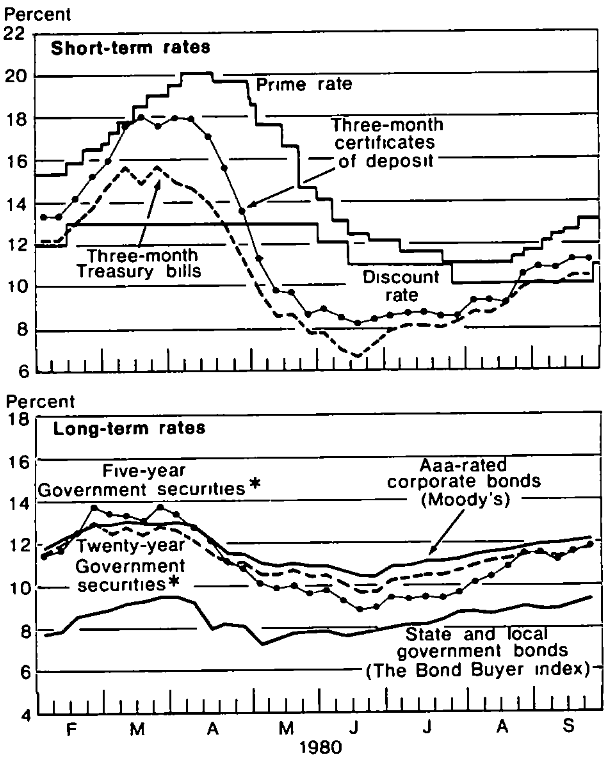
The financial markets
Current developments

Chart 1

Interest rates advanced during the summer and early fall.



*These yields are adjusted to five-year 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

The financial markets tightened substantially over the summer and early fall Rapid inflation, signs of a bottoming-out of the recession, and strong monetary growth all added to expectations of higher interest rates By late September, short-term interest rates stood more than 400 basis points above the lows reached last June (Chart 1) Long-term yields, including those on mortgage market instruments, were also much higher than they had been at the start of the summer At the end of September, the Federal Reserve raised the discount rate from 10 to 11 percent.

In announcing the increase in the discount rate, the Federal Reserve reaffirmed its intent to contain the pace of monetary growth Indeed, the narrower monetary aggregates, M-1A and M-1B, had grown very rapidly over the summer, making up for the shortfalls earlier in the year when these aggregates had fallen below the targets set by the Federal Open Market Committee (FOMC) for 1980 (Chart 2). According to the latest monthly statistics, M-1A was near the midpoint of the FOMC's targets while M-1B had risen above the top of the range In terms of quarterly averages, however, M-1A was in the bottom half of its target range in the third quarter while M-1B was in the top half of its target range The different positions of M-1A and M-1B relative to their respective target ranges reflect the extremely rapid growth of "other checkable deposits", which are included in the definition of M-1B but not of M-1A [1] As a result, M-1B has outpaced M-1A by a margin of about 2 percentage points, compared

[1] Included in "other checkable deposits" are automatic transfer service (ATS) accounts, negotiable order of withdrawal (NOW) accounts, credit union share drafts, and demand deposits at mutual savings banks For additional discussion of the definitions of the monetary aggregates, see the article "The Financial Markets, Current Developments" in the Spring 1980 issue of this *Quarterly Review*

with the ½ percentage point difference between the M-1A and M-1B targets. The growth of the broader monetary aggregates also picked up. For example, the annual growth rate of M-2 over July and August was almost twice what it had been over the three previous months. As a result of the recent speedup, the September level of M-2 was slightly above the upper bound of the FOMC's target for 1980.

In the wake of the renewed monetary growth, market sentiment turned cautious and money market rates jumped. After bottoming out at 6.2 percent in mid-June, for example, the yield on three-month Treasury bills rose to about 11½ percent by the beginning of October. Similarly, the rates on certificates of deposit (CDs), commercial paper, and other money market instruments paralleled the Treasury bill rate.

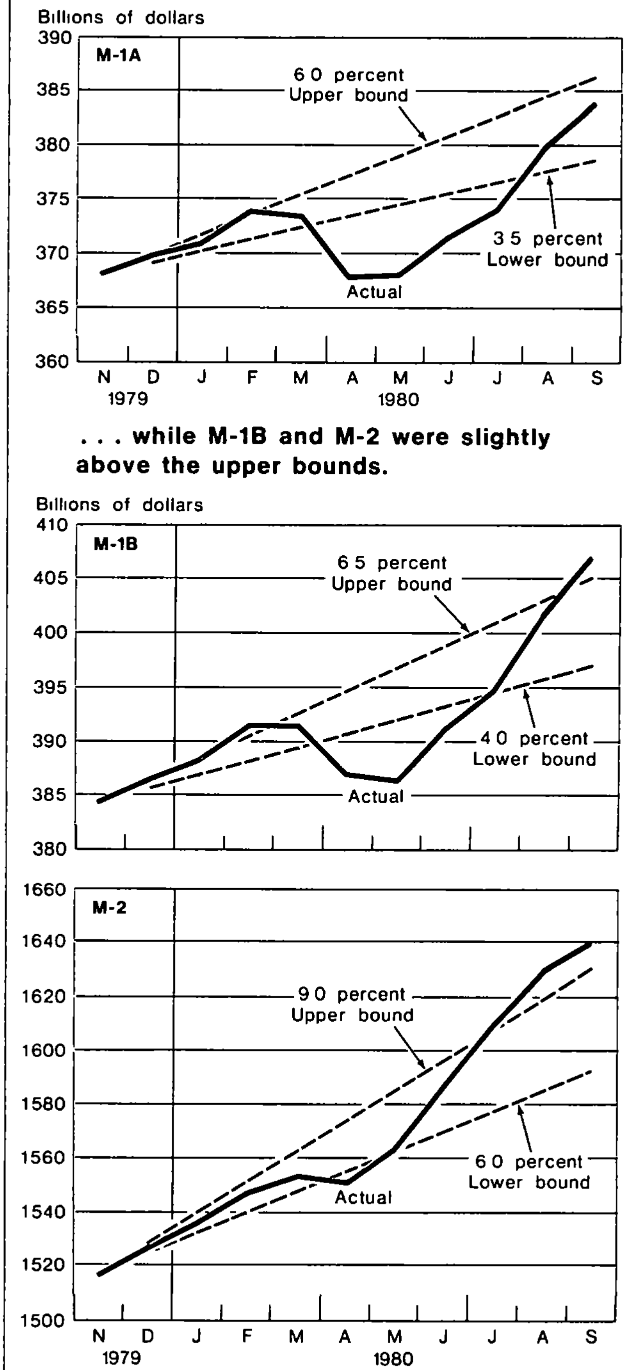
In response to the higher cost of funds, most commercial banks raised prime lending rates from the low of 11 percent to 14 percent. At the current level, prime lending rates are less than 2 percentage points above the rates on commercial paper of various maturities—well within the spread usually separating these rates. Just last spring, this spread had widened to as much as 7 percentage points.

As the spread between the prime lending rate and the rate on commercial paper narrowed, many companies have turned to banks for their short-term credit needs instead of tapping the commercial paper market. In addition, some banks are bidding very aggressively to increase their share of this business, with scattered reports that several major money-center banks are making short-term, below-prime loans to select large national corporations. Consequently, business loans expanded at a very strong pace in recent months. From June 25 to October 1, business loans (including loans sold to affiliates but excluding bankers' acceptances) increased by $8.3 billion whereas the amount of commercial paper issued by nonfinancial companies declined $2.7 billion. This was essentially the reverse of the situation that had occurred over the previous three months when the sizable increase in commercial paper outstanding offset the decrease in business loans.

The recent bulge in short-term credit demand may in part be the result of sharply higher long-term financing costs. Indeed, longer term yields rose sharply over the summer and early fall, impelled by investors' worries that an economic recovery was beginning even before there had been any significant letup in inflationary pressures. By the end of September, the rate on five-year Government issues was 3 percentage points above the low reached in mid-June. While yields on Government issues with longer maturities also increased, the extent of the rise tended to be smaller

Chart 2

By September, M-1A stood near the midpoint of the FOMC's 1980 target . . .



Sources: Federal Reserve Bank of New York and Board of Governors of the Federal Reserve System.

the longer the maturity. Consequently, the yield curve on United States Treasury obligations has flattened out (Chart 3). It is unusual for the yield curve to flatten out so soon after reverting to an upward slope during a recession For example, after the recovery from the severe 1974 recession commenced in March 1975, the yield curve remained upward sloping until mid-1978. Elsewhere in the bond market, the upward pressure on rates has been just as strong for corporate and tax-exempt securities as for Government issues

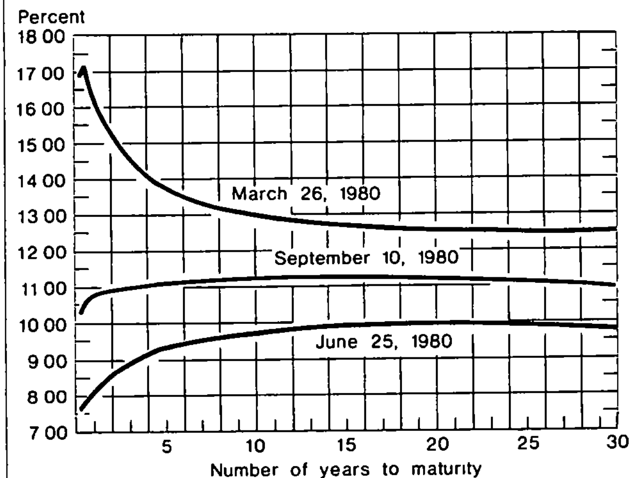
With bond yields on the rise, new corporate bond offerings have fallen off from the hectic pace of last spring New corporate bond issues amounted to about $4½ billion per month in the third quarter, more than $2 billion below the monthly average for the second quarter and far below the record $8 2 billion posted in June Some of the recent decline in new issues involves temporary postponements, as companies chose to withhold new issues from the market in the hope that interest rates will soon come down. Still, at the pace of recent months, the volume of new corporate bond issues remains large by historical standards.

New municipal bond offerings also have been strong in recent months, although certain strains and stresses do appear to be developing within the tax-exempt market New issues amounted to $4½ billion on average in each month of the third quarter, off only about $½ billion from the volume of the previous three months However, the yield curve for tax-exempt municipal securities has taken on a very steep slope, with the spread between one-year and thirty-year securities exceeding 300 basis points during much of August Over the past year, this yield spread was as low as 60 basis points and averaged roughly 130 basis points One of the private rating companies has been downgrading many municipal securities, and this appears to have generated concern on the part of market investors about the long-term financial prospects of municipalities

Mirroring the developments in the money and bond markets, albeit with a short lag, the mortgage markets began to get noticeably tighter toward the end of August Earlier in the summer, conditions had eased considerably from the winter In both June and July, the effective interest rate on lenders' new mortgage commitments declined and lending activity picked up

Chart 3

The yield curve on United States Treasury obligations moved from a downward slope in March to an upward slope in June, and then flattened out by September.



Source United States Department of the Treasury and the Federal Reserve Bank of New York

Outstanding mortgage commitments by thrift institutions increased $4½ billion during June and July, a sizable 23 percent gain over the low reached in May But, as interest rates in the money and bond markets continued to rise, conditions in the mortgage markets started firming up in late August By the end of September, the yield on conventional-mortgage commitments by the Federal National Mortgage Association (FNMA) was about 2 percentage points above what it had been at the mid-July auction At the same time, the rate on newly issued mortgage commitments by lenders rose as much as 2¼ percentage points Hence, lending activity is beginning to taper off. Although the latest data show that the volume of new mortgage commitments was still increasing in August, most of these newly issued commitments were the result of inquiries made many weeks earlier Scattered reports suggest that new inquiries from prospective home buyers are now below what they were earlier in the summer