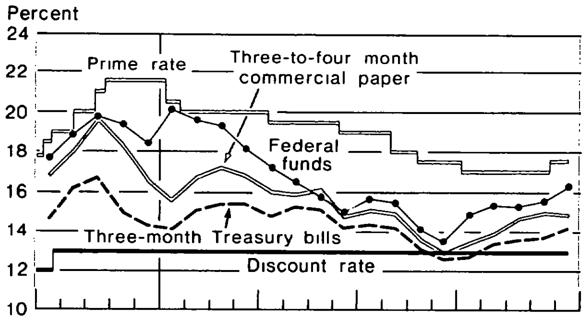
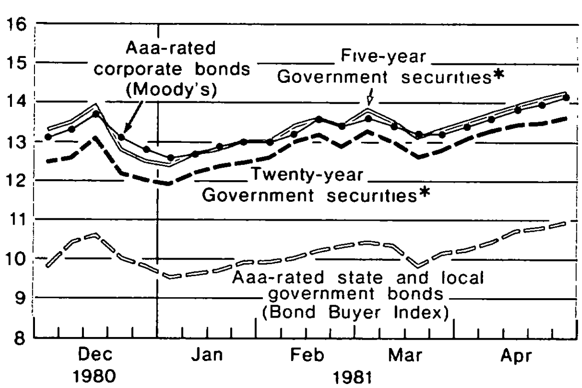
Chart 1

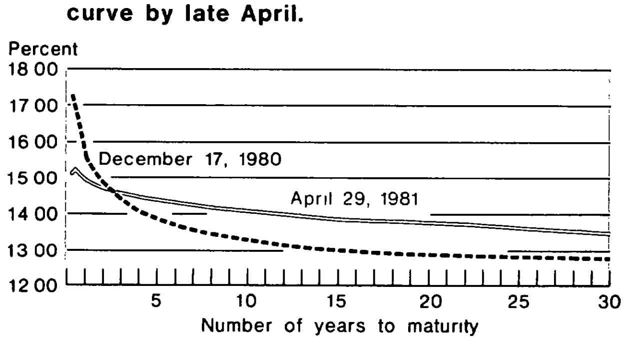
Interest rates showed considerable volatility during the winter and early spring, with short-term rates declining during the first three months of the year, and then rising sharply in April . . .



. . . while long-term rates moved steadily upward . . .



. . . causing a flattening of the yield curve by late April.



*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, and Moody's Investor Service, Inc

The financial markets

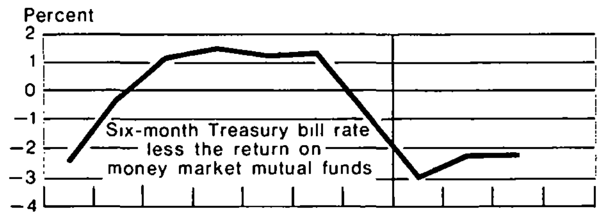
Current developments

The financial markets during the winter and early spring were unsettled by uncertainty over the near-term outlook for the economy and the longer run implications of the new Administration's economic policies. Short-term rates declined from mid-December to late March, reflecting an easing of short-term credit demand as well as market reaction to slower money growth, but then moved sharply upward during April as the market became concerned that monetary policy would tighten. Although short-term rates dropped during the first three months of the year, the market remained nervous about the outlook for inflation, and long-term yields edged back up to their mid-December highs (Chart 1).

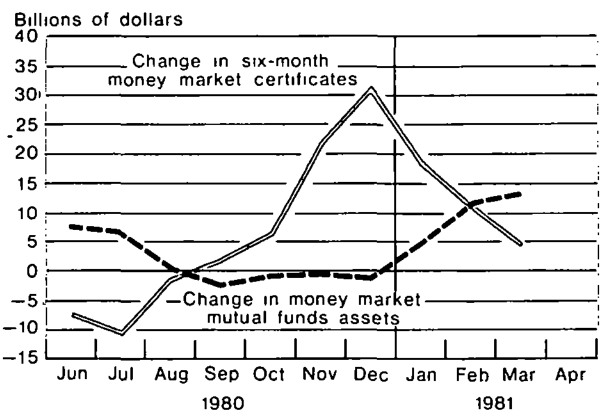
During the first quarter, short-term rates changed direction several times in response to often conflicting signals on the strength of the economy and the growth of the monetary aggregates. In late December and early January, the money market rallied on expectations that an economic slowdown was imminent and short-term rates fell sharply. However, as subsequent reports on the economy showed surprising strength in business activity and continuing inflationary pressures, rates began to edge up again in mid-January. The Treasury's heavy financing schedule and the Administration's proposal for large tax cuts also weighed on market sentiment. Then, in March, the economic statistics began to point to a slowdown in economic activity and rates declined once again. Also, despite the problems of interpretation resulting from the nationwide introduction of negotiable order of withdrawal (NOW) accounts on December 31, it appeared that the growth of the narrow monetary aggregates was below the Federal Open Market Committee's (FOMC) annual targets. This contributed to market sentiment that short-term rates would fall further. But, in early April, short-term rates increased sharply

Chart 2

As short-term rates fell, the spread between the money market rates and the return on money market funds became negative after November . . .



. . . leading to a sharp increase in the assets of money market mutual funds and a slowing in the growth of six-month certificates.



Sources Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, and Donoghue's Money Fund Report of Holliston, Massachusetts

as the market reacted to news that, even though the Federal funds rate had fallen below 15 percent, the Federal Reserve had not lowered its broad range for the Federal funds rate at the February FOMC telephone conference Rather, in the February directive, the FOMC instructed the Manager for Domestic Operations to notify the Chairman if, over a period of time, fluctuations in the Federal funds rate within a range of 15 to 20 percent were likely to be inconsistent with the monetary and related reserve paths Late in April, further impetus was added to the increase in short-term rates as the market became concerned that monetary policy would tighten in response to the more rapid growth of the money stock.

The decline in short-term rates during most of the first quarter occurred during a period of moderating short-term business credit demand. After increasing at an annual rate of 21.5 percent between September and December, business loans plus short-term commercial paper slowed to a 12.2 percent gain during the first three months of 1981 Moreover, with the prime rate lagging the decline in short-term rates, the growth of business borrowing slowed dramatically between December and March, while the issuance of new commercial paper increased Corporations also turned abroad for a larger share of their credit needs in the first quarter, as the prime rate also lagged the decline in the London interbank offer rate. Between December and March, borrowing by American businesses from the overseas branches of United States banks rose by $2.8 billion, compared with a decline of nearly $1.0 billion during the last three months of 1980. By late April, however, even though business loan demand remained moderate, banks increased their prime lending rates for the first time since December in response to tighter money market conditions

The easing in the money market during much of the first quarter reduced a little the pressures on the earnings of thrift institutions. As short-term rates fell in the first quarter, the additional cost of rolling over maturing six-month money market certificates eased In December, as six-month certificates matured and were rolled over, banks and thrift institutions paid 7.6 percentage points more for the funds than they had paid six months earlier, but by March this additional rollover cost had eased to 2.5 percentage points At the same time, however, declining short-term rates made it more difficult for the thrift institutions to attract additional deposits because as rates fell the returns on money market mutual funds declined less rapidly than yields on money market certificates (Calculations of returns on money market funds are based on average yields of portfolios with average maturities of about thirty days rather than on the most recent money market rates) As a result, the flow of funds into money market certificates at thrift institutions and commercial banks slowed dramatically from $30.4 billion in December to $4.9 billion in March, while the movement of funds into money market funds accelerated to $13.2 billion by March as compared with a small outflow in December. In contrast, when short-term rates were rising rapidly last autumn, the yields on money market certificates were considerably above the average return on money market funds, and a growing volume of funds flowed into money market certificates between September and December, while assets of the money market funds declined by $2.4 billion (Chart 2)

While short-term borrowers were able to obtain new funds at generally lower costs as the first quarter progressed, long-term borrowers had to pay substantially higher rates. After a brief rally in late December, long-term yields approached their mid-December highs in mid-February and again in early March, as market participants remained skeptical that the Administration's economic program would lower inflation. Subsequently, the market atmosphere improved for a brief period, and long-term rates declined sharply; but late in March the market reversed itself once again and by late April yields on Aaa-rated corporate bonds had reached a peak of 14.14 percent, up sharply from the early-January low of 12.63 percent.

The cautious attitude of investors about the outlook for inflation made it difficult at times to bring new long-term bonds to market and prompted some borrowers to find new ways to raise needed funds. When long-term yields rose rapidly during the last half of 1980, many corporations became reluctant to incur such high long-term borrowing costs. They postponed new bond offerings and increased their short-term borrowings instead. But with rallies in the bond market in the late December-early January period and again in early March, corporations were able to bring $10.5 billion of new bonds to the market during the first quarter, compared with $7.9 billion in the last quarter of 1980. Corporations however, remained sensitive to long-term rate movements. During the first quarter, they postponed new offerings when rates rose sharply and seemed to rush new issues to market when yields fell. Furthermore, as a result of investor reluctance to purchase long-term debt in the inflationary environment, corporations sought to reduce the risk and increase the marketability of new offerings by shortening the maturity and offering special features, such as deep discount bonds and put options.

The unsettled conditions in the bond market resulting from the uncertainty about the prospects for inflation occurred even as the narrow monetary aggregates weakened considerably during the first three months of the year. Interpretation of short-run movements in the narrow monetary aggregates, however, was even more troublesome than usual because of the nationwide introduction of NOW accounts on December 31. Since other checkable deposits such as NOW accounts are included in M-1B but not in M-1A, any shift out of demand deposits into NOW accounts reduces M-1A but leaves M-1B unaffected. At the same time, any movement of funds from sources other than demand deposits into NOW accounts increases M-1B. NOW accounts increased by $24.8 billion during the first quarter, and surveys of commercial banks and thrift institutions indicate that roughly 75 percent of the inflows into these accounts have come from demand deposits and 25 percent from other sources, primarily savings accounts (Chart 3). This means that the growth of M-1A is understated and M-1B overstated relative to what would have occurred in the absence of NOW accounts. Since the initial shift of funds into NOW accounts has been very large, the first-quarter impact on M-1A and M-1B was substantial. Thus, the reported statistics show that M-1A and M-1B changed at widely different rates during the first quarter as a result of the growth of NOW accounts. On an "adjusted" basis, however, the level of M-1B appears

1980 and 1981 Ranges for the Monetary Aggregates
Seasonally adjusted annual rates, in percent

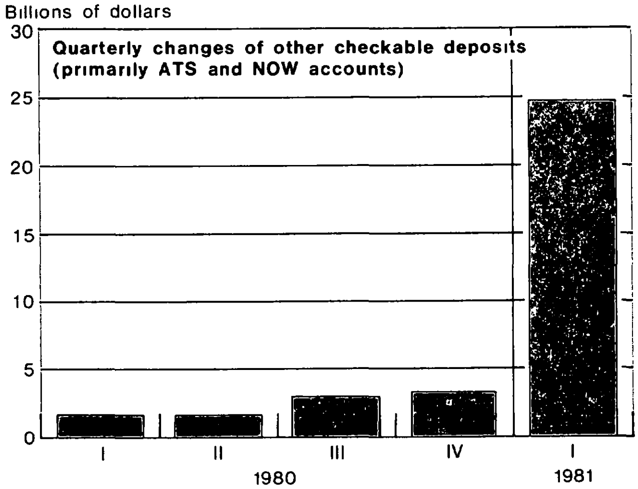
Aggregates	Fourth quarter to fourth quarter: 1980 annual target ranges	Fourth quarter to fourth quarter: 1980 actual growth rates	Fourth quarter to fourth quarter: 1981 annual target ranges	Over preceeding quarter: First quarter 1981
M-1A	3.5-6.0	5.0 (6.3)*	3.0-5.5†	—
M-1B	4.0-6.5	7.3 (6.7)*	3.5-6.0†	1.1†
M-2	6.0-9.0	9.8	6.0-9.0	8.4
M-3	6.5-9.5	9.9	6.5-9.5	11.9
Bank credit	6.0-9.0	7.9	6.0-9.0	12.7

* Adjusted for the more rapid than expected growth of automatic transfer service (ATS) accounts in 1980. The adjusted growth rates are based on the assumption that two thirds of the more rapid than expected growth of ATS accounts during 1980 resulted from shifts of funds out of demand deposits and one third from shifts out of savings accounts.

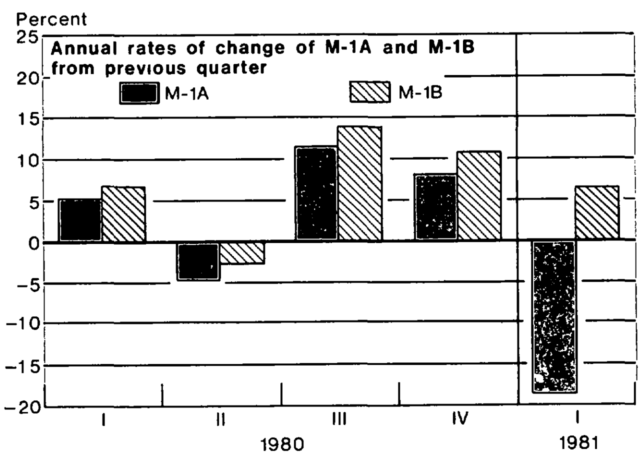
† After adjusting for the effects of nationwide NOW accounts. See Chart 3 for details on how "adjusted" figures for the first quarter 1981 were calculated.

Chart 3

As a result of the introduction of nationwide NOW accounts on December 31, 1980 . . .

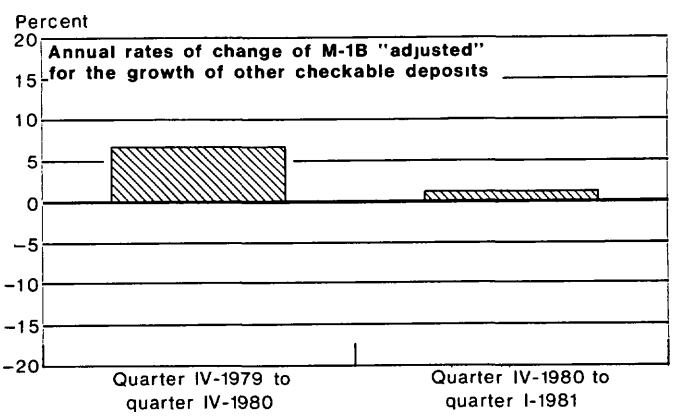


. . . M-1A and M-1B changed at widely different rates during the first quarter of 1981 . . .



Interpreting the growth of the narrow monetary aggregates during the first quarter relative to the FOMC's annual ranges is complicated by the rapid growth of NOW accounts. While it is difficult to make precise adjustments for the effects of NOW accounts, the Board of Governors of the Federal Reserve System has now released an estimate of M-1B growth for the first quarter of 1981 adjusted for the effects of NOW accounts. Surveys and other information suggest that about 22.5 percent of the increase in NOW accounts in January and 27.5 percent in February and March (after allowing for growth of NOW accounts in existence before December 31, 1980) came from sources other than demand deposits, primarily savings deposits, thereby raising the M-1B growth rates relative to what they would have been if nationwide NOWs had not been permitted. Hence, to arrive at an adjusted M-1B series, the above percentages were applied to the change in other checkable deposits in excess of trend. The resulting cumulative amounts were seasonally adjusted using the seasonal factor for commercial bank savings deposits and subtracted from the level of M-1B.

. . . but on an "adjusted" basis M-1B appears to have increased slightly in the first quarter.



to be largely unchanged from the last quarter of 1980. The broad monetary aggregates, which were not affected by the movements of funds into NOW accounts, showed stronger growth.

In February, the Federal Reserve presented its semiannual report to the Congress pursuant to the Humphrey-Hawkins Act and announced the 1981 targets for the monetary aggregates (table). The 1981 targets for M-1A and M-1B are ½ percentage point less than those in effect for 1980, whereas the ranges for the broader aggregates are the same as those set for 1980, but with upper limits below the 1980 actual growth rates. (On a quarterly average basis, M-1B on an "adjusted" basis appears to have been well below the lower bound of its range during the first quarter, while M-2 growth was within its annual range and M-3 about 2 percentage points above its upper limit.) In the report to the Congress, Chairman Volcker stressed once again the Federal Reserve's commitment to the goal of reducing long-term inflationary pressures through a policy of gradually slowing the growth of money.