Monetary and Financial Developments in the Fourth Quarter

During the fourth quarter of 1972, the narrowly defined money supply (M_1) increased more rapidly than it had during the preceding three months. Most of this increase was attributable to a sharp acceleration of M_1 in December following the more moderate expansion in October and November. Although M_1 advanced rapidly, a mild slowdown of the large inflows to savings and consumer-type time deposit accounts at commercial banks held the growth of the broad money supply (M_2) about even with the third-quarter rate. The bank credit proxy expanded at a somewhat faster rate than in the third quarter. Furthermore, burgeoning loan demand brought larger increases in total bank credit. Reflecting the high rates of growth of the monetary aggregates, reserves available to support private nonbank deposits (RPD) in the fourth quarter climbed at a seasonally adjusted annual rate of 10.5 percent, a little more quickly than in the third quarter. As was the case in the preceding three months, much of this reserve expansion resulted from a rising volume of member bank borrowings at the discount window.

Interest rates at the short and long ends of the maturity spectrum moved in different directions during the final months of the year. Short-term rates rose briskly in response to the continuing business recovery and the rising demand for short-term funds in the economy. In contrast, long-term bond yields fell substantially in October and November, as the moderation of inflationary expectations was joined by a decline in the volume of new corporate flotations and easing credit demands by state and local governments. Long-term yields did rise in December, however.

This strength in the capital markets was further manifested in the continuing healthy performance of the nonbank depository institutions as suppliers of funds to the residential mortgage market. Although deposit inflows slowed from earlier 1972 levels, these inflows remained substantial and mortgage lending stayed at high levels. Mortgage yields rose somewhat in the final quarter of the year, but still were lower than those prevailing at the beginning of the year.

THE MONETARY AGGREGATES

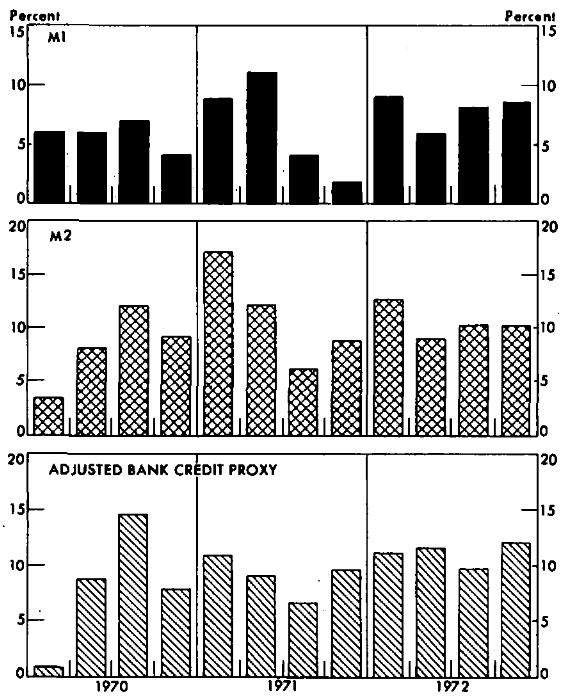
The narrowly defined money supply (M_1)—private demand deposits adjusted plus currency outside commercial banks—increased in the final quarter of 1972 at a rapid seasonally adjusted annual rate of 8.6 percent, 0.4 percentage point faster than the expansion of M_1 during the preceding three-month interval (see Chart I). This brought the growth of M_1 for the entire year to 8.3 percent, the largest yearly increase in the post-World War II era. The rapidity of M_1 growth during the fourth quarter reflected a 13.3 percent spurt during December. In contrast, during October and November M_1 increased at more moderate rates averaging 6.2 percent.

The impact of the December spurt in M_1 on the growth rate for the fourth quarter was similar to that of the major role played in the third-quarter expansion of M_1 by the quick jump in the money supply during July. Both the size of M_1 increases in July and December and their impact upon the quarterly growth rates illustrate the difficulty of influencing the monetary aggregates in the short run. The M_1 surge in December reflected to some extent a sharp increase in demand deposits of state and local governments, some of which were slow in investing their part of the \$2.7 billion in Federal revenue-sharing payments that were disbursed in December. Moreover, the general demand for money has doubtless been increasing as a result of the gathering momentum of the economic recovery.

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.

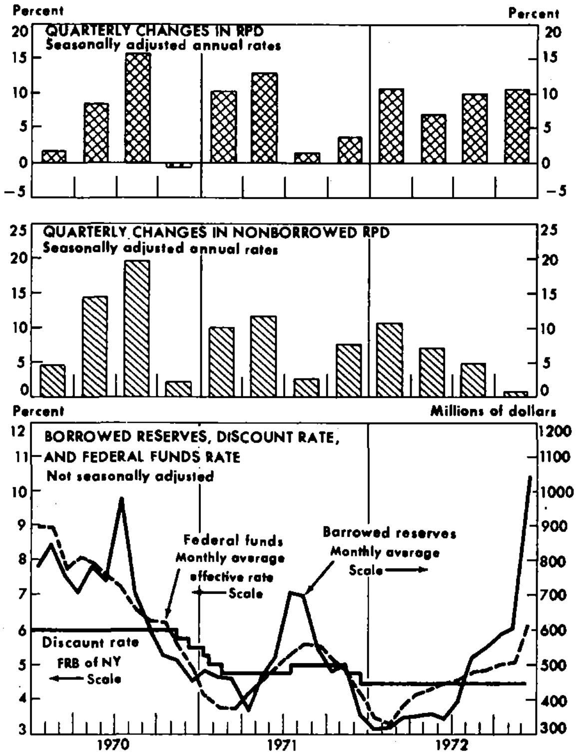
Source: Board of Governors of the Federal Reserve System.

The broad money supply (M_2)—which adds to M_1 savings deposits and time deposits other than large-denomination certificates of deposit (CDs) at commercial banks—advanced at a seasonally adjusted annual rate of 10.2 percent in the fourth quarter, about the same as in the previous quarter. This steady growth of M_2 reflected the effects of moderating flows in the time deposit component of M_2 which offset the acceleration in the narrow money supply. The growth of large CDs also slowed in the fourth quarter as a whole, although the investment of revenue-sharing funds by state and local governments contributed to the December climb in CDs at the extremely rapid annual rate of 58 percent. 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, grew at a relatively steady pace throughout 1972. United States Treasury deposits and commercial paper issued by bank holding companies increased significantly in the October-December interval. On balance, the bank credit proxy advanced at a 12.1 percent seasonally adjusted annual rate during the fourth quarter, which brought the credit proxy to a level 11.6 percent above that at the end of 1971.

RPD expanded at a 10.5 percent annual rate in the fourth quarter, compared with 10 percent for the third quarter and for all of 1972 (see Chart II). As was the case in the third quarter, the principal source of RPD expansion was the rise in member bank borrowings from the Federal Reserve. On the basis of monthly averages of daily figures, borrowings rose from \$514 million in September to \$1,050 million in December. On the other hand, the nonborrowed component of RPD moved up only marginally at a 0.4 percent rate in the fourth quarter. Most member banks had not made frequent use of the discount window earlier in the year. The large increase in borrowings toward the end of the year reflected mounting pressure on bank reserve positions, occasional shortages of Federal funds in the market, and the rising cost of obtaining Federal funds in the market. The average Federal funds rate

Chart II

RESERVES AVAILABLE TO SUPPORT PRIVATE NONBANK DEPOSITS AND RELATED INTEREST 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.

rose from 4.87 percent in September to 5.33 percent in December, while the discount rate remained unchanged at 4.50 percent. Effective January 15, 1973 the discount rate was raised to 5 percent.

BANK CREDIT, INTEREST RATES, AND THE CAPITAL MARKETS

Total bank credit advanced rapidly in the fourth quarter of 1972, as loan demand continued strong in almost all categories. Adjusted to include net loan sales to affiliates, bank credit grew at a 14.4 percent seasonally adjusted annual rate in the fourth quarter, compared with a 13.6 percent rate for the third quarter and a 12.8 percent rate for the first half of the year (see Chart III). Total loans (adjusted for loan sales to affiliates) increased at an 18.7 percent annual rate in the October-December interval, about equal to the third-quarter advance but above the 14 percent growth rate of the first half of the year.

Business loans strengthened markedly in the fourth quarter, stimulated by a strong advance in business inventories as well as by accelerating economic recovery in general. Reflecting the economy's strength throughout the year, the growth rate of business loans (adjusted for sales to affiliates) during 1972 was 11.7 percent, well above the 4.8 percent expansion during 1971. Bank loans to consumers rose at a 19 percent rate in the fourth quarter, which was a continuation of the rising trend of consumer lending seen throughout 1972. Real estate loans maintained a high 17.6 percent growth rate in October-December, about equal to the third-quarter rate but somewhat below the rate during the first half of the year.

While loan demand was strong, growth of banks' portfolios of securities slowed in the fourth quarter of 1972. There was no change in bank holdings of United States Government securities despite very large issues of new Treasury securities during the quarter to finance the Federal deficit. In the third quarter, banks had reduced United States Government securities holdings at a 7.6 percent annual rate, and this pattern might have been repeated in the fourth quarter if the Treasury had not offered notes at the very end of the year which were particularly attractive to banks. For the full year 1972, United States Government securities holdings grew 2.1 percent, compared with 4.7 percent in 1971 and 12.6 percent in 1970. A similar though less pronounced declining pattern was seen in bank acquisition of other securities, principally state and local government issues. Expansion in holdings of these securities slowed to an 8.1 percent annual rate in the fourth quarter, compared with a 9.8 percent rate in the third quarter and 11.7 percent in the first half of 1972.

The vigorous bank loan demand and rising money market rates of the fourth quarter put pressure on the banks' prime lending rate. In early October the prime rate was raised from 5½ percent to 5¾ percent, and in late December the prime rate was increased again to 6 percent. The yield on three-month Treasury bills increased from a 4.66 percent daily average rate in September to a 5.07 percent rate in December. Similarly, in the October-December interval, rates on three-month CDs in the secondary market rose 29 basis points to 5.42 percent, four- to six-month commercial paper rates rose 31 basis points to 5.45 percent, and six-month Treasury bill rates increased 17 basis points to 5.30 percent.

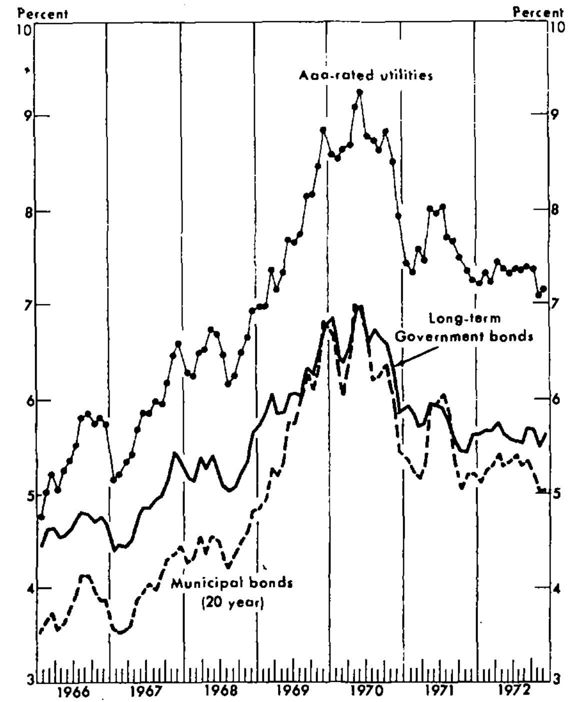
In spite of rising short-term rates, bond market yields declined. This reflected the apparent moderation of inflationary expectations, lower corporate demands for funds, and to some extent reduced state and local government demands. In the corporate bond market, total public and private placements were $6.5 billion in the fourth quarter of 1972, about 13 percent less than the same quarter of 1971. Offerings of state and local governments totaled $5.5 billion in the October-December 1972 interval, compared with $6 billion in the same period in 1971. Combined corporate and municipal bond offerings in 1972 were $50 billion, down more than 10 percent from the $56.4 billion raised in 1971. These lower credit demands stemmed from increased internal funds from improved corporate profits and large fiscal surpluses at state and local governments. During the fourth quarter the Federal Reserve Board's index of new-issue utility bonds adjusted to Aaa basis declined 25 basis points to an average rate of 7.15 percent in December, although this was an increase from the 7.09 percent recorded in November (see Chart IV). Yields in the long-term municipal market followed a similar path over the quarter as they also declined about ¼ percentage point to the 5 percent level.

The decline in the Federal budget deficit in calendar year 1972 helped to reduce Treasury new cash borrowings from $24.8 billion in 1971 to $15.3 billion in 1972. However, a large part of these borrowings occurred late in the year. During October-December 1972 they totaled $12.4 billion, almost identical to borrowings in the same interval of 1971. Federally sponsored agency net borrowing was $0.8 billion in the last quarter of 1972, down sharply from the comparable 1971 period. Yields on long-term Treasury bonds traced a declining pattern during the first half of the fourth quarter but rose thereafter.

Lower bond yields, higher profits, completion of the national elections, and an improving outlook for a Vietnam peace moved stock prices to record levels. As measured by the New York Stock Exchange composite stock index, prices climbed 6.4 percent during the fourth quarter to close on December 31 at a level of 64.48, an advance of 14.3 percent during 1972. The Federal Reserve increased the required downpayment on margin stock purchases from 55 percent to 65 percent effective on November 24. After the rapid advance of stock margin

Chart IV

LONG-TERM INTEREST RATES



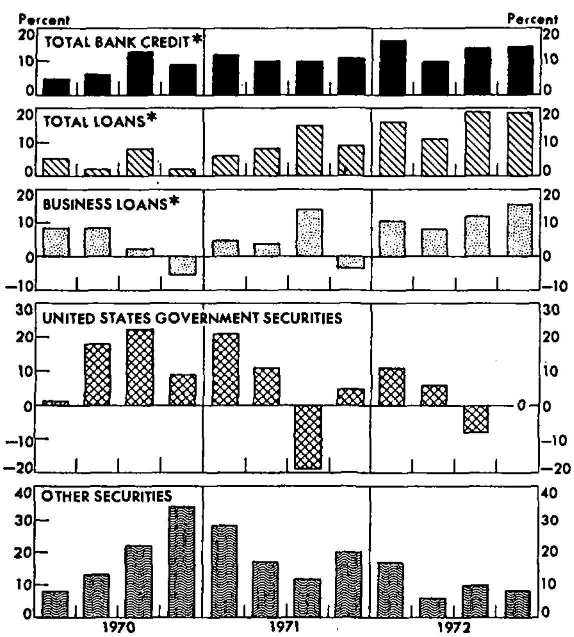
Note: Yields on the long-term Government bonds are monthly averages of daily figures. Yields on Aaa-rated utilities and twenty-year municipal bonds are monthly averages of weekly figures.

Source: Board of Governors of the Federal Reserve System and The Bond Buyer.

Chart III

CHANGES IN BANK CREDIT AND ITS COMPONENTS

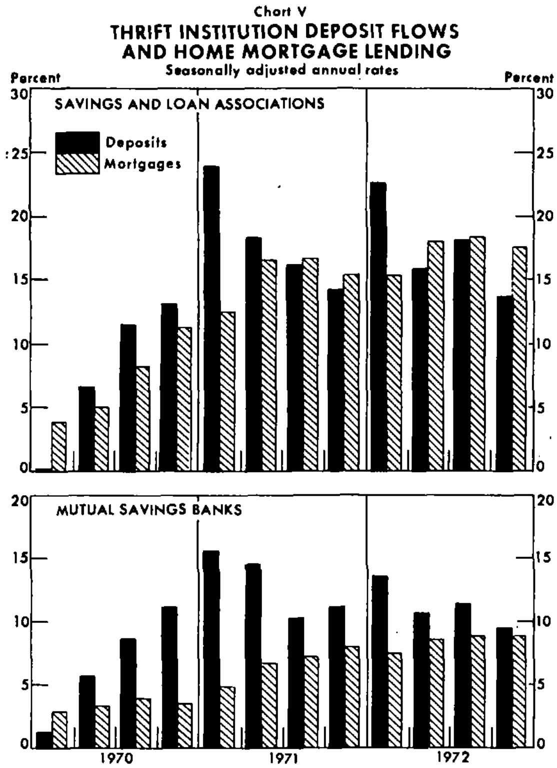
Seasonally adjusted annual rates



*Adjusted for loans sold to affiliates.

Source: Board of Governors of the Federal Reserve System.

credit during the first nine months of 1972, margin borrowing returned to more normal growth rates in the fourth quarter.



Note: Mutual savings bank mortgage statistics for the fourth quarter of 1972 are based on October and November data.
Sources: Federal Home Loan Bank Board and National Association of Mutual Savings Banks.

THRIFT INSTITUTIONS

The expansion of total thrift institution deposits slowed substantially during the fourth quarter, principally because of a significant moderation of deposit inflows to savings and loan associations (see Chart V). By comparison, deposit flows at mutual savings banks tapered only moderately from their rate of expansion in the July-September interval. These reductions notwithstanding, deposit inflows to the nation's thrift institutions continued at historically high rates. Together with the flow of deposits in the first nine months of the year, the growth during the fourth quarter brought the annual rate of thrift institution deposit growth to 16.7 percent, down only slightly from 17.5 percent in 1971.

The strong deposit inflows to thrift institutions that began in 1970 reflected the greatly improved competitive position of these institutions. In turn, this improved competitive capability was based upon the aggressive marketing of the thrift institutions' higher yielding certificate-type accounts and the relatively lower yields prevailing on competing credit market instruments. More than 70 percent of deposit growth at savings and loan associations over the two-year period ended December 1972 was concentrated in these higher yielding accounts. The minimum maturity feature of the certificate-type accounts should alleviate some of the volatility traditionally associated with thrift institution deposits.

The strong flow of deposits to thrift institutions was the major factor contributing to the stability of the residential mortgage markets in the fourth quarter and throughout the year. In addition, the volume of residential mortgage lending by commercial banks has been unusually strong. Reflecting the stability of the mortgage market, the effective yields on new-home conventional mortgages ended the year at 7.66 percent, down 11 basis points from the level in December 1971. Moreover, secondary-market yields on Federal Housing Administration-insured mortgages closed 1972 down 3 basis points for the year at 7.56 percent. The ratio of the average size of loan made to the value of the home purchased rose slightly during the fourth quarter, closing the year at 77.9 percent compared with 74.5 percent at the end of 1971.