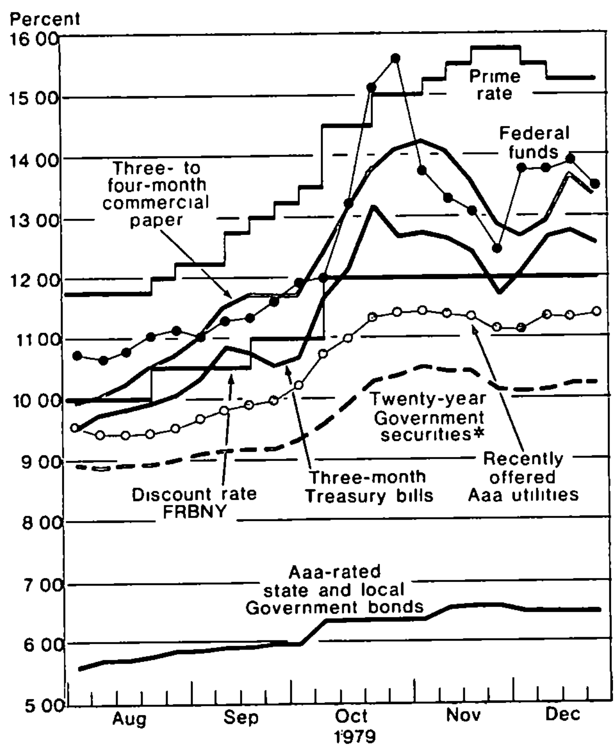
The financial markets
Current developments

Chart 1

Short-term rates changed direction several times during the fourth quarter, reflecting unsettled conditions in the money markets.



*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 financial markets went through a period of turbulent adjustment during the fourth quarter, as market participants reacted to the Federal Reserve's October 6, 1979 policy package, shifting views of the economy's prospective performance, and a series of unsettling developments in the Middle East. On October 6, the Board of Governors of the Federal Reserve System unanimously approved an increase in the discount rate to a record 12 percent, and imposed an 8 percent marginal reserve requirement on the managed liabilities of member banks and certain other institutions. On the same day, the Federal Open Market Committee (FOMC) announced that open market operations would be conducted with greater emphasis on measures of bank reserves to slow monetary growth and achieve the 1979 targets for the monetary aggregates, while permitting the Federal funds rate to vary within a broad range. The markets' adjustment to the greater variability in short-term interest rates which followed the System's actions was complicated by large revisions to the October money supply data as well as unexpected and often conflicting signals of the underlying strength in the economy. In this uncertain environment, it was not surprising to see interest rates change direction several times during the course of the fourth quarter (Chart 1).

Short-term interest rates moved sharply upward immediately following the October 6 policy actions and showed considerable variability, as market participants adjusted to the greater volatility in the Federal funds rate. For years, the financial markets had viewed the Federal funds rate as a clear yardstick of the Federal Reserve's policy intent. Now the markets had to find their own levels. In the five-day period following the Federal Reserve's policy actions, the Federal funds rate increased to an average level of 13.0 percent from 11.9 percent in the preceding five-day period. At the same time, the spread between the high and low daily rates during the course of a week increased from 84 basis points in the five-day period prior to the October 6 policy actions to 182 basis points in the week following these actions The spreads between the high and low daily rates within a week remained quite large for the next few weeks, but began to narrow again by mid-November as the financial markets adapted to the new operating procedures

The stock market, like the money market, was very unsettled for several days following the October 6 policy actions Stock prices plunged amid often heavy trading, reaching the lowest levels since June 1979. By late October, the stock market began to stabilize and prices gradually moved upward, attaining by mid-December the pre-October levels

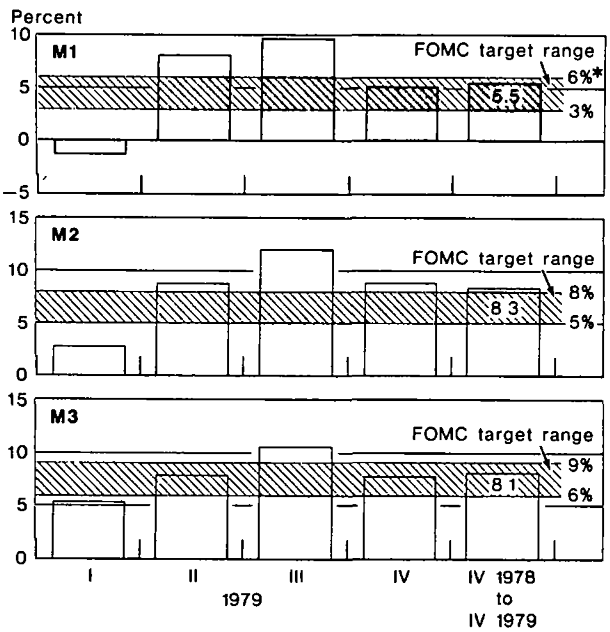
Following the sharp increases in short-term interest rates after the October 6 policy actions, rates declined considerably from late October to late November, although not totally reversing the initial upward swing Most strikingly, the Federal funds rate—for which the FOMC specified a broad range of 11½ to 15½ percent —declined to about 13 percent from rates near the top of the range In part, this reversal was due to a substantial reduction of monetary growth, which became apparent in late October, from the very rapid pace prevailing on average over the previous six-month period The slower monetary growth was accentuated by large revisions to the weekly data With monetary growth showing evidence of slowing, it appeared that monetary policy would not need to become more restrictive amid signs of slowing economic activity and moderating credit demands

In late November and early December, the financial markets' assessment of the outlook for rates shifted once again Not only did the incoming data suggest continuing rapid inflation, but retail sales and employment showed unexpected strength Meanwhile, the dollar suffered from bouts of severe weakness in the foreign exchange markets, and the prices of commodities, particularly of precious metals, began to spiral rapidly upward once again The financial markets were further unsettled by developments in Iran during this period Upward pressure on short-term rates resumed, and the Federal funds rate increased to about 13¾ percent by late December In the final two weeks of the year, the market seemed to ignore the rather strong increase in personal income and began to stabilize, partly because of evidence of some weakening in the housing market

Long-term rates and rates in the Treasury bill futures market generally mirrored the pattern in short-term rates, although the swings in the long-term rates over this period were not nearly so large Rapid inflation continued to be the predominant concern in the long-term markets Unlike the initial reaction to the November 1978 policy initiatives, long-term sectors moved higher immediately following the Federal Reserve's October actions, suggesting that the market was skeptical whether these policy moves would be adequate to break the inflationary spiral. The market for three-month Treasury bill futures—while moving up and down with developments affecting the cash market —continued to suggest a market expectation of gradually declining short-term rates through mid-1981 The yield on the September 1981 contract fluctuated in a range from 8 35 percent to 9 40 percent while, on the December 1979 contract, rates ranged from 10 19 percent to 12 51 percent

Chart 2

Growth of the monetary aggregates slowed in the fourth quarter. For the year, the Federal Reserve attained M1 and M3 growth consistent with the annual targets.



Data reflect January benchmark revisions

*The annual target for M1 was originally set at 1½ to 4½ percent, based on the assumption that growth of ATS and NOW accounts would reduce M1 growth 3 percentage points Since the actual reduction was only about 1½ percentage points, the equivalent adjusted target for M1 is 3 to 6 percent

Source Board of Governors of the Federal Reserve System

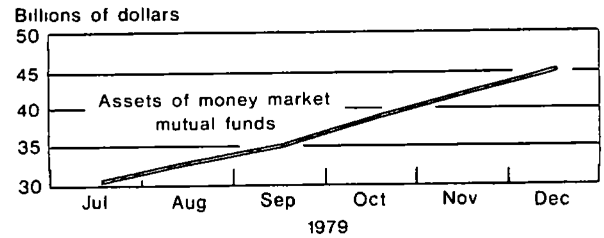
In the second and third quarters of 1979, any prospects for an immediate decline in short-term interest rates had been dimmed by very rapid growth of the monetary aggregates, the pace of inflation, and the strength of the economy. In the fourth quarter, however, growth of the monetary aggregates slowed considerably. M_1 growth, which had averaged almost 9.0 percent in the second and third quarters, slowed to 5.1 percent in the fourth quarter. Moreover, growth of time deposits at banks and thrift institutions also slowed in the fourth quarter, resulting in more moderate expansion of the broader aggregates as well. At the October FOMC meeting, the Committee established an objective of 4.5 percent for M_1 growth for the final three months of 1979 and 7.5 percent for M_2 and M_3 growth. The FOMC was willing to accept somewhat slower growth than this to counterbalance the excessive rates of expansion in the second and third quarters. As a result of attaining monetary growth below these objectives during the October-December period, the Federal Reserve also achieved its objectives for M_1 and M_3 over the period from the fourth quarter of 1978 to the fourth quarter of 1979, while M_2 growth was slightly above the upper end of its range (Chart 2).

Throughout 1979, the broader aggregates were bolstered by substantial flows of funds into six-month savings certificates. In October, largely because of the widespread attention given the rapid increase in short-term rates following the Federal Reserve's October 6 policy actions, the public's holdings of six-month certificates at banks and thrift institutions increased a record $31.7 billion, compared with an average monthly gain of $12.2 billion over the previous three months. This large sum, however, did not represent a substantial amount of additional funds for these institutions. Savings deposits and small time deposits other than six-month certificates were converted into high-yielding six-month certificates, leading to slower growth of small time and savings deposits even while six-month certificates expanded rapidly (Chart 3).

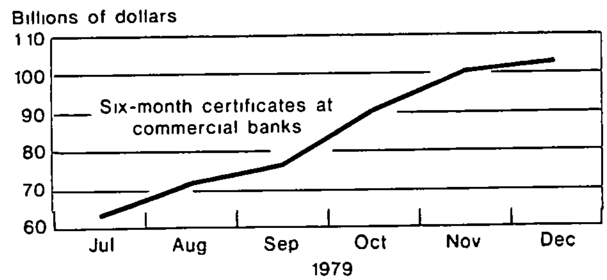
The sharp reduction of deposit growth at thrift institutions during the fourth quarter—along with the greater reliance of thrift institutions on the high-cost six-month certificates as a source of funds—made mortgage money very tight. Moreover, in many states the cost to thrift institutions of acquiring additional funds at market rates exceeded usury ceilings. This made it unprofitable to lend even if thrift institutions could acquire high-cost funds. As a result of these financial developments, housing starts slowed sharply in the fourth quarter, and a large drop in building permits suggested future weakness in the housing market as well. Near the end of December, however, the Congress enacted legislation suspending state ceil-

Chart 3

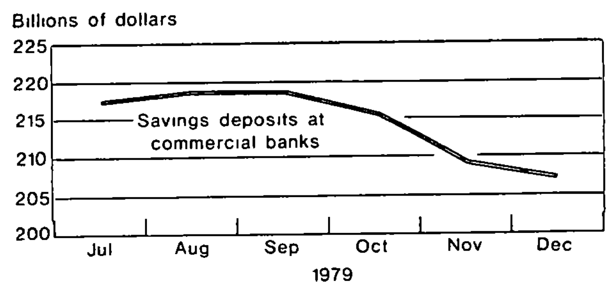
With short-term interest rates at record levels, the public placed funds in money market mutual funds . . .



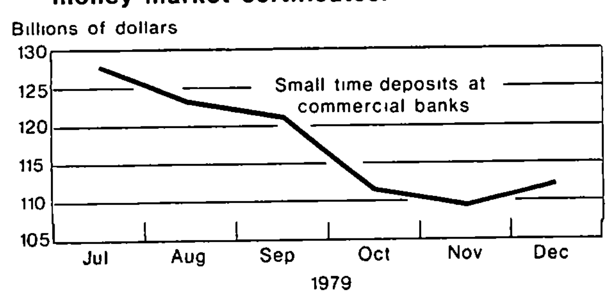
. . . and in money market certificates . . .



. . . while reducing savings deposits . . .



. . . and small time deposits other than money market certificates.



Sources: Donoghue's Money Fund Report (Holliston, Massachusetts) and the Board of Governors of the Federal Reserve System.

ings for mortgage rates during the first quarter of 1980. This action will attract some additional funds into the mortgage markets, although at very high rates of interest.

The mortgage market will be further bolstered in 1980 by a new type of money market certificate authorized beginning January 1980, but it remains to be seen whether this 2½-year certificate will be as popular as the six-month certificates. For the new certificate, thrift institutions are permitted to offer a yield 50 basis points below the yield on Treasury securities with two and one-half years to maturity, while commercial banks are limited to a rate 75 basis points less than the yield on these Treasury securities. The ceiling rate will be set once a month based on data announced by the Treasury during the last three business days of the month. There is no minimum deposit required by law, although individual institutions may set minimum denominations. Other changes in Regulation Q included an increase of 25 basis points on the ceiling rate for time deposits with maturities of ninety days to one year. With the new ceilings, banks may pay 5¾ percent and thrift institutions 6.0 percent

While the Federal Reserve was successful in attaining the 1979 targets for M_1 and M_3, bank credit increased at an annual rate of about 12 percent in 1979, a rate well above the 7½ to 10½ percent range associated with the monetary targets. In the fourth quarter, however, growth of bank credit slowed as business loans, both at banks in New York and outside New York, weakened dramatically immediately following the Federal Reserve's October 6 policy initiatives. The 8.0 percent marginal reserve requirement on managed liabilities typically used by commercial banks to finance loans contributed to upward pressure on the prime rate during October and part of November. In late November, however, as a result of the weaker demand for business loans, as well as some easing in the cost of funds to banks, the prime rate edged down from the record level of 15¾ percent.

Despite the weakening in loan demand and the marginal reserve requirement on managed liabilities, banks increased by $6.2 billion the outstanding level of large negotiable certificates of deposit (CDs) from September to December. With deposit growth slowing dramatically in the fourth quarter—in part due to the very rapid growth of money market mutual funds in October and November—banks were under pressure to bid for CDs as well as other sources of managed funds just to maintain their overall liability base. Assets of money market mutual funds increased over $10 billion in the final three months of 1979 to a level of $45 billion, over 11 percent of M_1 and 4.5 percent of M_2. To the extent that banks are issuing CDs to recover funds lost to money market mutual funds—which in turn are substantial holders of CDs—it appears that money market mutual funds provide an effective mechanism to avoid the effects of Regulation Q That is, money market mutual funds draw small time and savings deposits as well as some demand deposits away from the banking system by offering market rates of interest and then, in effect, sell the funds back to the banking system in the CD market at market rates of interest. Viewed in this light, it appears that Regulation Q will become less meaningful over time, as small investors become more sophisticated and other means to avoid the effects of Regulation Q are developed.

The Congress is currently considering legislation that would phase out Regulation Q over an extended period of time. Other legislation likely to be considered during 1980 includes a bill dealing with the problem of the Federal Reserve's declining membership and some permanent legislation authorizing ATS (automatic transfer service) accounts, credit union share drafts, and nationwide NOW (negotiable order of withdrawal) accounts. In the final days of 1979, the Congress extended for ninety days the ability of commercial banks to offer ATS accounts and credit unions to offer share draft accounts. Last April, a United States Court of Appeals had ruled these and certain other financial services illegal under current laws but gave the Congress until the end of 1979 to pass legislation legalizing these accounts.

Membership legislation, in contrast to ATS accounts and share drafts, raises many difficult issues. On the one hand, member banks view the income foregone by holding reserves as a costly tax—a tax some banks are willing to leave the System to avoid. The Federal Reserve, on the other hand, needs a broad reserve base to conduct monetary policy effectively. At the same time, the interest earned on the System's holdings of securities—holdings funded in part by the reserve balances of member banks—is an important source of revenue for the Treasury. This makes it difficult to solve the membership problem simply by paying market rates of interest on reserves, and also raises the question of whether the Federal Reserve should charge for the services it currently renders free to member banks if it pays any interest at all on reserves. Alternatively, if parity of sorts between member and nonmember institutions is attained by requiring nonmembers to hold some reserves, the question arises whether nonmembers should have access to Federal Reserve services, and how these services should be priced. All these conflicting considerations must be balanced in some sense to attain equitable legislation.