Monetary and Bank Credit Developments in the Third Quarter

The third quarter of 1972 was marked by somewhat faster growth of most monetary and bank credit aggregates than their generally moderate growth in the second quarter. Most notably, the narrowly defined money supply (M_1) surged upward early in July, inflating the growth rate for that month and for the quarter as a whole, even though only moderate growth was experienced in August and September. The acceleration in July of the growth of the broadly defined money supply (M_2) was much milder because a temporary slowing in the growth of the time deposit component partially offset the advances in the demand deposit component. The adjusted bank credit proxy, a measure of member bank liabilities subject to reserve requirements, advanced at about the same pace in this past quarter as in the first half of the year.

The growth of reserves available to support private nonbank deposits (RPD) accelerated during the quarter. A major source of this advance was the increase in borrowings from the Federal Reserve Banks. Borrowings had fallen to a very low level last December as the Federal funds rate dropped well below the discount rate. The Federal funds rate remained below the discount rate until the end of June, making it more attractive for commercial banks to borrow from one another than from the Federal Reserve Banks. In the third quarter, however, restraint on the growth of nonborrowed reserves placed upward pressure on the Federal funds rate, and banks turned increasingly to the Federal Reserve discount window to meet their growing reserve requirements.

Bank credit also advanced at an accelerated pace in the third quarter. However, an unusually low reading in June, which may have resulted more from seasonal adjustment problems than from any underlying weakness, probably exaggerates the acceleration. Even so, bank credit experienced a strong advance in the quarter. An unusually large increase in loans, particularly in August, was the major element in this strength. Investment growth was reduced by a sharp decline in holdings of United States Government securities.

Interest rates on short- and intermediate-term market instruments climbed during the third quarter, as indeed they have since February. Long-term rates, on the other hand, continued the virtual stability that they have exhibited through most of the year. The stability of long-term interest rates in the face of higher short-term rates has resulted partly from the reduction in the rate of expansion of long-term debt this year relative to the record demands placed on the capital markets last year. Additionally, the considerable progress that has been made in moderating the pace of price increases during the past year may have reduced the inflation premium demanded by investors.

THE MONETARY AGGREGATES

The narrow money supply, M_1—adjusted private demand deposits plus currency outside banks—grew at a sizable 8.5 percent seasonally adjusted annual rate in the third quarter of 1972 (see Chart I). Actually, most of the advance took place in the first two weeks of July when the money supply surged upward by nearly $5 billion. After that bulge, the level of M_1 changed little during the remainder of the quarter. Seasonal adjustment problems around the midyear statement publishing date and Independence Day holiday may have exaggerated the early July growth in M_1. Other factors that probably contributed to the increase in M_1 at that time were a temporary slowing of the advance of time deposits and an increase in Treasury disbursements which resulted in a transfer of funds from Treasury deposits at the Federal Reserve and at commercial banks (which are not included in M_1) to private deposits.

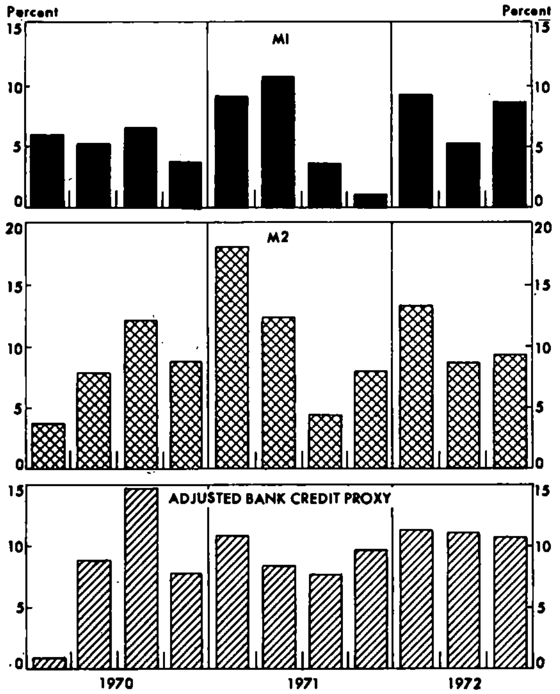
The sizable growth of M_1 in the third quarter, following the even more rapid advance in the first quarter and the moderate rise in the second quarter, resulted in a 7.8 percent annual rate of growth for the first nine months of 1972. This rate was almost the same as that of the first nine months of 1971. Last year, however, the fourth-quarter growth rate was a scant 1.1 percent. Consequently, over the twelve months that ended in September 1972, M_1 increased by a relatively moderate 6.2 percent.

M_2—defined as M_1 plus time deposits other than large certificates of deposit (CDs)—grew in the third quarter at a 9.3 percent seasonally adjusted rate, only slightly

Chart I

CHANGES IN MONETARY AGGREGATES

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.

Adjusted bank credit proxy = Total member bank deposits subject to reserve requirements plus nondeposit sources of funds, such as Euro-dollar borrowings and the proceeds of commercial paper issued by bank holding companies or other affiliates.

Source: Board of Governors of the Federal Reserve System.

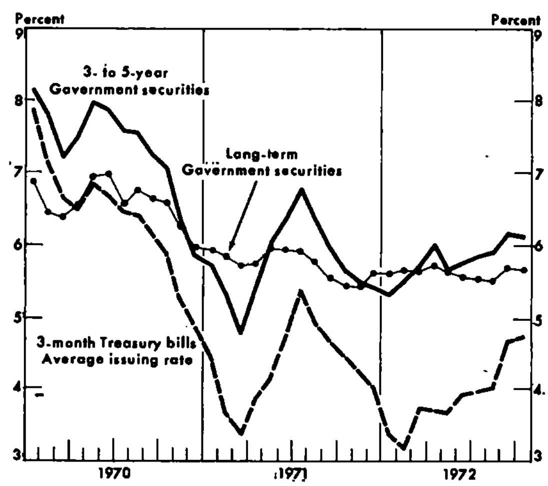
faster than the advance of the second quarter and significantly below the first-quarter pace. The growth of M_2, like that of M_1, slowed in August, reflecting the deceleration in demand deposit growth. The month-to-month variation in M_2 was less than that of M_1, however, because fluctuations in time deposits other than large CDs partially offset the movements in demand deposits. The 10.1 percent annual rate of growth of small time and savings deposits in the third quarter represented a significant slowing from the rate of advance in the first half of the year, partly as a result of generally increasing short-term interest rates since February. Rates on three-month Treasury bills, for instance, had fallen from an average of 5.39 percent in July 1971 to 3.18 percent in February 1972. By September, they had climbed back to an average rate of 4.66 percent (see Chart II).

RPD also rose sharply in the third quarter, advancing at a 10 percent seasonally adjusted annual rate compared with 7 percent in the second quarter (see Chart III). Total reserves, on the other hand, grew at a scant 3.6 percent rate, as reserves required against Treasury deposits declined. The sources of RPD changed as well. Banks increased their borrowings from the Federal Reserve in each month of the quarter. Borrowings jumped in part because the Federal funds rate increased from an average of 4.46 percent in June to an average of 4.87 percent in September. Therefore, it was frequently above the discount rate, which has remained at 4.50 percent since it was reduced last December. The increase in borrowings accounted for more than half of the advance in RPD in the quarter. The nonborrowed component of RPD —that is, RPD less borrowings from the Federal Reserve Banks—grew at a seasonally adjusted annual rate of only 3.8 percent in the third quarter, compared with 9.7 percent in the first half of the year.

The adjusted bank credit proxy, which is a measure of total member bank deposits subject to reserve requirements plus liabilities to foreign branches and bank-related commercial paper, has been growing at a fairly steady pace all year. It advanced at a 10.7 percent seasonally adjusted annual rate during the third quarter and at an 11.3 percent annual rate over the first nine months of 1972. While the increase in the entire series was about

Chart II

INTEREST RATES ON UNITED STATES GOVERNMENT SECURITIES

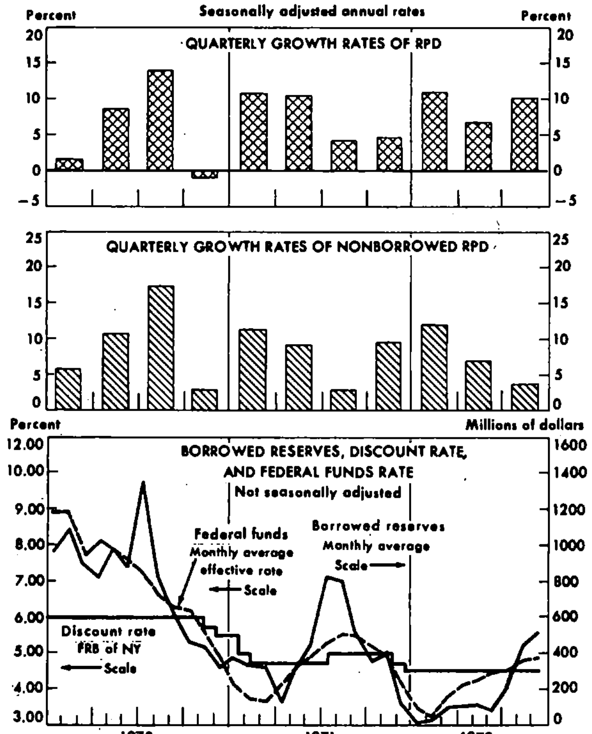


Sources: Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York.

Chart III

RESERVES AVAILABLE TO SUPPORT PRIVATE NONBANK DEPOSITS AND RELATED INTEREST RATES

Seasonally adjusted annual rates



Note: Reserve requirements on time deposits over $5 million were lowered from 6 percent to 5 percent on October 1, 1970.

RPD = Total member bank reserves less those required to support United States Government and interbank deposits.

Sources: Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York.

the same in each quarter, the relative importance of its sources has varied. In the most recent quarter, the acceleration in demand deposits, combined with an increase in nondeposit liabilities, was counteracted by the slowdown in the growth of time deposits from the unusually brisk pace set earlier in the year. As indicated above, time and savings deposits other than large CDs grew slightly less in the third quarter than earlier in the year. Large CDs advanced at a rapid 35 percent annual rate, a slowdown only relative to the extraordinarily strong 44 percent rate of growth in the preceding quarter. While much of the expansion in these certificates in the second quarter occurred at banks outside New York City, recently the expansion has strengthened at New York banks. Banks have been bidding aggressively for these deposits for some time now as loan demand has improved.

BANK CREDIT

Total bank credit continued to advance rapidly in the third quarter of 1972. When adjusted for net loan sales to affiliates, it grew at a 13.7 percent seasonally adjusted annual rate in the three months ended in September, compared with a 12.8 percent rate in the first half of the year (see Chart IV). To an even greater extent than earlier, the growth of bank credit stemmed from strong demand for loans. Total loans adjusted for loan sales to affiliates advanced at an unusually fast 18.8 percent annual rate in the quarter, while total investments edged up at a 3.5 percent rate. This pattern of accelerating loan demand combined with sluggish growth in investments, particularly since the first quarter, is in sharp contrast to the pattern in 1971 when banks increased their investments much more than their loans. Such growing relative importance of loans in the banks' asset portfolios reflects the accelerated rate of economic recovery in 1972 after the relatively slow climb in economic activity during most of 1971.

The expansion in loans appears to have taken place in practically every category. Business loans advanced in the third quarter at a 12.8 percent annual rate after adjustment for loan sales to affiliates. In the first half of the year, business loans were generally increasing rapidly outside New York City but were relatively weak at New York City financial center banks. It is not unusual, however, for commercial loan demand at New York banks to pick up later than that in the rest of the country during a period of recovery from a recession. In July and August, commercial loan demand at the large New York City banks did begin to expand. However, loan demand again dipped at these banks in September, in part because corporations relied more heavily than usual on internal liquidity and less on bank loans to meet their September 15 tax obligations. Even the absence of a tax anticipation bill maturing in September did not seem to stimulate loan demand. On the other hand, large CDs fell by a record $675 million at large New York banks in the week that included the tax payment date, indicating that maturing CDs were probably a significant source of funds for tax payments.

The prevailing prime rate at major New York City banks was raised from 5¼ percent in late June to 5¾ percent by the beginning of October, giving further indications of expanding commercial loan demand. However, most of the changes were initiated by banks with floating prime rates, suggesting that advances in market rates were at least as important as stronger loan demand in determining the prime rate increases. Most commercial paper rates, for instance, rose ⅜ percentage point over the quarter.

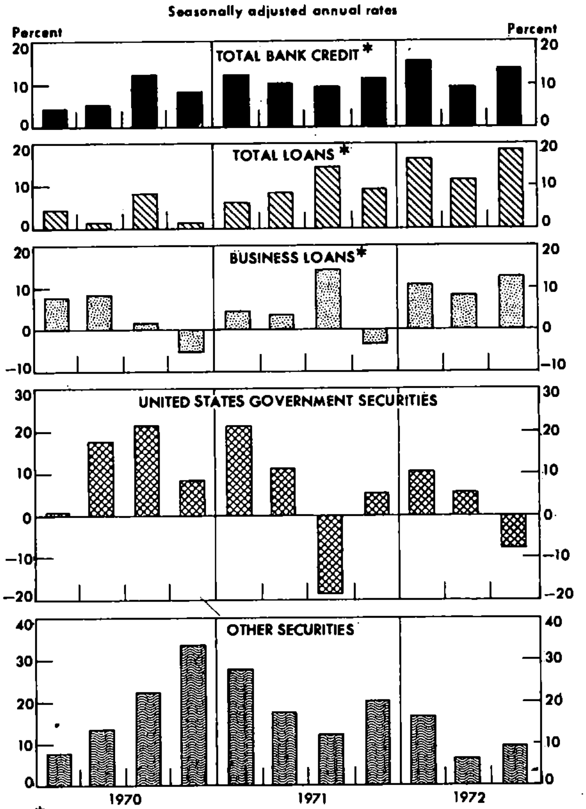
Loans in several categories continued to expand at roughly the same rates as in the first half of the year. Three categories—consumer loans, loans to nonbank financial institutions, and securities loans—actually accelerated from the already brisk paces set earlier. The latter two categories, of course, are subject to rather large month-to-month and even quarter-to-quarter variations but nonetheless have been exceptionally strong for the year as a whole. The growth of real estate loans slowed slightly from earlier in the year but nevertheless remained rapid.

The slow advance in bank investments reflected primarily the sharp declines in bank holdings of United States Treasury securities in both July and August. Treasury financing needs were considerably lighter in the third quarter than they had been in the corresponding year-earlier period because of a smaller deficit during the most recent quarter and a higher initial level of balances in Treasury accounts. In 1971 an occasional dip in holdings of Treasury securities was usually overshadowed by a large increase in other securities, predominantly tax-exempt issues of state and local governments. This year, however, holdings of these securities have increased at a more moderate 11.2 percent annual pace, or about half of the 1971 growth rate. Yields on tax-exempt securities have remained relatively stable thus far this year despite the slowing in the rate of bank acquisitions of these issues.

Chart IV

CHANGES IN BANK CREDIT AND ITS COMPONENTS

Seasonally adjusted annual rates



* Adjusted for loans sold to affiliates.
Source: Board of Governors of the Federal Reserve System.

THRIFT INSTITUTIONS

Funds flowed into thrift institutions in the third quarter at a slightly faster pace than that of the preceding quarter. The 15.6 percent seasonally adjusted annual rate of advance, however, remained below the extraordinary rates experienced in the first quarter of this year and during 1971. Some slowing in thrift deposit growth was to be expected because short-term interest rates have generally been increasing since February, while the interest paid on most types of thrift institution deposits has remained at the legal ceiling rates throughout the year.

Thrift deposits began to accelerate during the 1970 recession, and such savings have continued to expand rapidly throughout the recovery period. In fact, the most recent three-month period marks the eighth consecutive quarter that thrift deposits have grown at an annual rate in excess of 12 percent. Of course, thrift institution deposits have experienced strong rates of growth in the past. In the ten years from 1955 through 1965, for instance, these deposits increased at a compound annual rate of 10 percent. During the second half of the 1960's the rate slowed to about 6 percent, while over the two years ended in September the compound average growth rate was an unusually strong 15.7 percent.

Mortgage lending continued to expand at a very rapid pace in the third quarter, particularly at savings and loan associations where loans outstanding advanced at an 18.3 percent rate. Indeed, in the second and third quarters, mortgage credit actually rose at a somewhat greater pace than deposits at these institutions. At mutual savings banks, on the other hand, mortgages expanded at a more moderate 8.4 percent rate in July and August. This is in line with the pattern of the preceding year and a half when mortgage portfolios advanced at a 7.5 percent rate at mutual savings banks but at a 17.3 percent rate at savings and loan associations.