 billion average increase of earlier months. Responding to the rising cost of funds, commercial banks lifted their prime lending rate in several steps. By the end of the year, the prime rate stood at 11¾ percent, ¼ percentage point below its 1974 peak.

The rise in short-term interest rates weakened market sentiment in the longer term taxable markets in late October. Additionally, the markets' pessimistic assessment of the probability of the success of the President's program of wage-price restraint, which was announced on October 24, resulted in sharp upward rate adjustments. In the atmosphere of a deteriorating market, the Treasury, as part of its November refunding, auctioned $2.5 billion of 3½-year notes on October 31 at an issuing rate of 9.36 percent. The 9¼ percent coupon established on the notes was the highest since the Civil War. The policy initiatives launched on November 1 were viewed positively by the market, leading to large yield declines for intermediate- and longer term securities. The rate declines accelerated, as many participants acted to cover short positions which, in the process, generated a powerful bond market rally. The rally soon faded, however, as evidence of a higher rate of inflation, coupled with the continued increase in short-term interest rates, led to the reemergence of upward rate pressures. Incoming business data, which pointed to greater than expected strength in the economy, also contributed to the yield rise. Rates on intermediate- and long-term Government issues ended the year around 80 and 35 basis points higher, respectively, than in mid-October. In the corporate sector, AAA-rated bond yields posted increases similar to those in the long-term Government markets.

In the tax-exempt markets, yields on municipal bonds rose in the closing months of the year. Most of the yield increase occurred in December, when larger supplies contributed to a weakening in market tone. Although offerings in recent months were well below the borrowing bulge that preceded the September 1 tightening in Treasury regulations concerning interest rate arbitrage by state and local governments, new bond issues remained surprisingly large. In the closing weeks of 1978, the Bond Buyer index of twenty municipal bonds rose by some 32 basis points. In mid-December, dealers' inventories as advertised in the Blue List rose above $1 billion, the largest volume in a half year. Although the market generally viewed the default by the city of Cleveland on $15 million of notes as an isolated event, cuts in Federal funds to state and local governments under the CETA program, as well as other factors such as the large financing gap of New York City, appeared to raise investors' quality consciousness. Increases in yields on lower quality offerings generally exceeded those on yields of higher quality issues. However, the spreads between yields on high- and lower quality issues remained far below the record levels reached in the summer of 1976.

In contrast to the heavy supplies of municipal bonds, the Treasury reduced its marketable offerings. Net marketable issues offered in the closing quarter were substantially below the pace of earlier months. Large numbers of nonmarketable offerings to official foreign institutions and a foreign borrowing by the United States, which were related to support of the dollar, met much of the Treasury's new cash needs in the fourth quarter. Responding to the market imbalance created in short-dated bills by strong foreign demand, the Treasury enlarged the proportion of three-month bills in the regular weekly auctions. In December, the Treasury raised the equivalent of $1.6 billion through its first public offering of foreign-currency-denominated notes. These notes were sold through the Bundesbank to West German investors. The three- and four-year mark-denominated notes were enthusiastically received and oversubscribed, at a yield comparable to that on issues of the West German government. The Treasury subsequently "warehoused" the marks with the Federal Reserve, obtaining dollars which added to its cash balances. The Treasury has announced its intention to offer a Swiss franc-denominated issue early in 1979.

After many quarters of rapid growth, there was a marked slowing in the growth of the monetary aggregates. Based on the available data, the growth of the narrowly defined money stock—M_1—slowed to an annual rate of about 4.3 percent in the fourth quarter, well below the 7.6 percent annual rate of growth posted in the previous quarter. M_1 grew more moderately in October following the bulge in September and then actually declined slightly in the November-December period. Some slowing in the growth of M_1 in November and December had been widely expected as a result of the November 1 introduction of automatic transfer accounts. These accounts enable depositors to authorize their banks to transfer funds automatically between checking and interest-bearing savings accounts. In view of the prospective shift of funds from checking accounts to savings accounts, the FOMC at its October meeting lowered the range of growth of M_1 for the four quarters ending in the third quarter of 1979 to 2 to 6 percent from the range of 4 to 6½ percent in the preceding period (second quarter 1978 to second quarter 1979). The new accounts appear to have reduced the annual rate of growth of M_1 for November and December by roughly 2 to 3 percentage points. For the fourth quarter as a whole, therefore, M_1 growth was lowered by about 1 percentage point.

Because of the difficulty posed by the introduction of automatic transfer service in interpreting M_1 data, and in view of the widening role in financial transactions played by savings deposits, the FOMC staff constructed a new aggregate, M_1 plus. This aggregate includes M_1 and savings accounts at commercial banks, NOW accounts, demand deposits at mutual savings banks, and credit union share drafts. In the fourth quarter, M_1 plus is estimated to have grown 2.4 percent at an annual rate, compared with 5.3 percent in the third quarter.

Primarily as a result of the slowing of M_1, M_2 also rose more slowly in the final three months of 1978 than in recent quarters. The growth of M_3, which adds deposits of thrift institutions to M_2, appears to have slowed slightly from the third quarter. The FOMC reestablished the ranges of M_2 and M_3 at 6½ to 9 percent and 7½ to 10 percent, respectively, for the year ending in the third quarter of 1979.

The growth of the broader monetary aggregates slowed despite a step-up in the sales of the six-month money market certificates in October and November. It appears that the new instrument, which probably added significantly to the growth of thrift institutions' deposits in the summer months, more recently represented a shifting from other types of time and savings deposits, rather than a net addition to such deposits. Whatever the effect on deposit growth, the new instrument has raised the cost of funds to issuing thrift institutions. The average issuing yield on six-month Treasury bills, to which the ceiling rate is tied, has risen more than 200 basis points since this instrument was first introduced in June. These cost pressures will be intensified as maturing issues are renewed.

The rising cost of thrift deposits has played a role in the increase in mortgage interest rates. The rates charged on mortgage closings have crept up and are at historical highs. Moreover, the rates charged on commitments to make new mortgages point to continuing upward pressures on the mortgage market. The going commitment rate on a single-family conventional mortgage of twenty-five years with a 25 percent downpayment posted a sharp increase in December to 10.36 percent.