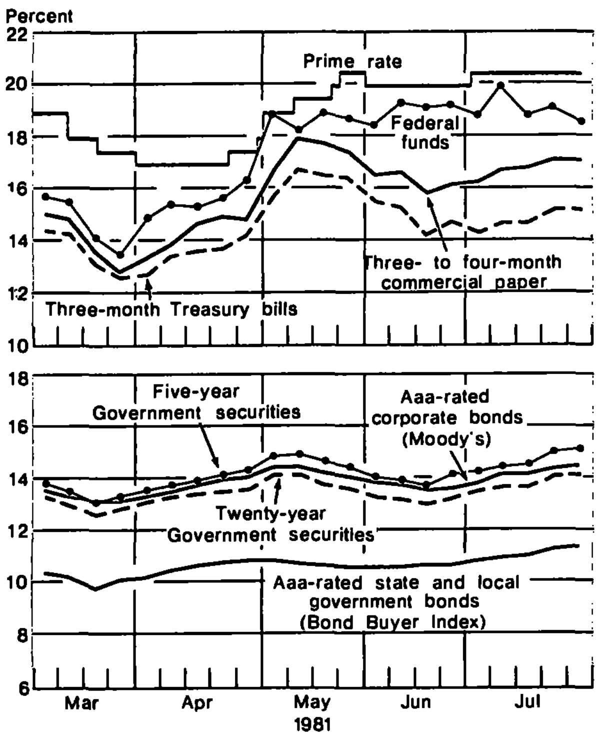
The financial markets
Current developments

Chart 1

In recent months, interest rates have remained at or near record levels.



Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, and Moody's Investors Service, Inc.

Interest rates rose at the beginning of the second quarter and remained at or near record levels into July. At the short end of the term structure, rates were sustained by both strong demands for bank credit and restraint in the provision of bank reserves to contain the growth of the monetary aggregates, which was rapid in March and April. Longer term rates were kept high by concerns in financial markets about the implications for the economy of proposed tax cuts and continued sizable Federal budget deficits, especially in view of Federal Reserve determination to hold the growth of the monetary aggregates within target ranges.

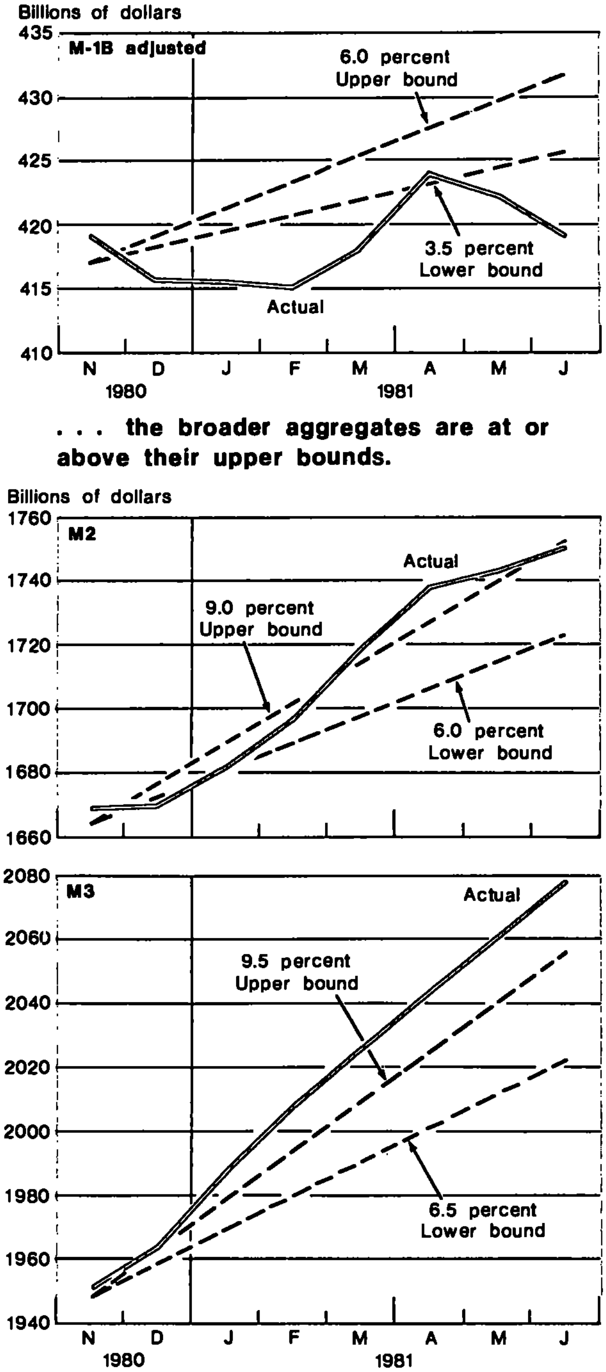
In light of the levels of short-term market interest rates and consistent with the need for restraint over bank reserves, the Federal Reserve System raised the discount rate 1 percentage point to 14 percent, effective on May 5. At the same time, it raised the surcharge imposed on large banks that borrow frequently at the discount window from 3 percent to 4 percent.

By the end of the first half of the year, the paths of the monetary aggregates showed divergent trends. M-1B, adjusted for shifts in 1981 to newly authorized negotiable order of withdrawal (NOW) accounts, fell in May and June to below the lower bound of its target range. M-2 was at the upper edge of its range at midyear, while M-3 was above its upper bound.

The public apparently has adapted to high interest rates by managing their zero- or low-interest transactions balances very carefully and placing more of their funds in high-yielding liquid alternatives. This response accounts for the large divergence between M-1B (which is made up mainly of transactions balances and exclusively of balances paying a zero- or low-interest rate) and the broader aggregates, M-2 and M-3 (which add a range of assets yielding market interest rates to M-1B). Noting this divergence, Federal Reserve Board

Chart 2

Although M-1B is below the lower bound of its target range . . .



Source: Board of Governors of the Federal Reserve System.

Chairman Paul Volcker announced that the Federal Open Market Committee (FOMC) considered growth of M-1B near the lower end of its target range for 1981 as a whole to be acceptable and desirable, while it continued to view growth of the broader aggregates near the tops of their ranges as acceptable. Given the public's closer control over transactions balances, lower growth of M-1B is consistent with an unchanged degree of anti-inflationary restraint.

Money market mutual funds

Money market mutual fund shares, which are included in M-2 and M-3, have been prominent in the public's shift into high-yielding liquid assets. Although the first money funds appeared in 1972, they have only recently become an important segment of the financial markets, growing from $10 billion in 1978 to more than $130 billion now. The expansion of money funds accounted for two thirds of the difference between the growth of M-2 and the growth of M-1B over the first half of 1981.

The appeal of money funds

Money market mutual funds have become popular with individuals, many corporations, and small- to medium-size bank trust departments. For all, they offer a diversified vehicle that is more liquid than most other money market instruments. For investors of small amounts, an important additional advantage is the small (generally $2,000 to $5,000) required initial investment, and even smaller minimum for subsequent purchases and redemptions. By contrast, the direct purchase of money market instruments generally requires an expenditure of at least $10,000, and many instruments are available only in units of $100,000. Through their investment activities, money funds effectively transform large-denomination open market claims—like certificates of deposit, bankers' acceptances, and commercial paper—into fund shares, which can be bought or redeemed in smaller units.

Economies of scale in money management appear to be important for corporations and bank trust department customers of money funds. They can achieve greater net returns by investing in money funds than they could by establishing and operating their own facilities for short-term investments. They and some wealthier individual holders also respond to changes in relative yields by shifting back and forth between money funds and money market instruments. Such behavior helps explain both the strong growth of money funds over most of the first half of 1981, and their slow growth in May, when interest rates were widely thought to be reaching a peak and three- to six-month investments were available with yields exceeding those posted by money funds.

Banks and thrift institutions respond to the competitive challenge of the money funds

The Federal Reserve's Regulation Q and parallel regulations of other Federal regulators limit the interest rates that banks and thrift institutions can pay in the retail market—that is, on deposits of less than $100,000. These regulations are a fundamental reason why money funds have developed—to pool small amounts of funds and obtain the higher yields available in the unregulated wholesale market. Banks and thrift institutions have sought ways to continue to attract funds in the retail market that would not be subject to Regulation Q.

Since 1978, these institutions have been authorized to offer six-month money market certificates in minimum units of $10,000 with an interest rate tied to the United States Treasury bill rate. Many institutions offer these certificates together with credit lines that serve to reduce the minimum amount needed to acquire the certificates and to enhance their liquidity.

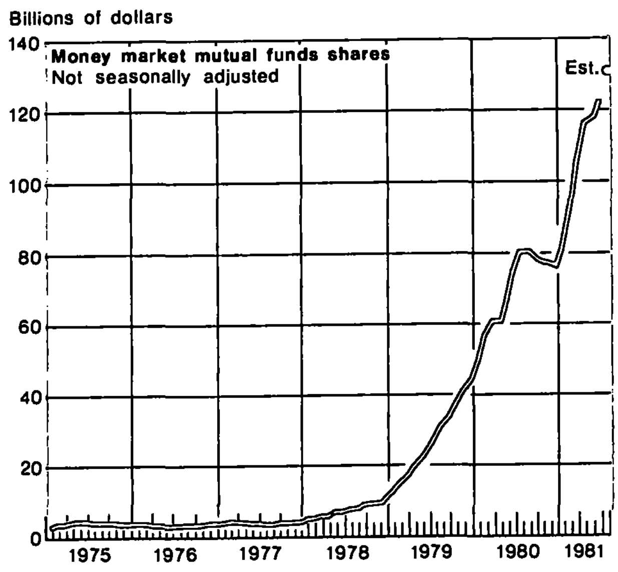
In recent months, many banks and thrift institutions have begun to accept funds through "retail repurchase agreements". In these transactions, the consumer purchases a participation in the depository institutions' holdings of United States Government or agency securities. The institution agrees to buy back the participation at a specific time or on notice. Such transactions are not subject to Regulation Q, but neither are they covered by deposit insurance.

In another effort to compete with money market funds, three large bank holding companies and one major industrial firm each recently announced plans to issue $100 million in seven-year money market notes to be sold in $1,000 denominations. To approximate the yield and the stable principal value of money funds, the interest rates on these notes were to be reset each week in line with the thirty-day commercial paper rate. The underwriting firm was to establish a secondary market in the notes to enhance their liquidity. This innovation was not an immediate success. In the midst of misunderstandings concerning the distribution network and turbulence in the money market, the three bank holding companies postponed their issues. The industrial company dropped its plans.

Still another effort to compete with money funds was launched by a California bank in May. The bank began to offer Eurodollar deposits at its foreign branch to small investors. The Federal Reserve Board responded to this initiative by amending Regulations Q and D to subject small Eurodollar deposits to interest rate ceilings and reserve requirements.

Chart 3

The continuing popularity of money market funds explains most of the difference in the recent growth of the narrow and broad aggregates.



Shares in July 1981 estimated from incomplete weekly data.

Sources: Board of Governors of the Federal Reserve System and Investment Company Institute.

Issues raised by money funds

The rapid growth of money funds has raised a number of issues. One is whether banks and thrift institutions should be given additional latitude within Regulation Q to offer deposits that are competitive with money funds. The Depository Institutions Deregulation Act of 1980 mandated the phasing-out of Regulation Q ceilings on time and savings deposits. The Depository Institutions Deregulation Committee established by the act has set a schedule for phasing out these restrictions between now and 1985, beginning with the longer maturities. Since short-dated deposits are the closest substitutes for money funds, the opportunities for banks and thrift institutions to offer deposits competing with money funds will continue to be limited by Regulation Q for some time. Nevertheless, these institutions can be expected to look for ways of enhancing the liquidity of the deregulated deposits and to experiment further with nondeposit instruments to compete with money funds.

A second issue arises from the arrangements for the use of share drafts to make third-party payments from money fund balances. (Many funds provide their investors with these check-like instruments which can be used, for example, to pay household bills.) These arrangements create a potential for money funds to substitute for demand deposits and NOW accounts, although share drafts are normally restricted to a minimum size of $500. To date, few money fund accounts are used routinely for making third-party payments. Nevertheless, the transactions capability of money funds has reinforced concerns over competitive equity and has raised monetary control questions.

In addition to the freedom from interest rate restrictions, money funds enjoy an advantage over demand deposits and NOW accounts in being free from reserve requirements. Proposals have been made to subject money funds to reserve requirements, including a proposal by Chairman Volcker that those accounts carrying a third-party payment privilege be subjected to the reserve requirement on transactions deposits. Such a reserve requirement would reduce, but not eliminate, the interest rate advantage of money funds over demand deposits and NOW accounts. At current interest rates, yields on money funds would be reduced by about 200 basis points.

A reserve requirement on those money fund accounts that allow third-party payments could improve the regulatory structure for monetary control somewhat. To use their money fund balances for transactions purposes, shareholders would have to accept somewhat lower returns. Those willing to hold fund shares without a third-party-payment arrangement would earn higher returns. The segregation of money fund balances in this way would facilitate monetary analysis. With this regulatory distinction, it might then be logical to include money fund transactions balances in M-1B. More importantly, Federal Reserve control over total reserves would then directly influence the aggregate supply of transactions balances in depository institutions and money funds. However, a large volume of transactions balances in money funds with variable, market-oriented interest rates could mean that the demand for transactions balances would be less stable in the short run and less responsive to interest rate movements. As a result, attempts to control these balances over short intervals could entail even greater interest rate variability. At the same time, the issue of competitive equity between money market funds and deposits at banks and thrift institutions would remain unresolved.

A third issue is the effect of the growth of money funds on the allocation of credit in the economy. Money fund managers have concentrated their investments in the liabilities of major money-center banks and in commercial paper issued by large prime-rated firms. Because of these investment practices, some observers have questioned whether credit is being channeled increasingly to large banks and corporations. Recently, however, brokers have begun to package certificates of deposit issued by thrift institutions and small banks for sale to money funds. This development suggests that market forces are at work to sustain the flow of funds to smaller institutions and their customers.

The broad appeal of money funds is indicated by their rapid growth, which resumed again in June, and by public support for them whenever states have considered restrictions on them. As long as interest rates on money market instruments remain higher than the deposit rate ceilings on retail deposits, households and other investors of moderate sums will have strong incentives to hold money fund shares. Even without binding rate ceilings, the liquidity and diversification of these investments would be attractive features.

Market forces already have begun to ease some of the dislocations caused by the success of the money fund industry. However, the issues of monetary control are likely to become more acute in the future. Therefore, it is important to consider ways for ensuring that the treatment of money funds' transactions balances is part of a consistent framework for monetary control.