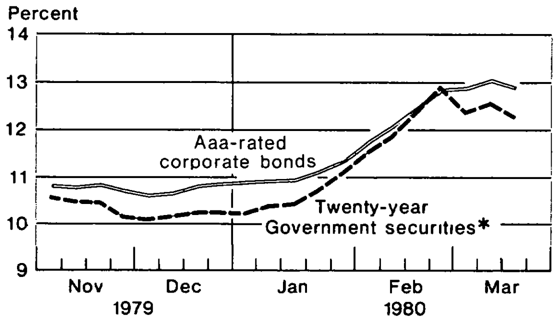
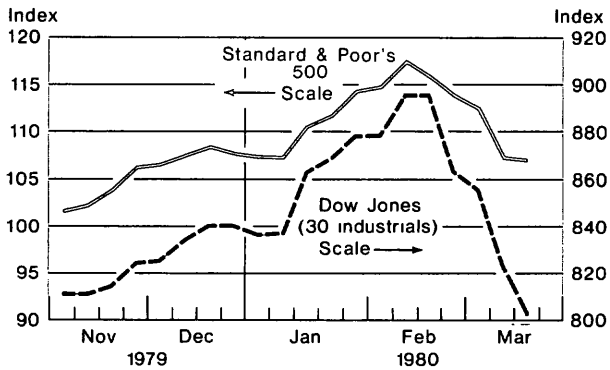
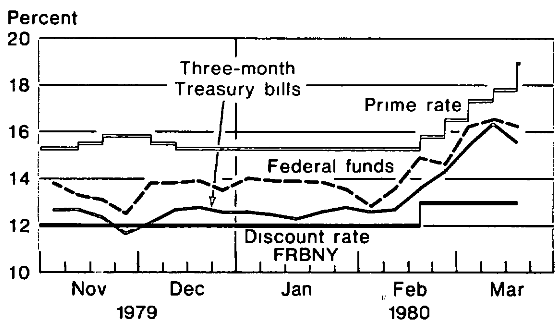
Reflecting expectations of accelerating inflation, long-term bond yields increased sharply . . .



. . . while the stock market rallied briefly amid signs of continued economic strength but quickly retreated . . .



. . . and short-term rates rose as market participants reevaluated the prospects of a tighter monetary policy.



*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, Moody's Investors Service, Inc, Dow Jones and Company, Inc, and Standard & Poor's 500

The financial markets

Current developments

In the face of burgeoning credit demands and worsening inflationary expectations, President Carter announced a broad program in mid-March designed to reduce the price pressures plaguing the economy. As part of this anti-inflation effort, the Federal Reserve System instituted on March 14 a series of steps intended to restrain credit growth.

- The Board of Governors has asked that leading financial institutions voluntarily restrain the growth of their domestic lending. Special efforts will be made to ensure the flow of credit to farmers and small businesses. Cooperation will be closely monitored by each Federal Reserve Bank.
- Steps were taken to moderate the growth of consumer credit. Under Presidential authority granted by the Credit Control Act of 1969, the Federal Reserve System introduced for all lenders a special deposit requirement of 15 percent on increases in covered, primarily unsecured, consumer credit.
- A 15 percent special deposit was also introduced on increases in assets of money market mutual funds.
- The marginal reserve requirement on managed liabilities that had been established last October was increased from 8 to 10 percent. In addition, the base under which the reserve requirement is computed was reduced, and the scope of the requirement was broadened to include nonmember banks.
- A 3 percent surcharge above the basic discount rate (established at 13 percent in mid-February) was imposed on certain discount window borrowings by large member banks.

- Finally, the Board imposed interest rate ceilings under Regulation Q on certain debt instruments issued by bank holding companies.

Prior to the new initiatives, the nation's securities markets had been besieged by turmoil and almost complete demoralization. Bond prices crumbled in successive waves of selling, as investors revised their expectations of future inflation sharply upward. From January through mid-March, prices plummeted as much as 15 percent. In the process, the secondary market for long-term debt virtually dried up at times, as investors retreated to the sidelines. In this fragile market environment, numerous issues were postponed, partly because borrowers were reluctant to lock in high long-term credit costs but also because many were concerned that their issues could not be sold at all to final investors. From a broader perspective, serious doubts inevitably arose about the capital market's ability to function if inflation continued to accelerate.

As a result of the severe turbulence in the long-term bond markets and the consequent postponement of new issues, there was a sharp increase in credit demands in the commercial paper market as well as at commercial banks. Nonfinancial commercial paper outstanding had increased on average at about a 10 percent annual rate in October and November, but then surged to annual growth rates over 90 percent in December and January. Similarly, the growth of commercial and industrial loans (excluding bankers' acceptances) accelerated to a 20 percent seasonally adjusted annual rate in January, after holding steady in November and inching up in December.

This vigorous bidding for short-term funds catapulted short-term interest rates to unprecedented levels. For example, the rate on 90- to 119-day prime dealer-placed commercial paper rose from around 13 percent in mid-January to almost 17 percent by mid-March. Bank prime rates for commercial loans, after holding steady at 15.25 percent until mid-February, shot up to 19 percent by mid-March. However, there were few signs that even these record high interest rates were significantly deterring many borrowers.

In response to the strong credit demands and rapid inflation, the Federal Reserve initiated the new measures on March 14 to complement and reinforce the System's continued application of restraint over the growth of money and credit. That policy is designed to keep money growth within the monetary targets for 1980 announced by the Federal Reserve in mid-February. These targets were set in terms of new definitions of the money supply, adopted by the Board of Governors earlier this year.

The redefined monetary aggregates consist of M-1A and M-1B, which replace M-1, and new concepts of M-2 and M-3 (Table 1). M-1A is much the same as the previous M-1 definition (currency in circulation outside banks plus demand deposits) except that demand deposits held by foreign commercial banks and by certain foreign official institutions at domestic banks are excluded. As a result, M-1A represents a better measure of funds available for domestic transactions than the previous M-1 definition. The FOMC (Federal Open Market Committee) target for M-1A was set at 3.5 to 6 percent for the four quarters of 1980. During 1979, M-1A expanded at a rate of 5.5 percent, down about 2 percentage points from the growth posted in 1978. An estimated 1 to 1½ percentage points of this slowing resulted from a shift out of demand deposits into ATS (automatic transfer service) accounts nationwide and NOW (negotiable order of withdrawal) accounts in New York State. This shift is not expected to continue in 1980. Thus, the M-1A target relative to 1979 growth is more restrictive than the figures suggest at first glance.

The second measure of the narrow money stock—M-1B—consists of M-1A plus NOW accounts, credit union share drafts, savings subject to automatic transfer, and demand deposits at thrift institutions. M-1B is designed to capture all "checkable" deposits at banks and thrift institutions. For 1980, the FOMC set a target of 4 to 6.5 percent for M-1B. M-1B grew at an annual rate of 8 percent in 1979, well above the upper limit set for the upcoming year. The 1979 growth rate, however, was augmented by a shift of funds from sources other than demand deposits into NOW accounts and ATS accounts In setting the 1980 targets, it was assumed that such shifts were pretty much completed.

The broader aggregate—M-2—is the sum of M-1B and small time and savings deposits at banks and thrift institutions, certain overnight Eurodollar deposits, overnight RPs (repurchase agreements) at commercial banks, and money market mutual fund shares. The redefined M-3 measure includes M-2, term RPs, and large time deposits with minimum denominations of $100,000 or more whether negotiable or nonnegotiable. The 1980 targets, respectively, for the redefined measures of M-2 and M-3 are 6 to 9 percent and 6.5 to 9.5 percent. The *upper limits* of these targets were set about in line with the 1979 growth rates of these aggregates. All in all, the monetary objectives for 1980 signal a continuation of the objective of gradually winding down monetary growth and the rate of inflation.

The redefined monetary aggregates differ from the previous definitions in two major ways. (1) The new measures, for the most part, are aggregated consistently across financial institutions. That is, in the new definitions similar deposits are included in the same monetary aggregate regardless of whether they are the liabilities of commercial banks or thrift institutions. (2) The new definitions also incorporate money-like assets that result from recent financial innovations and regulatory changes in the financial system. These innovations, including RPs, money market mutual fund shares, and certain Eurodollar deposits, are incorporated in the new M-2 and M-3 definitions, whereas in the former definitions these items had not been incorporated. "Checkable" deposits resulting from regulatory changes permitting NOW accounts, savings subject to automatic transfer, and credit union share drafts are included in M-1B as well as in the broader measures.

Since these financial innovations and new types of deposits resulting from regulatory changes have become important only in recent years, the long-run trends of the new monetary definitions were in many respects similar to the behavior of their earlier counterparts (first four columns of Table 2). From the early 1960s to the early 1970s, the growth rates of M-1A and M-1B, like M-1, accelerated gradually. However, since the velocities (measures of how many times during the course of a year a dollar of money turns over) of

Table 1

Definitional Comparison of Previous and Redefined Monetary Aggregates

Components	M-1	M-1A	M-1B	M-2	M-2	M-3	M-3
	Previous	Redefined	Redefined	Previous	Redefined	Previous	Redefined*
Currency in circulation	X	X	X	X	X	X	X
At commercial banks:							
Demand deposits†	X	X	X	X	X	X	X
NOW accounts			X	X	X	X	X
Savings subject to automatic transfer			X	X	X	X	X
Other savings accounts‡				X	X	X	X
Small time deposits				X	X	X	X
Large time deposits§				X		X	X
CDs¶							X
Overnight repurchase agreements					X		X
Term repurchase agreements							X
At thrift institutions:							
Demand deposits			X		X		X
NOW accounts			X		X	X	X
Other savings accounts‖					X	X	X
Small time deposits					X	X	X
Large time deposits						X	X
Credit union share drafts			X		X	X	X
Term repurchase agreements							X
Other items:							
Money market mutual fund shares					X		X
Overnight Eurodollars held by United States residents at Carribean branches of United States banks					X		X
Traveler's checks (when data available)			X		X		X

* In addition to the four redefined monetary aggregates, a broad liquidity measure (L) was introduced. It consists of new M-3 plus other Eurodollar holdings of United States nonbank residents, bankers' acceptances, commercial paper, savings bonds, and marketable liquid Treasury obligations

† The definition of demand deposits differs between the previous and redefined aggregates in that deposits held by foreign commercial banks and certain foreign official institutions at domestic banks are excluded in the new definitions.

‡ Excluding negotiable order of withdrawal (NOW) accounts and savings subject to automatic transfer.

§ $100,000 or more.

¶ Negotiable certificates of deposit in denominations of $100,000 or more issued by large weekly reporting banks.

‖ Excluding NOW accounts

Table 2

Comparison of Redefined and Previous Monetary Aggregates

Averages of quarterly growth rates; seasonally adjusted annual rates in percent

Monetary aggregate		1960-64	1965-69	1970-74	1975-79	1960-79 Recoveries	First year of recoveries	Recessions
M-1	Growth rate	2.6	4.9	6.1	6.0	5.3	4.9	3.9
	(Growth of velocity)*	(2.9)	(3.0)	(2.5)	(4.7)	(3.7)	(5.6)	(0)
New M-1A	Growth rate	2.7	4.8	6.0	6.0	5.2	5.0	3.9
	(Growth of velocity)	(2.8)	(3.1)	(2.6)	(4.7)	(3.8)	(5.4)	(0.1)
New M-1B	Growth rate	2.7	4.8	6.0	6.8	5.5	5.0	3.9
	(Growth of velocity)	(2.8)	(3.1)	(2.6)	(3.9)	(3.5)	(5.4)	(0)
M-2	Growth rate	5.4	7.1	9.0	8.9	8.0	8.6	6.8
	(Growth of velocity)	(0.2)	(0.8)	(−0.4)	(1.8)	(1.0)	(1.8)	(−2.7)
New M-2	Growth rate	7.1	6.7	8.8	10.5	8.8	11.2	6.1
	(Growth of velocity)	(−1.5)	(1.2)	(−0.2)	(0.2)	(0.2)	(−0.8)	(−2.1)
M-3	Growth rate	7.1	6.9	9.6	10.2	8.9	10.6	7.1
	(Growth of velocity)	(−1.6)	(1.0)	(−1.0)	(0.5)	(0.1)	(−0.2)	(−3.0)
New M-3	Growth rate	7.7	6.8	11.2	10.4	9.4	10.6	8.1
	(Growth of velocity)	(−2.1)	(1.2)	(−2.5)	(0.3)	(−0.3)	(−0.3)	(−3.9)

* Velocity is the ratio of GNP to a monetary aggregate

these three aggregates increased at a moderate and fairly constant pace over this period, the more rapid growth of these narrow monetary measures seemed generally in tune with the overall expansion in the economy after allowing for a gradual increase in the efficiency of money management. In contrast, over the latter half of the 1970s, the velocity growth of these three aggregates increased markedly, that is, there was considerably more rapid growth of nominal gross national product (GNP) relative to the growth of the monetary aggregates. Of the three narrow measures, the velocity of M-1B increased the least, suggesting that part of the acceleration in the growth of the velocities of M-1 and M-1A was due to expanding usage of NOW accounts, credit union share drafts, and savings deposits subject to automatic transfer. These items are included in M-1B but not in M-1 or M-1A. The broader aggregates also have shown some tendency for more rapid velocity growth in the last half of the 1970s, although the magnitudes involved are difficult to evaluate because of the greater variability over the preceding fifteen-year period.

Velocity growth has also tended to vary over the business cycle. Movements of the velocities of M-1A and M-1B during recessions and recoveries were quite similar to the behavior of velocity of the previous M-1 definition (last three columns of Table 2). Velocity growth of all three aggregates slowed significantly in recessions, compared with periods of economic expansion. In addition, velocity growth of these three aggregates has been very rapid during the first year of economic recoveries. The cyclical patterns of velocity growth for the broader aggregates were less clear. However, substantial declines tended to occur during recessions, compared with little or no growth during periods of expansion.

While the new money definitions differ conceptually from the earlier aggregates, their long-run behavior has been similar to the previous definitions in many respects. However, as increased emphasis is placed on managing money efficiently, and as other institutional changes occur—such as the phase-out of Regulation Q currently being considered by the Congress—these new money definitions may show markedly different behavior relative to economic activity than in the past. Moreover, as the financial system continues to evolve, it may be necessary to consider redefining the monetary aggregates again in the future.