Banking and Monetary Developments in the First Quarter

The Federal Open Market Committee, at its meeting of January 15, 1970, concluded that "in the conduct of open market operations increased stress should be placed on the objective of achieving modest growth in the monetary aggregates, with about equal weight being given to bank credit and the money stock. It was agreed that operations should be directed at maintaining firm conditions in the money market, but that they should be modified if it appeared that the objective with respect to the aggregates was not being achieved".[1] In fact, the growth of the money supply accelerated somewhat in the first quarter from the rates of expansion recorded in the final quarter of 1969. Bank credit increased slowly in the first quarter, but credit growth tended to accelerate as the quarter progressed. In the case of the money supply, growth rates within the quarter fluctuated widely, owing in part to technical factors. Time deposit flows also strengthened in this period as the higher Regulation Q interest rate ceilings, made effective by the Board of Governors of the Federal Reserve System on January 21, and the lower money market rates in February and March enhanced the banks' ability to attract these funds. As a result of their more favorable deposit position, commercial banks began to reduce their dependence on nondeposit sources of funds. Bank credit expansion was characterized by a shift in the composition of newly acquired earning assets. The pace of lending slowed, and banks reversed the liquidation of securities holdings that occurred over most of 1969 and early 1970. Interest rates, spurred by widespread expectations of a more relaxed monetary environment and signs of a slowdown in business activity, were marked by a broad-based decline. Rates leveled off, however, at the end of the quarter and rose sharply again in April.[2]

MONEY SUPPLY AND TIME DEPOSITS

The growth of the narrowly defined money supply—privately held demand deposits plus currency held by the nonbank public—quickened during the first quarter. The seasonally adjusted daily average money supply grew at a 3.8 percent annual rate from December through March, up from the 1.2 percent rise in the fourth quarter of 1969. The stronger growth of the money supply in the first

[1] "Record of Policy Actions of the Federal Open Market Committee", *Federal Reserve Bulletin* (April 1970), pages 338-39.

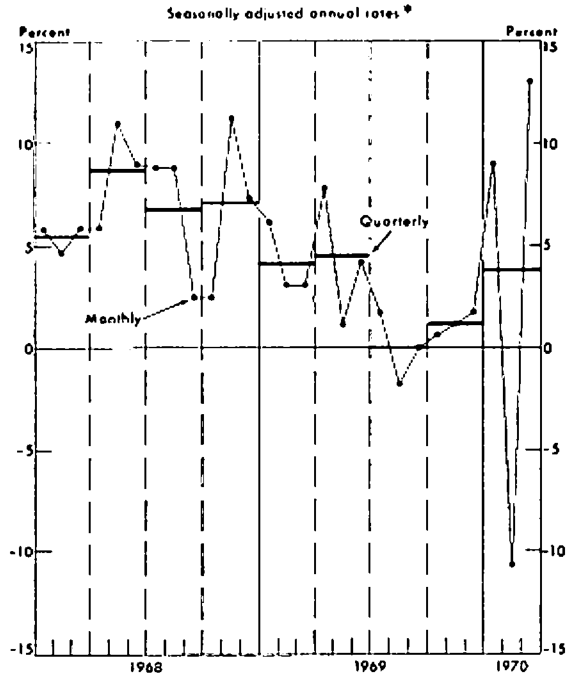
[2] See this *Review*, pages 98-103 for money and bond market developments in April.

quarter reflected primarily more rapid increases in demand deposits, though the currency component also rose faster than in earlier quarters. Within the first quarter, however, there were very wide month-to-month swings in the rate of growth of the money supply. It grew at a rapid 9.0 percent annual rate in January, dropped sharply by 10.7 percent in February, and rose by 13.2 percent in March (see Chart I), the largest monthly advance since the series began in 1947. Such erratic fluctuations in the narrow money supply suggest some of the difficulties monetary authorities may encounter in attempting to control monetary aggregates in the short run. Erratic short-run swings in the monetary aggregates may largely reflect measurement problems. Seasonal factors, for example, are used to adjust monetary data, but the factors may not adjust for newly emergent seasonal patterns.

One of the major sources of fluctuations in the money supply is associated with the processing and clearing of checks that transfer funds between individuals and economic units throughout the economy. Check-clearing procedures require the physical processing and transportation of a large and rapidly growing volume of checks, and introduce an element of double counting in demand deposits held at commercial banks. When recipients deposit checks at their banks, the depositors' accounts are credited immediately, but usually some time must elapse before the accounts of the issuers can be reduced. This duplication of demand deposits is called "float", and is estimated by cash items in the process of collection plus Federal Reserve float.[3] Since estimated float is subtracted from demand deposits held by the nonbank public in computing the money supply, distortions in the estimate affect the measure of the money supply. At any point in time, there may be a difference between the estimate of float and the true duplication of demand deposits. Part of this difference is attributed to variations in bank accounting practices. Some banks in forwarding checks for collection classify them as "due from banks" rather than as cash items in the process of collection. The double counting of deposits included in due from bank balances cannot be ascertained; thus, there is no way of adjusting the deposit data for this difficulty. Another part of the difference is that some cash items in the process of collection represent debits to deposit accounts not in the money supply. Also, cash items in the process of collection are typically reduced on the basis of an automatic time schedule used by the payee bank; scheduled dates may not correspond to the actual dates on which check issuers' accounts are debited. Estimated float therefore can be subject to wide fluctuations whenever check-clearing processes are interrupted—for example, as a result of bank holidays or disruptions in mail or transportation due to labor strikes or bad weather.

The monthly fluctuations in the money supply within the first quarter of 1970 were related partly to the interruption of transactions in the Euro-dollar market, when European banks closed for holidays on December 26 and again for the Good Friday-Easter Monday weekend (March 27-30) while New York City banks remained open. Typically, there is a large volume of Euro-dollar payments outstanding each day. During European bank holidays, check-clearing procedures continue at American banks and such payments are cleared, but no new transfers arise from European banks. As a result, cash items in the process of collection at American banks fall, without a comparable decline in deposits held by the nonbank public,

Chart I
GROWTH OF THE NARROW MONEY SUPPLY
Seasonally adjusted annual rates*



* The growth rates are computed in all cases from monthly averages of daily money supply figures. The quarterly growth rates are from the last month of the preceding quarter to the last month of the quarter indicated.

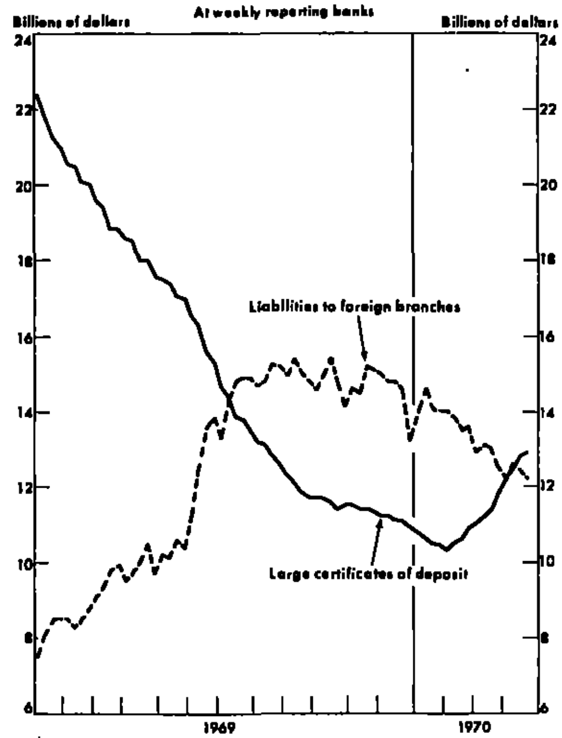
Source: Board of Governors of the Federal Reserve System.

[3] For further information about "bank" float and Federal Reserve float, as well as check-processing problems and proposed remedies, see John J. Clarke, "The Payments System: Problems, Fantasies, and Realities", this *Review*, pages 109-15.

and the measured money supply rises. Tbe mail strike and tbe air controller "sick out" were additional disturbances that interrupted the check-clearing process and no doubt increased the discrepancy between the accounting adjustment for float and the true value of float; these disturbances may have been contributing factors to the rapid growth of the money supply on a seasonally adjusted basis.

The more rapid money supply growth during the first quarter was accompanied by increased time deposit flows as well. Commercial banks experienced strong time deposit gains late in the period, signaling a noteworthy reversal of the losses that prevailed throughout 1969 and early 1970. In the first quarter, seasonally adjusted total time and savings deposits rose at a 0.4 percent annual rate in contrast to the 6.7 percent decline in the last balf of 1969. This improvement in deposit flows reflected the renewed ability of commercial banks to attract funds, as higher Regulation Q interest ceilings became effective on January 21 and as yields on alternative market instruments fell in February and March. Tbus, the outflow, which had continued into January, reversed as tbe quarter progressed, and in March time deposits rose sharply at an annual rate of 14.4 percent.

Chart II
LARGE CERTIFICATES OF DEPOSIT AND LIABILITIES TO FOREIGN BRANCHES*
At weekly reporting banks



*Weekly, Wednesday figures.
Source: Board of Governors of the Federal Reserve System.

The first-quarter gain in time deposits was primarily attributable to sizable inflows of large certificates of deposit (CD's), which commenced during February (see Chart II). For the first time in over a year commercial banks experienced a steady increase in sucb deposits, and this development gained momentum as market interest rates declined. During 1969, the level of large CD's at weekly reporting banks dropped precipitously from $22.4 billion in the first week of January and continued to decline moderately through the fourth quarter. Although banks bad increased tbe volume of CD's issued to official foreign institutions at rates exempt from Regulation Q ceilings in the closing months of 1969, declines in total CD holdings persisted into 1970 and a low of $10.3 billion was reacbed in the first week of February. Bank sales of CD's to a broad spectrum of investors began to resume, as yields on Treasury securities fell below rate ceilings on CD's of comparable maturities in February and the yield advantage of CD's widened during most of March. The volume of large CD's outstanding at weekly reporting banks rose by $1,522 million, seasonally unadjusted, between tbe first week of February and the end of the quarter. The March gain of $448 million in holdings of individuals, partnerships, and corporations was the first monthly increase in this category since November 1968. State and local governments also purchased sizable quantities of CD's during the same period.

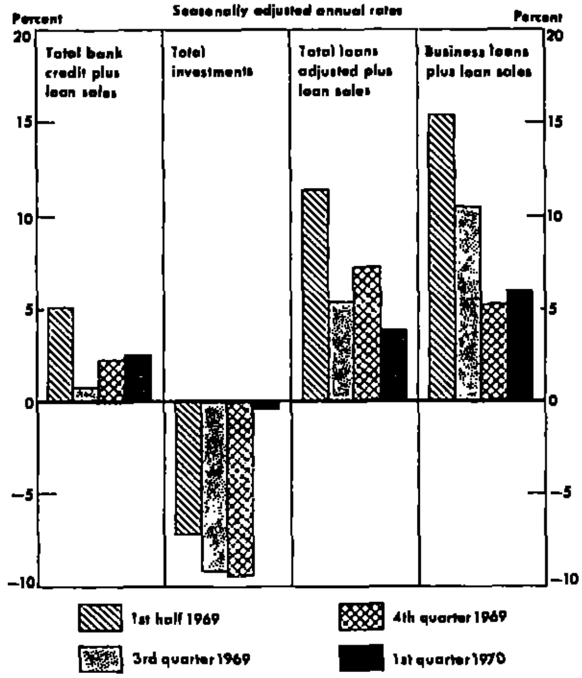
The first-quarter reversal in deposit flows is also apparent in the bebavior of time and savings deposits other tban large CD's and reflects the sensitivity of small savers to yield differentials between bank deposits and alternative investments, sucb as Treasury bills. Weekly reporting banks sustained a heavy $1.3 billion drop in other time and savings deposits in January, following the interest-crediting period. Noncompetitive tenders on Treasury bills—usually submitted by small investors—accounted for more than one third of the new bills awarded in the first three weekly auctions in January. The increase in Regulation Q ceilings later in January tended to curb this disintermediation, as did the Treasury decision—effective with the auction on March 2—to issue new bills in minimum denominations of $10,000. Weekly reporting banks experienced modest inflows of otber time and savings deposits in February and substantial gains in March.

Commercial banks thus became less dependent on nondeposit sources of funds as the quarter progressed. Commercial bank liabilities to their own foreign branches fell \$1.5 billion from the first week of January to a level of \$12.5 billion at the end of March (see Chart II). The drop in three-month Euro-dollar interest rates from 10.4 percent early in January to 8.7 percent at the end of March probably reflected in part tbe slackening demand of United States banks for these funds. Although bank-related sales of commercial paper rose by \$2.2 billion to \$6.4 billion at the end of the first quarter, most of this increase occurred in January, before tbe resurgence in deposit flows began. Much of the January increase is a seasonal reversal of tbe significant moderation that took place in December sales of commercial paper by bank affiliates. Furthermore, although the Board of Governors on February 24 deferred action on its proposal to apply interest rate ceilings and/or reserve requirements on funds obtained by banks through sucb issues, the growth of bank-related commercial paper in March was by far the smallest of the quarter.

Chart III

CHANGES IN BANK CREDIT AND ITS COMPONENTS AT ALL COMMERCIAL BANKS

Seasonally adjusted annual rates



Source: Board of Governors of the Federal Reserve System.

BANK CREDIT

There are a number of bank credit measures; two reviewed bere, the "adjusted bank credit proxy"[4] and "all commercial bank credit",[5] have been found to be particularly useful. These two measures of bank credit, however, are constructed on different statistical bases. The adjusted proxy is based on average daily deposit and nondeposit liabilities of member banks and provides a quickly available approximation of cbanges in total bank credit. All commercial bank credit is available only as of the last Wednesday of each month. Tbe adjusted bank credit proxy expanded at a 0.7 percent seasonally adjusted annual rate in the first quarter, down somewbat from tbe 1.9 percent recorded in the last quarter of 1969. All commercial bank credit, however, rose at a 2.5 percent seasonally adjusted annual rate, compared with the 2.3 percent rise in the prior quarter; some quickening in the first quarter was indicated by a 5.1 percent rise in February and a 4.2 percent gain in March. The commercial bank credit data also provide information about the composition of bank credit.

First-quarter changes in tbe composition of bank credit were striking by comparison with earlier quarters (see Chart III). The persistent liquidation of investment holdings over 1969, a common phenomenon in periods of severe monetary restraint, moderated during the first quarter and, by the end of the period, banks were adding to their securities portfolios at a rapid rate. This reflects

[4] The adjusted bank credit proxy consists of member bank deposits subject to reserve requirements plus liabilities to foreign branches and, beginning in September 1969, other nondeposit liabilities including Euro-dollars borrowed directly from foreign banks or through brokers and dealers, bank liabilities to own branches in United States territories and possessions, commercial paper issued by bank holding companies or other bank affiliates, and loans or participation in pools of loans sold under repurchase agreement to institutions other than banks and other than banks' own affiliates or subsidiaries.

[5] All commercial bank credit is estimated from selected asset data taken from the consolidated statement of condition supplied by commercial banks in the United States. Major sources for this series are the Wednesday statements of condition for weekly reporting large commercial banks and a less-detailed weekly statement for smaller member banks. The assets of nonreporting nonmember banks are estimated in calculating the series. Loans sold by banks to their affiliates are included in the figures for all commercial bank credit given above. Loans sold represent part of the total credit extended by the banking system during the period, even though they do not remain on the banks' balance sheets. During the first quarter, total loans sold rose by \$2.8 billion; seasonally adjusted total bank credit, excluding loan sales, actually fell by \$0.3 billion. Of the \$2.8 billion in loans sold, \$1.9 billion occurred in January and was associated with the reversal in early January of tax-related portfolio adjustments made at the end of 1969. After the heavy volume in January, loan sales moderated considerably in February and March, reflecting in part the improved deposit flows into banks and the decline in the pace of business lending in March.

large March purchases of short- and long-term issues, related in part to the growing portfolios of banks which function as dealers in Treasury and other securities. First-quarter holdings of securities other than those of the United States Government rose at a 10.8 percent annual rate, following a year in which liquidation proceeded at a 1.1 percent annual rate. The growth in these securities holdings, primarily state and municipal government obligations, accelerated in March, as banks added to their portfolios at a sharp 27.1 percent annual rate. Although the liquidation of United States Government securities moderated during the first quarter, bank holdings of Government debt dropped at an annual rate of 15.4 percent, roughly equal to the rate of decline for all of 1969. In March, however, banks increased their holdings of United States Governments at a 9.7 percent annual rate, the first monthly gain since August. Contributing to this strength were bank purchases of April and September tax anticipation bills (TAB's), payable in the first and last weeks of March. A heavy volume of new issues of corporate and tax-exempt securities, in addition to the Treasury TAB's, tended to inflate dealer inventories in February and March. Bank loans to securities dealers, which tend to vary with dealer inventories, registered considerable strength in the last two months of the quarter and grew at a 12.9 percent annual rate for the quarter as a whole.

Total bank loans less securities loans, but adjusted to include loan sales to affiliates, registered a modest 3.5 percent annual rate in the first quarter of 1970. This growth was down considerably from the 6.6 percent rate recorded over the last two quarters of 1969. Business loans comprise the single largest component of the banks' loan portfolios—roughly 38 percent—and fluctuations in this component explain much of the movement in total bank lending. While business loans (including loan sales) grew in each quarter of 1969, the rate of growth dropped in each successive quarter, reaching a 5.3 percent annual rate in the fourth quarter of 1969. The first quarter's 6.0 percent rate was slightly higher, despite a March decline of 3.3 percent, the first monthly drop since 1966 and the largest since mid-1958. The March decline in business loans may have stemmed from repayments by corporations' raising funds directly in the money and capital markets.

Loans to nonbank financial institutions declined very sharply at a seasonally adjusted annual rate of 30.3 percent in the first quarter. This drop followed a sharp rise during the previous quarter, particularly in December when finance companies sought temporary credit in the banking system. The drop represented in large part the shift by nonbank financial institutions back to borrowing through commercial paper. In March, this loan component declined at a more rapid pace, as commercial paper rates fell below the prime rate toward the end of the month, making it less expensive for nonbank financial institutions to borrow through issuing new paper rather than by obtaining credit in the banking system.

Consumer and real estate loans both increased at modest rates in the first quarter, and bank lending in these categories slowed as the quarter progressed. Consumer loans grew at a 3.3 percent annual rate, less than half that recorded in the prior quarter, while real estate loans showed virtually the same advance, 5.7 percent, for the first quarter as in the preceding three months.

INTEREST RATE DEVELOPMENTS AND MEMBER BANK RESERVE POSITIONS

A reversal in the movement of short-term interest rates was a striking development during the January-March quarter. The downturn in rates was particularly sharp in February but showed signs of moderating toward the end of March. The lower levels were in any case still high by historical experience.

In the last quarter of 1969, three-month Treasury bill rates had climbed to a record high, reaching 8.10 percent in early January and then falling dramatically 184 basis points to 6.26 percent in March. The January-March drop in other short-term rates was also striking. Three-month Euro-dollar rates declined from 10.4 percent to 8.7 percent. The rate on four- to six-month prime commercial paper fell from 9.00 percent to 8.03 percent and was below the 8.5 percent prime bank-lending rate for the first time since November. The prime rate was reduced to 8.00 percent by major money market banks on March 25. Over the January-March quarter, the average weekly yield on United States securities maturing in three to five years fell 118 basis points to 7.08 percent, while yields on long-term Government bonds dropped 67 basis points to 6.33 percent. As the quarter drew to a close, rates on intermediate- and long-term Governments rose somewhat, paralleling a rise in bill rates. During the quarter, the average effective rate on Federal funds remained stable at 8.98 percent in January and February and then dropped to 7.76 percent in March. In a related development, member bank reserve positions were somewhat less strained in the first quarter of 1970, compared with the previous two quarters. The average level of net borrowed reserves (unadjusted for seasonal fluctuations) remained high relative to past experience but was reduced from an average $950 million and $936 million in the third and fourth quarters of 1969, respectively, to $815 million by March.

THRIFT INSTITUTIONS

Deposit growth at thrift institutions in the first quarter was quite weak, continuing the pattern that persisted throughout 1969. By the end of the period, however, thrift institutions experienced substantially improved deposit flows, as did the commercial banks. Combined deposits at savings and loan associations and mutual savings banks seasonally adjusted grew at a 1.9 percent annual rate in the first quarter, up somewhat from the 1.4 percent growth posted in the preceding quarter. Deposit flows were particularly adverse in January, and combined deposits dropped sharply by 5.2 percent, the worst monthly performance recorded since the series began in 1955. This weakness followed the quarterly interest-crediting period, when yields on alternative market instruments were at, or near, record highs. During the remainder of the quarter, deposit growth showed substantial improvement and registered a 7.5 percent annual rate of increase in March alone. This reversal reflected the declining yields on market instruments and the late January increase in ceiling rates paid on deposits at thrift institutions. Moreover, the Treasury's announcement that minimum denominations on newly issued Treasury bills would be $10,000 beginning in March discouraged late-quarter withdrawals.

The rate of growth of mortgage loan portfolios at thrift institutions moderated in the January-March period and fell below that posted in the preceding quarter. In order to sustain the level of mortgage lending, the Federal Home Loan Banks (FHLB) have advanced substantial quantities of credit to savings and loan associations, particularly during the latter half of 1969. Some associations began to repay part of their outstanding borrowings as deposit flows improved during the quarter. As a result, growth in the aggregate level of advances from the FHLB continued, but at a much slower rate than in the last quarter of 1969. In an effort to free additional funds for housing construction, the FHLB Board announced liberalized borrowing terms on March 25. The Board authorized sharp increases in advances to savings and loan associations by raising the ceiling on borrowings from 17.5 percent to 25 percent of each association's withdrawable savings and also froze at 7¾ percent the maximum rate charged on these borrowings.