Research Department
Federal Reserve
Bank of
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Fluctuating Rates

Financial developments in 1975 were molded first by a steep recession and then by the forces of early recovery, and amidst these strong crosscurrents, interest rates diverged considerably from their traditional cyclical pattern. Rates reversed direction several times during the year in both the short- and long-term ends of the maturity spectrum, but at year-end they remained at historically high levels for a period of early economic recovery. But to some analysts, the late-year downturn in rates suggested that the typical cyclical pattern might finally be asserting itself.

An overriding concern for financial solvency dominated the financial markets, and this was intensified in the latter part of the year by New York City's seemingly insuperable financial problems. At the same time, record financing demands emerged in the corporate-bond and municipal markets, along with the Treasury's massive borrowing requirements—although these forces were offset somewhat by business firms' repayments of short-term bank debt and by households' heavy buildup of funds in thrift accounts. Some uncertainty developed in financial markets because of wide fluctuations in money-supply growth—including the late-spring spurt associated with the massive tax-cut bill. Interest rates at times appeared highly sensitive to short-run movements in the money supply.

Financing pattern

The Treasury raised over $80 billion in new cash during calendar 1975, reflecting the severe recession-caused strains on the Federal budget, with revenues falling and expenditures soaring. Municipalities, also faced with rising costs and dwindling revenues, raised a record $30 billion through bond obligations. Corporations meanwhile turned to the capital market for a record amount of well over $30 billion in long-term financing, in an attempt to repair imbalances resulting from the high inflation rate of 1973-74 and the associated upsurge of short-term borrowing. These firms used close to $8 billion of these funds to repay short-term bank debt, and the remainder to rebuild liquidity and purchase new capital goods.

Commercial banks remained reluctant lenders despite this heavy repayment of close to $8 billion in corporate debt. Instead, banks used available funds to rebuild liquidity—especially through heavy Treasury-bill purchases—and to increase loan-loss reserves and improve capital ratios. In an effort to compensate for the mistakes of the past several years, bankers concentrated their efforts on improving their rate of return, and reduced their earlier emphasis on rapid growth. Thus they permitted the prime business-loan rate to lag considerably behind the movement of money-market rates.

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Rate pattern

Short-term rates generally declined until about mid-June. Rates then rose rapidly as economic activity accelerated in the aftermath of the tax cut, and as Treasury borrowing also speeded up. Indeed, by late summer the rate upsurge triggered some outflow of funds from deposit institutions. A third-quarter slowdown in money growth then led in October to a reduction in the targeted Federal-funds rate—the rate governing overnight lending of unused member-bank reserves. Market rates thereupon declined until mid-November, rose for several weeks, and then declined again in the second half of December.

The three-month Treasury bill rate reached 5.20 percent around year-end—lower than at any other time in the past three years, except for a brief spell last spring. The Fed-funds rate in December averaged 5.25 percent—more than two percentage points below the year-before level. But as already noted, money rates remained historically high for an early recovery period, with an inflation premium imbeded in the rate pattern.

A similar pattern prevailed in the long-term end of the market. After early-year weakness, a record volume of corporate financing placed pressure on the capital market and led to a run-up in rates in April and May. Following some post-tax cut easing in June, the upward trend of rates resumed in the third quarter, reflecting a slowdown in money growth, accelerated Treasury financing, and mounting concern over New York's problems. After another pause, rates strengthened again in mid-November when a heavy volume of corporate and Treasury financing converged. However, the market's ability to absorb these offerings with only moderate increases in yields contributed to a renewed rate downtrend in the last half of December.

Over the course of the year, long-term interest rates (with one notable exception) fluctuated within a relatively narrow range of less than one percentage point, although remaining at levels which are high for the early stages of an economic recovery—especially a recovery following a severe recession. The exception to this trend was the market for tax-exempt municipal bonds, which was heavily affected by the New York crisis. Municipal yields rose steadily from March to September, at that time hitting an all-time high of 7.76 percent. Although declining thereafter, yields held at near-record levels at year-end.

Pattern for early '76?

As 1976 begins, many analysts are looking forward to a continuation of the general easing of interest rates. For some, December's slowdown in money-supply growth suggests a reduction in the Federal Reserve's target for the Fed-funds rate. For others, normal seasonal factors operating in the market—such as the seasonal pay-down of bank credit and the post-Christmas return flow of currency—indicate downward pressures at least on short-term rates. In particular, the still-modest pace of the recovery and the hesitancy of businesses to rebuild inventories indicate continued weakness in short-term bank credit demand.

On the other hand, the Treasury remains a very strong presence in the market, since it will be borrowing heavily for both cyclical and seasonal reasons. The Treasury will raise new cash through increases in its regular bill auctions, and perhaps also in connection with its February 15 refunding, when $4.2 billion in publicly-held debt matures. But its refunding issues will have to be restricted to intermediate-term maturities, since the Treasury has already reached the limit on the amount of long-term bonds it can issue above the traditional 4¼-percent rate ceiling—unless the Federal Reserve purchases some long-term issues.

Corporate offerings in contrast could decline in coming months, in view of a January calendar which is well below the average 1975 volume. Improved corporate liquidity and reduced bank debt have by now removed much of the urgency in corporate financing that marked the 1974-early 1975 period, while the modest expectations for plant-equipment spending could also temper private credit demands in the capital market. (Of course, further declines in yields could entice many firms to increase their offerings in that market.) The tax-exempt market meanwhile could remain sluggish, reflecting the reduced access of many municipalities and state agencies to financial markets, as well as the public sector's overall retrenchment in planned capital expenditures.

If all these elements fall into place, the economy's financing needs in the first quarter could be accommodated at the current or even a declining level of interest rates, according to the broad consensus view. However, this optimistic scenario rests upon several key assumptions, including a continued moderate expansion in economic activity and (above all) a continued deceleration in the inflation rate.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/24/75	Change from 12/17/75	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	89,121	− 236	+ 2,042	+ 2.34
Loans (gross, adjusted)—total	65,866	− 131	− 2,329	− 3.42
Security loans	1,385	− 207	− 453	− 24.65
Commercial and industrial	23,535	− 19	− 1,440	− 5.77
Real estate	19,597	− 26	− 413	− 2.06
Consumer instalment	10,196	+ 44	+ 316	+ 3.20
U.S. Treasury securities	10,566	− 164	+ 4,693	+ 79.91
Other securities	12,689	+ 59	− 322	− 2.47
Deposits (less cash items)—total*	88,904	− 323	+ 5,649	+ 6.79
Demand deposits (adjusted)	23,895	− 178	+ 1,710	+ 7.71
U.S. Government deposits	358	− 386	− 153	− 29.94
Time deposits—total*	62,851	+ 545	+ 3,957	+ 6.72
States and political subdivisions	7,337	+ 525	− 26	− 0.35
Savings deposits	21,866	+ 53	+ 3,855	+ 21.40
Other time deposits‡	29,782	− 113	− 75	− 0.25
Large negotiable CD's	16,235	− 224	− 871	− 5.09

Weekly Averages of Daily Figures	Week ended 12/24/75	Week ended 12/17/75	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	110	19	89
Borrowings	23	1	134
Net free(+)/Net borrowed (−)	+ 87	+ 18	− 45
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (−)	+ 2,351	+ 1,968	+ 1,656
Transactions of U.S. security dealers			
Net loans (+)/Net borrowings (−)	+ 1,154	+ 527	+ 914

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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