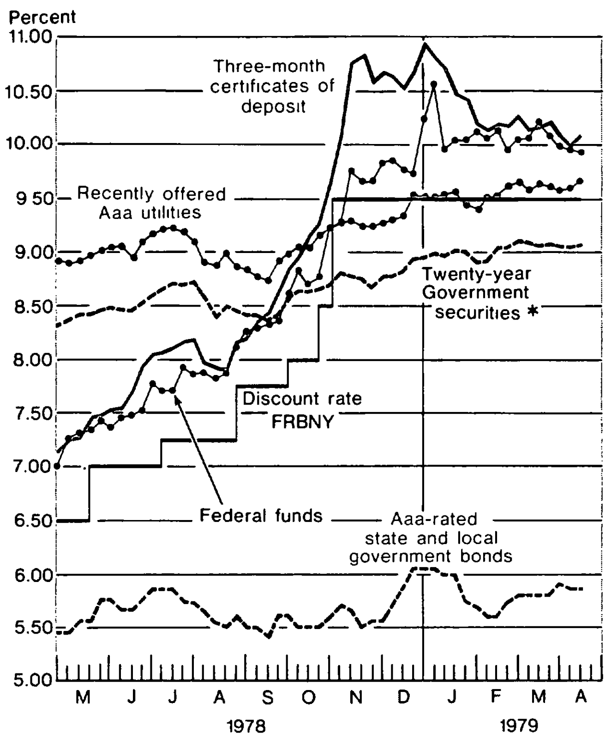
The financial markets

Current developments

Chart 1

Recent Changes in Interest Rates



*This yield is adjusted to twenty-year maturities and excludes 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 winter and early spring was a period of relative stability in the credit markets. After rising throughout most of 1978, interest rates generally came under downward pressure as the new year began. Thereafter, yields on shorter term securities remained at their lower levels, while those on longer term instruments retraced their earlier declines. The monetary aggregates continued to show little or no growth, as they had during the closing months of 1978. Among the factors contributing to these developments were a slackening of the pace of economic expansion, continuing changes in the public's asset management practices, and greater stability in the foreign exchange markets.

As the new year unfolded, money market interest rates quickly reversed the sharp run-ups that had occurred in the previous two months and then held fairly steady over the balance of the winter and early spring. Changes in the yield on three-month certificates of deposit (CDs) are representative of these movements. During January the secondary market rate on these instruments fell by approximately 85 basis points to 10.15 percent, which is about where it stood in late October, and subsequently moved very narrowly around this level (Chart 1). These developments came against a background of sluggish monetary growth and a Federal funds rate that hovered close to 10 percent throughout the period beginning in mid-December. In retrospect, it appears that, as the winter wore on, market participants reevaluated their interest rate outlook and came to view an additional firming move by the Federal Reserve as unlikely to occur in the near term.

Yields on long-term securities tended to follow short-term rates down during the latter part of January but then reversed field in February. By late March, these rates were also fluctuating within narrow limits and on balance showed little net change for the period as a whole. In the markets for Treasury and corporate bonds, yields began the spring slightly higher than where they were at the end of 1978. For example, recently offered Aaa-rated utility issues were trading around 9.65 percent, up some 15 basis points from their levels in late December.

Similarly modest rate increases were recorded on long-term United States Government securities. Toward the end of March, a delay in Congressional enactment of legislation raising the temporary ceiling on the national debt caused uncertainty over the Treasury's financing schedule. The delay led the Treasury to postpone a number of securities auctions, to suspend temporarily the sale of savings bonds, and briefly to interrupt the mailing of income tax refund checks. Following enactment of the legislation on April 2, the suspended services were resumed and the Treasury announced a series of securities sales totaling $26.7 billion over an eight-day period.

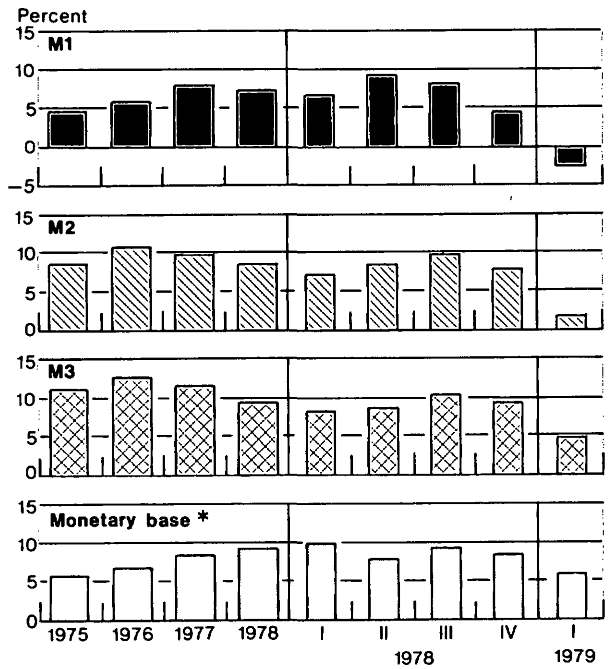
The tax-exempt sector of the capital markets benefited from a relatively strong technical position in the early months of 1979, with inventories of unsold securities generally remaining modest. Indeed, at times dealer inventories, as measured by the Blue List, reached their lowest levels in three years. As a result, while yields on municipal bonds followed the same general pattern as other long-term rates, they completed the winter somewhat below their initial levels.

Recently, an increasing number of municipalities have been issuing a new type of tax-exempt instrument, revenue bonds backed by mortgages on single-family homes. Typically, a community sells tax-exempt securities and then uses the proceeds to purchase mortgage loans originated and serviced by local banks, thrift institutions, and mortgage bankers. The loans go to home buyers satisfying criteria set by the issuers (e.g., maximum income levels). State governments recently have been issuing such securities at an increasing rate, and in July 1978 Chicago became the first local government to enter the market. The bonds are secured by the mortgages, insurance on the mortgage pool, and reserve funds equaling about 15 percent of the bond issue. With these provisions, tax-exempt bonds have been sold at a cost of around 7 percent and mortgages have been extended at rates of up to 8½ percent, or about 2 percentage points below open market rates. Programs like these provide an additional means by which governments may seek to stimulate residential construction by subsidizing mortgage financing. Among the questions raised by such efforts are whether the people who obtain the funds need the subsidy and what percentage of the funds contributes to additional construction as opposed to other expenditures.

Chart 2

Growth of Monetary Aggregates and Base

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.

*Adjusted for changes in Regulation D.

Source: Board of Governors of the Federal Reserve System.

The unexpected, but prolonged slowing in the growth of the monetary aggregates contributed to the generally stable atmosphere in the credit markets. The sharpest deceleration was for M_1. After advancing at roughly an 8 percent rate during most of 1977 and 1978, it rose at a 4.4 percent rate in the fall and actually declined during the first quarter of this year (Chart 2). At its meeting on February 6, the Federal Open Market Committee (FOMC) anticipated some continuation of the sluggishness in M_1. Hence, it projected the growth of this aggregate at between 1½ and 4½ percent for all of 1979, down from the 2 to 6 percent range that had been projected for the four quarters ending in 1979-III. Nevertheless, since the meeting, M_1 growth has fallen short of the Committee's expectations.

The rates of advance of the broader monetary aggregates (M_2 and M_3) have also eased considerably since last summer. At first, this was due largely to the weakness in the M_1 component of these measures. However, in recent months there has been a marked slowing in the growth of savings and small-denomination time deposits, particularly those at commercial banks. As a result, the first-quarter growth rates of the broader aggregates, like that of M_1, are well below the ranges projected by the FOMC for all of 1979. The range for M_2 is 5 to 8 percent, while for M_3 it is 6 to 9 percent. Both of these are approximately 1 percentage point below the bands that had been established for the four quarters ending in 1979-III.

The current 1979 growth ranges set by the FOMC at its February meeting are the first monetary aggregate projections made under the Full Employment and Balanced Growth Act of 1978 ("Humphrey-Hawkins" Act). The act requires the Board of Governors of the Federal Reserve System to report in writing to the Congress by February 20 and July 20 of each year on its and the FOMC's "objectives and plans" for the aggregates for that calendar year. In addition, the July report is to include an early statement of objectives and plans for the aggregates for the coming calendar year. A key element of the legislation is that the one-year growth ranges will no longer be adjusted forward once a quarter. Instead, the ranges may be revised or adjusted (with explanation), but the time periods are calendar years.

Some slowing in monetary growth normally occurs in the advanced stages of a business expansion. The present decline is unusually large, though, and raises questions of whether special factors are influencing the public's asset management practices. The November 1 introduction of negotiable order of withdrawal (NOW) accounts in New York State and automatic transfer accounts throughout the country are such factors. These developments caused a shift of funds from checking accounts to savings accounts, without having any apparent impact on the real economy. Thus, there is general agreement that the reported growth of M_1 should be adjusted or "corrected" for this effect. On the basis of current estimates, such an adjustment would increase M_1 growth in the fall and winter quarters by 1 and 3 percentage points, respectively.

The analysis of the monetary aggregates in the article beginning on page 1 of this *Review* suggests that it may also be appropriate to adjust the currently reported data to take account of the public's investment in highly liquid nondeposit assets. Included among these are overnight repurchase agreements, overnight Eurodollar deposits, and money market mutual funds. It is unlikely, though, that every dollar invested in these assets would otherwise have been held in a checking account. Hence, the magnitude of the latter corrections is open to further analysis.

The resulting uncertainties over the growth rates of the monetary aggregates have led some observers to focus more attention on the monetary base. Whether the use of the base can help resolve these uncertainties is not clear. The Federal Reserve Bank of St. Louis has published a measure of the monetary base for some time and, on March 15, the Board of Governors of the Federal Reserve System began publishing a slightly different series. Put simply, the monetary base is an adjusted measure of the net monetary liabilities of the United States Treasury and the Federal Reserve System held by the commercial banks and the nonbank public. Specifically, it is the sum of member bank deposits at the Federal Reserve, vault cash held by all banks, plus currency held by the nonbank public.

In recent months the growth of the monetary base has slowed, like that of the other aggregates, but the deceleration did not begin until this year and thus far has been relatively modest. After rising at about a 9 percent rate through the fourth quarter of last year, the growth rate of the monetary base dropped to slightly less than 6 percent in the first quarter.[1] Such a slowing is comparable to some of the results obtained when the growth rates of the conventional aggregates are adjusted for various special factors influencing the public's asset management practices.

Sales of six-month money market certificates of deposit continued at a rapid pace during most of the first quarter, and this helped to moderate the slack in the broader monetary aggregates. While the certificates have been favorably received by depositors, there was concern over their effect on the cost of funds to the issuing institutions. Reflecting this concern, the Board of Governors, the Federal Home Loan Bank Board, and the Federal Deposit Insurance Corporation took joint action, effective March 15, to lower the ceiling interest rates payable on the certificates.

Subsequently, on April 13 the Board of Governors proposed a 3 percent reserve requirement on Federal funds and on repurchase agreements (RPs) on Treasury and agency securities made by member banks or Edge Act units with any lenders except those subject to reserve requirements imposed by the Federal Reserve. The action is designed to establish more effective control over the growth of bank credit.

[1] The growth rates reported here are those published by the Board of Governors and are adjusted for changes in Regulation D.