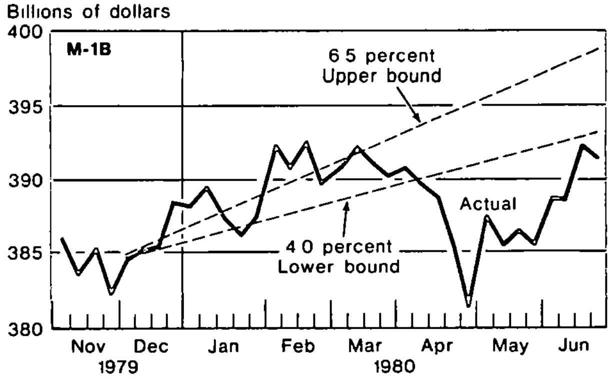
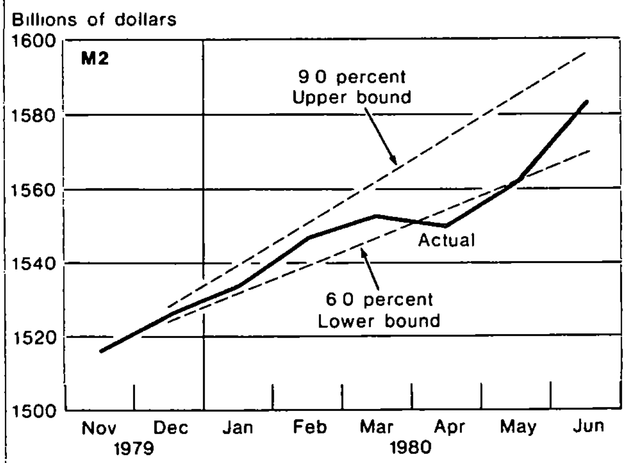
Chart 1

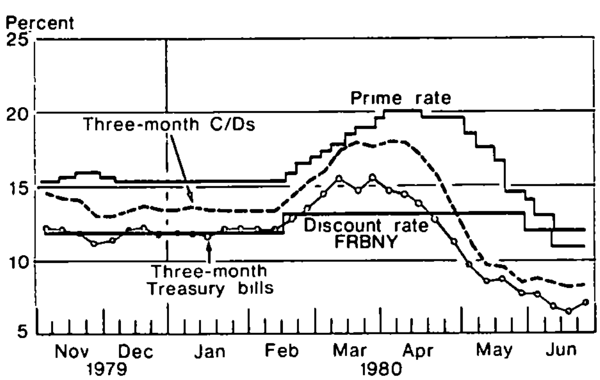
With M-1B below the FOMC's objectives . . .



. . . and with M-2 close to the lower bound during the spring . . .



. . . short-term interest rates plummeted from their peaks.



Source Federal Reserve Bank of New York and the Board of Governors of the Federal Reserve System

The financial markets

Current developments

Financial market developments during the spring and early summer were dominated by the unexpectedly severe downturn in business activity After surging to all-time highs earlier in the year, money market interest rates plummeted in the second quarter as the demand for money and short-term credit contracted along with economic activity Long-term rates also plunged, as the bond markets rebounded vigorously from the chaotic conditions of March Borrowers took advantage of the lower long-term yields in May and June by issuing massive volumes of new bonds Around mid-June, however, rates in both the money and the bond markets showed signs of backing up somewhat

With the demand for bank credit softening, the credit restraint program instituted on March 14 was gradually phased out In early May, the Federal Reserve System eliminated the 3 percent surcharge on certain discount window borrowings by large banks Later in the month, the Federal Reserve Board partially dismantled the credit controls—principally by halving the special deposit requirements and easing the reporting rules for various large financial and nonfinancial institutions Then in early July, the Federal Reserve Board announced plans to complete the phase-out of the special credit restraint program by the end of that month and to eliminate the 2 percent supplementary reserve requirement imposed in November 1978 on large time deposits of member banks Meanwhile, in two separate steps, the Federal Reserve lowered the discount rate from 13 percent in late May to 11 percent in mid-June.

As the weakening economy undercut the demand for money, the Federal Reserve continued its efforts to supply enough reserves to achieve the 1980 objectives of the Federal Open Market Committee (FOMC) for the growth of the money stock, and short-term interest rates tumbled from the all-time highs reached earlier in the year (Chart 1) After reaching 16 percent at the end of March, for example, the rate on three-month Treasury bills fell almost continuously to less than 7 percent by early June—far below the 10.4 percent rate recorded the week before the Federal Reserve's October 6 policy initiatives. Around the middle of the month, however, the Treasury bill rate started to rise, climbing more than 1¼ percentage points over the next two weeks Other money market rates paralleled the movements in the Treasury bill rate

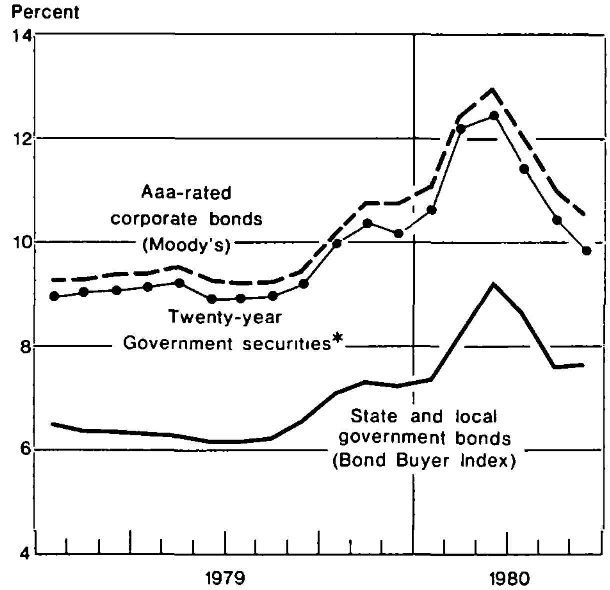
In response to the lower cost of funds, commercial banks have cut prime lending rates, which had peaked at 20 percent in the first half of April By early July, the prime lending rate had been reduced to 11½ percent, but it was about 3 percentage points above the rates on commercial paper or certificates of deposit (CDs)—a much larger spread than usual Apparently, banks are trying to protect their profit margins. The rates on existing as well as on new bank loans are generally linked to the prime lending rate Thus, in a recession when loan demand is weak, a decrease in the prime lending rate will not generate enough new loan demand to compensate for the loss in earnings on the portfolio of existing loans. Moreover, insofar as banks' liabilities consist of money market certificates or CDs which were issued several months earlier, the average cost of funds for commercial banks tends to lag behind prevailing market rates

Prompted by the wide spread between the prime rate and the commercial paper rate, many corporations borrowed short-term funds in the commercial paper market rather than from banks. From April 2 to June 25, the amount of commercial paper issued by nonfinancial companies rose $5.3 billion whereas bank loans (including loans sold to affiliates but excluding bankers' acceptances) declined $4 8 billion.

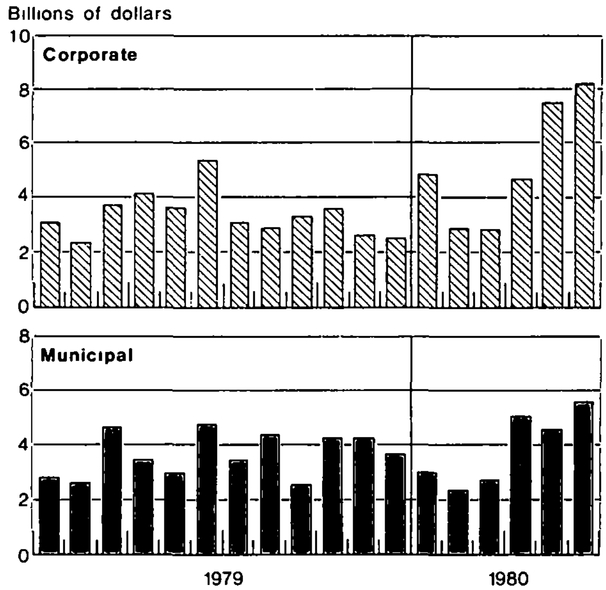
While the demand for short-term credit languished, activity in the longer term debt markets has been robust Just last March, the bond market had almost totally collapsed as investors, alarmed by the sudden flare-up in inflation and afraid that it would worsen, abandoned the market. Since then, however, the capital markets have rebounded Indeed, assuaged by the mounting evidence of recession and a slowdown in inflation, inflationary expectations eased and investors showed renewed interest in longer term issues In response to the vigorous bidding, long-term yields backed off sharply from the record heights of March. Rates on five-year and twenty-year Government issues fell as much as 4 and 2¼ percentage points, respectively, from the end of March to early May. With short-term rates dropping even more sharply, the yield curve resumed an upward slope for the

Chart 2

Long-term yields declined . . .



. . . and the volume of new bond issues soared.



Data on new bond issues in April, May, and June 1980 are preliminary

*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 , and The Bond Buyer first time since the end of 1978. Similar rallies occurred in the markets for corporate bonds and tax-exempt securities.

As long-term yields have fallen, the volume of new bond issues has ballooned (Chart 2) New corporate bond offerings surged to $7.5 billion in May and $8.2 billion in June, many times larger than those issued during February and March when the debt markets were in extreme disarray. Companies are evidently using the proceeds from their bond issues in large part to repay their short-term borrowings Around mid-June, however, the market began to show signs of strain under the continuingly heavy flow of new issues. In the tax-exempt market, the volumes of new bond issues for May and June were also much greater than those of February and March Many of these issues had been postponed earlier in the year when interest rates had risen to such high levels that they actually exceeded the statutory ceilings at which some state and local governments were permitted to borrow.

The mortgage market also showed signs of renewed life with the reflow of deposits into thrift institutions. In March and early April, faced with sharply rising interest rates, the thrift institutions were offering mortgage commitments at rates which averaged about 16½ percent—up about 3½ percentage points since the start of the year. Few potential home buyers actually took commitments at those rates, and the outstanding commitments of the thrift institutions declined by almost 30 percent over the first four months of the year. By May, however, the situation had begun to improve. Investors reacted to the steep decline in short-term rates by shifting funds away from Treasury bills and six-month money market certificates and into passbook accounts and thirty-month special floating-ceiling accounts (the so-called small saver certificates) offered by the thrift institutions. Savings inflows strengthened while withdrawals eased, and mortgage rates plunged By early June, the prevailing rate on new commitments stood at 13½ percent.

Overshadowed to some extent by the stunning swings in interest rates was the enactment on March 31 of the Depository Institutions Deregulation and Monetary Control Act of 1980 This new law is a legal milestone which will greatly overhaul the structure of the United States financial system (box). Under the new legal framework, financial institutions will look and function much differently than they do today For instance, the Federal Reserve System is accorded a more central role within the financial structure inasmuch as certain provisions of the new law extend reserve requirements to cover all depository institutions. The new reserve requirements are to be gradually phased-in over a period of eight years for financial institutions that are not members of the Federal Reserve System and over four years for member banks At the same time, nonmember depository institutions were also given access to the Federal Reserve's discount window.

Other provisions of the new law will improve the competitive balance among financial institutions. The Regulation Q ceilings on interest rates paid by financial institutions are to be entirely removed by March 31, 1986. In the interim, the newly created Depository Institutions Deregulation Committee (DIDC) will prescribe rules for the payment of interest. Still other provisions of the new omnibus law eliminate or liberalize the restrictions on the lending activities of Federally chartered savings and loan associations and mutual savings banks.

In its brief tenure, the DIDC has promulgated several new rulings on interest rates. One of its rulings revised the schedule of ceiling rates on six-month money market certificates (MMCs). Under the new schedule effective June 5, the ceiling rates that commercial banks and thrift institutions may pay on their MMCs are equal when Treasury bill rates are either above 8¾ percent or below 7¼ percent. In addition, MMCs now carry a slight premium over the Treasury bill rate, thus making MMCs more attractive to certain kinds of investors. Another of the DIDC's rulings raised the interest rates that commercial banks and thrift institutions may pay on their small saver certificates in relation to the prevailing rate on Treasury two and one-half year securities

Highlights of the Depository Institutions Deregulation and Monetary Control Act of 1980

Monetary Control Act

To facilitate control of the monetary aggregates, the Board of Governors can require all depository institutions (commercial banks, savings banks, savings and loan associations, and credit unions) to submit directly or indirectly reports of assets and liabilities

Each depository institution must maintain reserves against transaction accounts—demand, negotiable order of withdrawal (NOW), share draft, deposits subject to automatic and telephone transfer—in a ratio of 3 percent for amounts of $25 million or less and, initially, 12 percent for amounts in excess of $25 million. The statutory range for amounts in excess of $25 million is 8 percent to 14 percent Reserves on nonpersonal time deposits must be held initially at a ratio of 3 percent The legal range is 0 percent to 9 percent.

The $25 million level of transaction accounts will be adjusted annually by the Board depending on the growth of the total level of transaction accounts nationwide

If five Board members find that extraordinary circumstances exist, the Board may, after consultation with Congressional banking committees, alter reserve ratios from the statutory ranges for renewable 180-day periods

Five Board members also may impose a supplemental reserve requirement of up to 4 percent on an institution's transaction accounts

The supplemental reserves may be held as vault cash or placed in an "earnings participation account", which will earn interest at a rate not exceeding what the System open market account portfolio earned during the previous calendar quarter No interest will be earned on supplemental reserves in the form of vault cash

The Board may impose reserves on any depository institution's borrowings from its foreign offices, loans to United States residents by its foreign offices, and assets purchased by its foreign offices from its domestic offices

Reserve requirements for nonmember depository institutions will be phased-in evenly over seven years Starting September 1, 1987, all nonmember depository institutions, except those in Alaska and Hawaii, will be subject to full reserve requirements But reserves will be required immediately for any new types of deposits or accounts authorized by Federal law after April 1, 1980 The necessary adjustments in reserve requirements for member banks will be phased-in over a three-year period

Reserves must be in the form of Reserve Bank balances, but also, with Board consent, may be vault cash. Nonmembers may keep balances with correspondents, a Federal Home Loan Bank, or the National Credit Union Administration Central Liquidity Facility, if those institutions maintain balances at Reserve Banks.

Depository institutions with transaction accounts or nonpersonal time deposits are entitled to the same discount window privileges as member banks

The Board must publish for comment a set of pricing principles and a proposed schedule of fees for Reserve Bank services by September 1, 1980 By September 1, 1981, the Board must begin to put a schedule of fees for services into effect.

Depository Institutions Deregulation Act

The act provides for the phase-out of limitations on interest and dividend rates paid by depository institutions by extending the authority to impose such limitations for six years, subject to specific standards designed to ensure their replacement by market rates. During the six-year period, the ¼ percent interest rate differential payable on certain accounts by commercial banks and thrift institutions continues

A new Depository Institutions Deregulation Committee (DIDC) will asume authority to prescribe rules for payment of interest

Voting members of the DIDC are the secretary of the Treasury, the chairman of the Board of Governors, the chairman of the Board of the Federal Deposit Insurance Corporation (FDIC), the chairman of the Federal Home Loan Bank Board, and the chairman of the National

Credit Union Administration (NCUA) Board. The Comptroller of the Currency is a nonvoting member.

The DIDC must exercise its authority to provide for the phase-out and ultimate elimination of interest and dividend rate ceilings as rapidly as permitted by economic conditions.

The DIDC must increase all interest and dividend rate ceilings to market rates as soon as feasible during the six-year period following March 31, 1980.

Within eighteen months of March 31, 1980, the DIDC must vote on at least a ¼ percent increase in the passbook account limit. It must vote on a ½ percent increase in the limit on all accounts not later than the end of the third, fourth, fifth, and sixth years after March 31, 1980.

Consumer Checking Account Equity Act

Member banks and FDIC-insured nonmember banks may continue to provide automatic transfers from savings to checking accounts.

NOW accounts will be permitted nationwide December 31, 1980 at all depository institutions for individuals and certain nonprofit organizations.

Federally insured credit unions are authorized to offer share draft accounts.

Federal deposit insurance at commercial banks, savings banks, savings and loan associations, and credit unions is increased to $100,000 per account.

Federal credit unions can make residential real estate loans on residential cooperatives.

A Federal credit union can charge up to 15 percent annually on loans. The NCUA Board may establish a higher loan interest ceiling for periods not to exceed eighteen months.

Powers of Thrift Institutions

Federal savings and loan associations may invest in shares or certificates of open-end investment companies registered with the Securities and Exchange Commission, if the portfolio of the investment company is restricted to certain investments that savings and loan associations may invest in directly.

Up to 20 percent of the assets of a Federal savings and loan association may consist of consumer loans, commercial paper, and corporate debt securities.

Federal savings and loan associations may make real estate loans without regard to the geographic area, as well as acquisition, development, and construction loans.

Federal savings and loan associations may issue credit cards.

Federal savings and loan associations may exercise trust and fiduciary powers.

A Federal mutual savings bank may have up to 5 percent of its assets as commercial, corporate, and business loans, if the loans are made only within the state where the bank is located or within seventy-five miles of the bank's home office.

A Federal mutual savings bank may accept demand deposits in connection with a commercial, corporate, or business loan relationship.

State Usury Laws

Effective April 1, 1980, state residential first-mortgage real property, co-op, and mobile home usury ceilings were rendered inapplicable, unless prior to April 1, 1983 a state adopts a new usury ceiling or certifies that its voters have voted in favor of or to retain the state constitutional provision imposing a usury ceiling.

A state may adopt a law placing limitations on discount points or other charges on residential real estate, co-ops, and mobile homes.

Between now and April 1, 1983, unless state law provides otherwise, a lender may charge an interest rate of not more than 5 percent in excess of the basic Federal Reserve discount rate (including any surcharge) on business and agricultural loans in amounts of $25,000 or more, in states where the usury loan rate is lower than that rate.

Federally insured state-chartered commercial and mutual savings banks, branches of foreign banks, savings and loan associations, credit unions, and small business investment companies may charge interest on loans at a rate equal to 1 percentage point above the basic Federal Reserve discount rate. This excludes any surcharge imposed by a Reserve Bank.