Recent Monetary and Bank Credit Developments

Commercial banks and thrift institutions continued to accumulate time deposits at a very rapid rate during the first quarter of 1971. At commercial banks, most of the first-quarter strength in time deposit flows reflected a surge in time and savings deposits exclusive of large negotiable certificates of deposit (CD's in denominations of $100,000 or more). The growth of CD's, meanwhile, slowed markedly from the rapid expansion of the second half of 1970. At thrift institutions, the first-quarter growth in deposits was by far the strongest performance on record. The ability of commercial banks and savings institutions to attract this massive volume of time deposits reflects the very favorable spread between the rates paid by these institutions on time deposits and rates on competing market instruments. Market rates declined substantially over the last three quarters, while rates on savings deposits remained mostly unchanged. In responding to this incentive, households reduced their holdings of other financial assets—particularly United States Government securities—and acquired time deposits in their place.

In the first three months of 1971 the narrowly defined money supply expanded at a rapid 8.9 percent annual rate, but for the six months ended in March the growth rate was a more moderate 6.2 percent. Reflecting the sizable growth in time deposits, the broader monetary aggregates that include some categories of time deposits at commercial banks and savings institutions posted very large increases in the January-March period. Total commercial bank credit also moved upward strongly, rising at a rate of 13.8 percent over the quarter. However, total loans, especially business loans, showed weaker gains. Business loan demand was particularly sluggish around the March 15 corporate tax date and afterward. Thus, a large share of the deposit flows to the commercial banks was directed into purchases of United States Government and tax-exempt securities.

TIME AND THRIFT DEPOSIT GROWTH

During the first quarter of 1971 the strong growth of time deposits continued, enabling banks to accumulate funds and expand their earning assets rapidly. For the first three months of this year, time deposits at all commercial banks advanced at a seasonally adjusted annual rate of 27.3 percent. While this was below the record 32.2 percent pace set in the third quarter of 1970, it nevertheless marked an acceleration from the still rapid fourth-quarter advance of 21.8 percent. Overall, during the nine months ended in March 1971, the $44 billion rise in time deposits was without precedent.

The resurgence of time deposit growth began in the third quarter of 1970, with the Federal Reserve's partial suspension of ceiling rates on large CD's following the announcement of the Penn Central insolvency on June 21. Because of the relaxation of Regulation Q ceilings, banks were better able to compete for funds, and throughout the quarter the growth of large CD's was spectacular. The rate of growth was cut by over one half in the fourth quarter but still remained substantial.

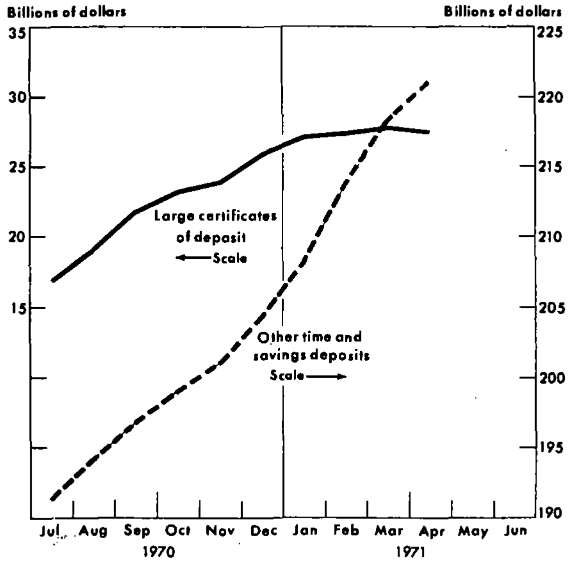
The growth of large CD's leveled off during the first quarter of 1971, while the growth in other time and savings deposits accelerated (see Chart I). Over the quarter, large CD's increased by $1.8 billion at all commercial banks after seasonal adjustment, compared with gains of $8.5 billion and $4.3 billion posted in the third and fourth quarters of 1970, respectively. Other commercial bank time and savings deposits, however, rose by $13.9 billion in the first quarter, up substantially from the $7.8 billion and $7.6 billion gains of the previous two quarters.

The increased growth in time deposits during the first quarter was even more impressive at thrift institutions. This performance came on the heels of a year in which the growth of thrift deposits had staged a substantial recovery. Thrift deposit growth had accelerated in each of the four quarters of 1970, but nevertheless this did not suggest the far larger inflows that would occur in the first quarter of 1971. In January the upsurge of thrift deposits was phenomenal. Over the month, deposits at savings and loan associations grew at an annual rate of 30.7 percent after seasonal adjustment, and mutual savings banks' deposits increased at a rate of 18.1 percent. For savings and loan associations and mutual savings banks combined, the rate of deposit growth was 26.5

Chart I

LARGE CERTIFICATES OF DEPOSIT AND OTHER TIME AND SAVINGS DEPOSITS

Seasonally adjusted at all commercial banks



Source: Board of Governors of the Federal Reserve System.

percent, which was by far the most impressive one-month performance since the beginning of the data series in 1955. Although the pace of increase slackened somewhat over the next two months, the annual growth rate for thrift deposits was a record 23.1 percent for the quarter. Moreover, Federally insured savings and loan associations reported total new savings received for the quarter were $7.4 billion, which is larger than the receipts of any previous entire year.

The strong growth in time deposits in the past quarter largely resulted from the ability of banks and thrift institutions to offer attractive rates in acquiring funds and to use those funds to make profitable investments. This development, in turn, had its roots in the decline in interest rates which occurred principally in the second half of 1970 and into this year. Reflecting the moderately expansive monetary policy and the sluggishness in the economy, interest rates declined substantially, especially in the short-term area. For instance, market rates on three- and six-month United States Treasury bills in March averaged their lowest levels in seven and one-half years. Long-term rates, on the other hand, fell less rapidly and remained relatively high by historical standards. This created a substantial spread between long- and short-term rates which worked to the advantage of those financial intermediaries, such as commercial banks and thirft institutions, that supply shorter term assets and make longer term investments. By keeping rates offered on passbook-type savings near the regulation ceilings, both banks and thrift institutions were able to benefit from the drop in short-term rates. Responding to this incentive, depositors rapidly built up their time and thrift deposits. On the other hand, large CD's became less competitive with other market instruments as banks slashed CD rates. In fact, banks' offering rates on one- to six-month maturities in March were nearly as low as rates on comparable maturities of bills. Concurrently, the growth rate of CD's continued to fall, and in April the amount of CD's outstanding (seasonally adjusted) actually declined.

THE MONETARY AGGREGATES AND NONDEPOSIT SOURCES OF FUNDS

Despite the considerable weakness shown in January, the narrowly defined money supply (M_1)—currency plus demand deposits held by the public—posted a relatively large gain of 8.9 percent at a seasonally adjusted annual rate in the first quarter (see Chart II). By comparison, in the fourth quarter of 1970, M_1 had expanded at an annual rate of only 3.4 percent. To a large extent, the resurgence of the growth of the narrow money supply in 1971 corresponded with an upswing in economic activity. In the fourth quarter, the gross national product had been depressed by the strike at General Motors and managed a gain of only $4.4 billion. However, after the settlement of the GM strike, the economy was able to rebound with a $28.5 billion increase in GNP in the first quarter of this year. Because of this situation, averaging the growth of the money supply over these two quarters yields more meaningful results than analyzing either the fourth or first quarter independently. Thus, over the September to March six-month period, the growth rate of M_1 was 6.2 percent, which is slightly higher than the rate achieved over the first three quarters of 1970.

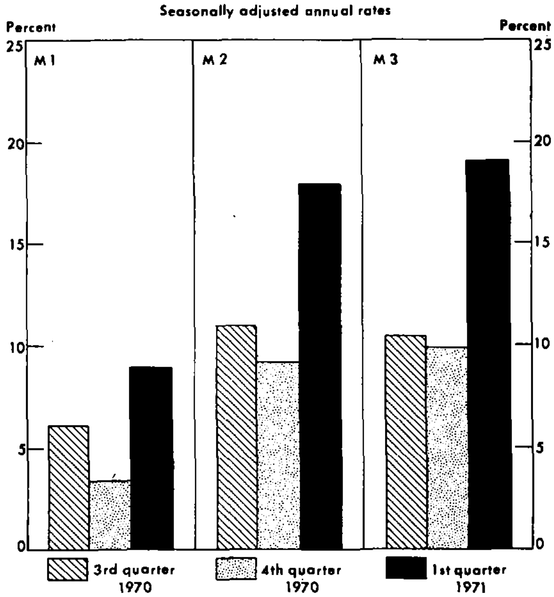
The acceleration of the growth of the narrow money supply and the strong growth of time and thrift deposits in the first quarter were reflected in the performance of the broader measures of the money supply as well. These other measures are often designated as M_2 and M_3. M_2 consists of M_1 plus savings and time deposits at all commercial banks other than large negotiable CD's. Although M_2 includes funds not directly transferable by check, these funds may nevertheless serve as close substitutes for demand deposits which are so transferable. Large CD's are excluded from the definition, as their specialized characteristics (such as their large denominations and negotiability) make them similar to other market instruments. Since deposits at thrift institutions serve essentially the same purposes as other time and savings deposits and are competitive with them, M_3 includes thrift deposits in addition to the components of M_2.

Over the first quarter of this year, M_2 rose at a seasonally adjusted rate of 17.8 percent, which is well above the 11.0 percent and 9.2 percent rates of the third and fourth quarters of 1970, respectively. M_3 showed similar movements, rising in the first quarter at an annual rate of 19.0 percent as contrasted with the consecutive growth rates of 10.3 percent and 9.6 percent in the previous two quarters. Thus, these data suggest that the growth in the holdings of monetary assets over the past nine months is substantially larger than M_1 alone would indicate. While these broader monetary aggregates typically show a significantly more rapid growth than does M_1 in a period of reintermediation, the magnitude of the divergence in this most recent episode has been somewhat greater than was experienced in other periods.

Chart II

CHANGES IN MONEY SUPPLY

Seasonally adjusted annual rates



M1 = Currency plus adjusted demand deposits held by the public.

M2 = M1 plus commercial bank savings and time deposits held by the public, less negotiable certificates of deposit issued in denominations of $100,000 or more.

M3 = M2 plus deposits held by the public at savings and loan associations and mutual savings banks.

Source: Board of Governors of the Federal Reserve System.

Despite the increases in demand and time deposits, the first-quarter growth rate of the adjusted bank credit proxy —which includes all member bank deposits subject to reserve requirements plus nondeposit liabilities—accelerated only moderately from the fourth quarter of 1970. In the first three months of 1971, the adjusted proxy expanded at a seasonally adjusted annual rate of 10.9 percent, while in the third and fourth quarters of 1970 the respective rates were 17.2 percent and 8.3 percent. Within the proxy, there was a substantial rundown of United States Government deposits late in the first quarter and a persistent decline in nondeposit funds (see Chart III).

The decline in nondeposit liabilities at member banks in the first quarter represented a continuation of the runoff which began in mid-1970. As a result of the large influx of funds from CD's and the introduction of reserve requirements on funds obtained through the issue of bank-related commercial paper, both liabilities to foreign branches and bank-related commercial paper declined in the second half of 1970. Liabilities to foreign branches, which comprise the bulk of bank Euro-dollar borrowings, fell from a level of $12.4 billion at the end of June 1970 to $7.7 billion at the end of the year, and declined by an additional $4.6 billion in the first quarter. Since many of these high-cost borrowings were incurred during the earlier period of restrictive monetary policy, some decline following a return of funds to the banking system was to be expected. However, the magnitude of the Euro-dollar runoff has complicated an already serious balance-of-payments situation. As a consequence, a number of steps were taken in an attempt to stem the runoff in Euro-dollar borrowings. For example, in an effort to encourage banks to preserve their reserve-free bases against a time of future need, as well as to reduce the immediate outflow of dollars abroad, the Federal Reserve raised the reserve requirement for Euro-dollar borrowings in excess of the base from 10 percent to 20 percent, effective January 7, 1971.

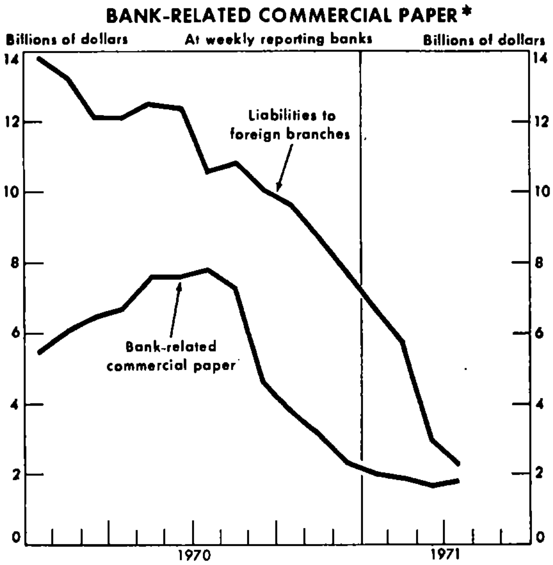
In addition, the Export-Import Bank of the United States in January sold $1.0 billion in 6 percent three-month notes to foreign branches of United States banks. The effect of the undertaking was potentially to "lock up" a portion of the Euro-dollar funds borrowed by the overseas branches, which otherwise might have flowed into foreign central banks. The initial offering of notes in January was followed by another issue of $0.5 billion in early March, and both issues were oversubscribed. The Bank refinanced the original issue upon its maturity in April. Moreover, the Treasury announced on April 1 that it would borrow $1.5 billion of Euro-dollars from the overseas branches of United States banks. The Treasury set a rate of 5⅜ percent on the three-month issue, which corresponded with the then-current rate on Euro-dollar borrowings. To accommodate this latest offering, the Federal Reserve amended its regulations to allow member banks to count funds invested in the Treasury's issue toward the maintenance of their reserve-free Euro-dollar bases. A similar amendment had been made earlier at the time of the Export-Import Bank's offerings.

From December 30 to March 31, liabilities of United States banks to their foreign branches declined from a level of \$7.7 billion to \$3.0 billion. If purchases of the special Export-Import Bank securities are combined with Euro-dollar holdings, the amount of decrease is \$3.1 billion, which is still larger than the \$2.4 billion and \$2.3 billion repayments in the third and fourth quarters of last year, respectively. In April, however, total liabilities to foreign branches and special securities holdings actually expanded slightly. This was the first monthly increase since August of last year.

Although bank-related commercial paper also declined in the first quarter, the amount of decline represented a deceleration from that in prior quarters. From December 30 to March 31, the volume of bank-related commercial paper fell from \$2.3 billion to \$1.7 billion (see Chart III).

Chart III

LIABILITIES TO FOREIGN BRANCHES AND BANK-RELATED COMMERCIAL PAPER*



* Outstanding on the last Wednesday of each month.

Source: Board of Governors of the Federal Reserve System.

By comparison, in the last five months of 1970, banks had reduced this form of borrowing by 70 percent from the peak of \$7.8 billion at the end of July. This suggests that banks may be nearing the end of the runoff of their commercial paper, especially since they probably prefer to maintain a presence in the commercial paper market. In this regard, during April the amount of bank-related paper rose slightly. Although this increase may partly reflect the financing activities of the affiliates themselves—i.e., financings not used to supplement bank funds—it nevertheless is the first monthly increase since the runoff began.

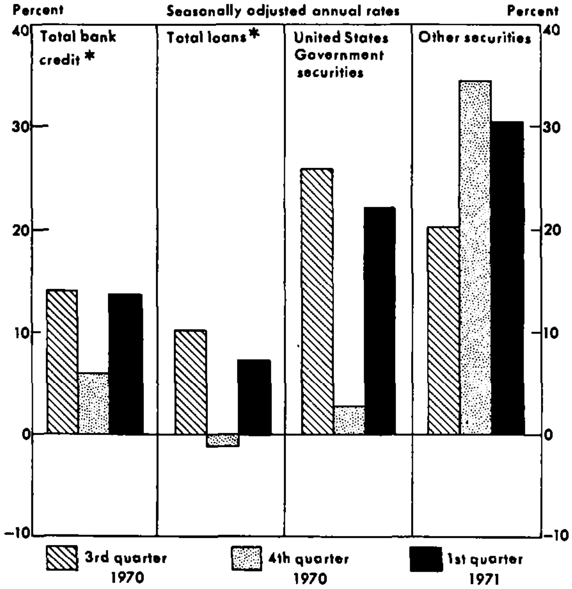
BANK CREDIT

The large flow of funds into the banking sector in the first quarter contributed to the rapid growth of bank credit. Total credit at all commercial banks, adjusted for loan transactions with affiliates, expanded at a 13.8 percent seasonally adjusted annual rate (see Chart IV). This is well above the 6.0 percent rate registered in the prior quarter, and just below the 14.1 percent rate achieved in the third quarter of 1970. Total loans, similarly adjusted, showed the greatest improvement, despite recording no growth in March. During the quarter, total loans adjusted for repurchases grew at a seasonally adjusted annual rate of 7.3 percent, compared with the 1.1 percent rate of decline posted in the fourth quarter of 1970.

The slack in the economy and the tendency of nonfinancial corporations to restructure their debt, however, were evident in the business loan category. Business loans, also adjusted for transactions with affiliates, managed an annualized seasonally adjusted growth rate for the quarter of only 2.5 percent. This low rate came in spite of the substantial reduction of the prime lending rate from 6¾ percent to 5¼ percent. Although the growth of business loans in the quarter was an improvement over the 9.5 percent rate of contraction recorded in the fourth quarter of 1970, it was still of very modest proportions. Much of the weakness occurred in March, when business loans contracted at a seasonally adjusted annual rate of about 12 percent. Weekly reporting bank data, which are not adjusted for seasonal variation, suggest that most of the weakness of these loans relative to past years occurred in the week ended March 17, which included the corporate tax date, and in the two weeks afterward. Although corporate tax payments were below last year's, the lack of borrowing would seem to be more related to the immense volume of large CD's maturing in March. In addition, a somewhat larger amount of United States Treasury tax anticipation bills was available for the payment of taxes this year. Also, the large volume of corporate flota-

Chart IV

CHANGES IN BANK CREDIT AND ITS COMPONENTS AT ALL COMMERCIAL BANKS



*Adjusted for loan transactions with affiliates.

Source: Board of Governors of the Federal Reserve System.

tions in the quarter, especially in March, may have allowed businesses to reduce their short-term loans at banks.

The growth in other loan components generally demonstrated good strength in the quarter. Loans to nonbank financial institutions moved higher rapidly, while consumer and real estate loans posted moderate gains. Loans in each of these categories bettered their increases of the fourth quarter. Securities loans, which typically are volatile, also expanded but did not equal the strong performance registered one quarter earlier.

Investment holdings of commercial banks continued to increase at a rapid pace in the first three months of 1971. The first-quarter growth rate for total investments was 27.0 percent after adjustment for seasonal variations, which is slightly higher than the 22.6 percent and 21.1 percent rates of the third and fourth quarters of 1970, respectively. Holdings of United States Government securities showed a dramatic increase in growth in February and March and for the quarter grew at a rate of 22.1 percent. This is similar to the 25.9 percent rate of the third quarter and in sharp contrast to the fourth-quarter growth rate of 2.8 percent. Banks also added large amounts of other securities to their portfolios, as they did for most of the second half of 1970. The first-quarter growth rate for these securities stood at 30.4 percent, while in the third and fourth quarters of 1970 the comparable growth rates were 20.3 percent and 34.5 percent.

After increasing in each month in the second half of 1970, bank liquidity showed a tendency to stabilize in the first quarter. While the expanded loan-deposit ratio —the ratio of loans (other than loans to brokers and dealers) to deposits (less cash items in the process of collection) plus liabilities to foreign branches—did decrease by 1.1 percentage points at all weekly reporting banks to a level of 71.2 percent over the quarter, this was less than half the rate of decline of the previous two quarters. Moreover, the liquid-asset ratio[1]—which is an alternative measure of bank liquidity that typically moves inversely to the expanded loan-deposit ratio—showed almost no change in January and February from December's average of 12.6 percent, and then declined to 11.9 percent in March.

[1] The liquid-asset ratio is defined as loans to brokers and dealers, loans to domestic commercial banks, Government securities due within one year, balances with domestic commercial banks, bankers' acceptances, municipal tax warrants, and short-term notes as a percentage of total liabilities excluding capital accounts.