Monetary and Bank Credit Developments in the First Quarter

During the first quarter of 1973, the growth of the narrowly defined money supply (M_1) slowed substantially from that of the two preceding quarters. This slowdown brought M_1 growth over the twelve-month period that ended in March to 6.3 percent, compared with 8.3 percent over the twelve months ended December 1972. The broad money supply (M_2) also advanced less rapidly than in previous quarters. In contrast to the slowing of the monetary aggregates, the bank credit proxy expanded vigorously in the first quarter, as banks aggressively marketed large-denomination certificates of deposit (CDs) to meet heavy loan demand. Although reserves available to support private nonbank deposits (RPD) maintained a high growth rate, these reserves were required primarily because of the rapid growth of large CDs. Furthermore, the expansion of RPD in the first quarter was accomplished solely through the increase in borrowings at the discount window as Federal Reserve open market operations held a close rein on nonborrowed reserves. Both borrowed reserves and the Federal funds rate rose sharply.

Total bank credit advanced very rapidly in the first quarter as loan demand from businesses surged and continued strong in almost all other categories. The burgeoning demand for business loans stemmed from the short-term financing requirements imposed by very strong national economic growth, the desire for funds with which to hedge against dollar devaluation in the international currency crisis, and the relatively low bank prime lending rate compared with the costs of alternative sources of funds such as commercial paper. In addition to acquiring funds by issuing CDs, banks liquidated securities to meet the heavy loan demand.

The rapid advance of short-term interest rates during the quarter led to increases in the Federal Reserve discount rate and placed upward pressure on bond yields. Long-term rates rose during the quarter, though less rapidly than short-term rates, amid growing concern about the outlook for inflation. Rising short-term rates also have reduced deposit flows to the thrift institutions. Residential mortgage growth remained strong, however, and mortgage interest rates rose only slightly.

THE MONETARY AGGREGATES

M_1—private demand deposits adjusted plus currency outside commercial banks—increased slowly at a 1.7 percent seasonally adjusted annual rate in the first quarter of 1973 (see Chart I). This restrained growth contrasted markedly with the rapid 8.6 percent rate of advance in the final quarter of last year. In the twelve months ended in March, M_1 expanded by 6.3 percent, well below the 8.3 percent increase during 1972 but above the 5.5 percent compound annual growth rate during the years 1966 through 1971. Demand deposits included in M_1 showed virtually no change on a seasonally adjusted basis during the first quarter, while the currency component climbed at a 7.7 percent seasonally adjusted annual rate.

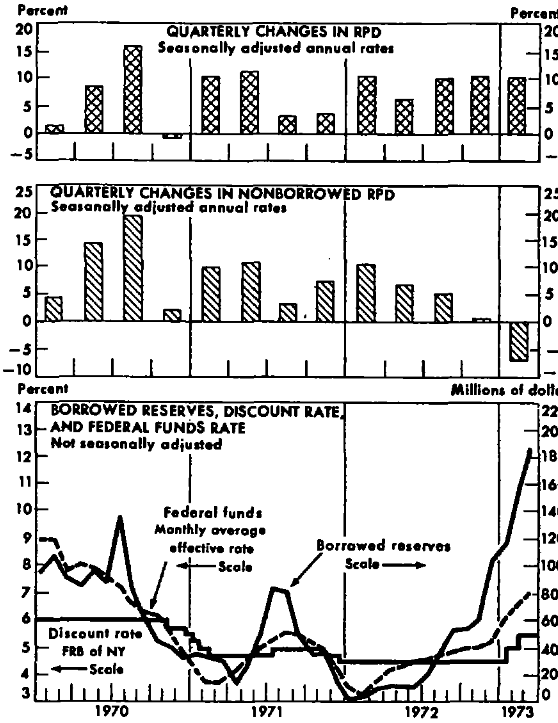
M_2—which adds to M_1 savings deposits and time deposits other than large denomination CDs at commercial banks—advanced at a seasonally adjusted rate of 5.7 percent in the first three months of 1973, substantially slower than the 10.2 percent rate of increase in the previous quarter. During the twelve months ended in March, M_2 increased by 8.9 percent. The growth of consumer-type savings deposits included in M_2 slowed somewhat to a 9.5 percent rate in the first quarter from 11.6 percent in the fourth quarter of last year. In contrast, large CDs rose sharply at a 108 percent annual rate in the January-March interval, the highest quarterly rate of advance since the third quarter of 1970 when banks were faced with substantial loan demands diverted from the commercial paper market in the wake of the Penn Central insolvency. Indeed, commercial bank demand for CD funds was so great that by the end of March the banks were bidding rates as high as 7⅜ percent on 89-day CDs. New takings were largely restricted to the short maturity area because market rates rose above the Regulation Q ceilings of 6¾ percent for 90- to 179-day maturities and 7 percent for 180- to 365-day maturities. Posted rates on CDs of longer than one year maturity, however, remained below the 7½ percent ceiling for that category. Because of the heavy issuance of CDs in the under-90-day maturity range, the average maturity of outstanding CDs at weekly reporting banks dropped to 2.6 months in March, compared with 2.9 months in December and 3.3 months in March 1972.

The surge in CDs contributed significantly to the first quarter's rapid 15 percent seasonally adjusted annual growth rate of the adjusted bank credit proxy. This measure of total member bank deposits subject to reserve requirements plus liabilities to foreign branches and bank-related commercial paper had expanded at a 12.1 percent rate in the previous quarter and by 12.6 percent over the twelve months ended in March. Substantial increases in United States Treasury deposits and in commercial paper issued by bank holding companies also added to the credit proxy during the January-March interval.

RPD continued to display the strength exhibited in the second half of last year, increasing at a 10.5 percent annual rate in the first quarter (see Chart II). The Federal Reserve maintained restraint on the provision of nonborrowed reserves to the banking system. Consequently, member banks borrowed very much larger amounts at the Federal Reserve Bank discount windows. The increase in borrowed reserves more than accounted for the growth in RPD, as nonborrowed RPD fell at a 6.8 percent annual rate in the January-March interval. With virtually no change in member bank demand deposit liabilities, the first-quarter rise in RPD provided reserves primarily against the large increase in CDs outstanding. Reflecting the banks' tight reserve positions, the Federal funds rate rose from an average of 5.33 percent in December to 7.09 percent in March.

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.

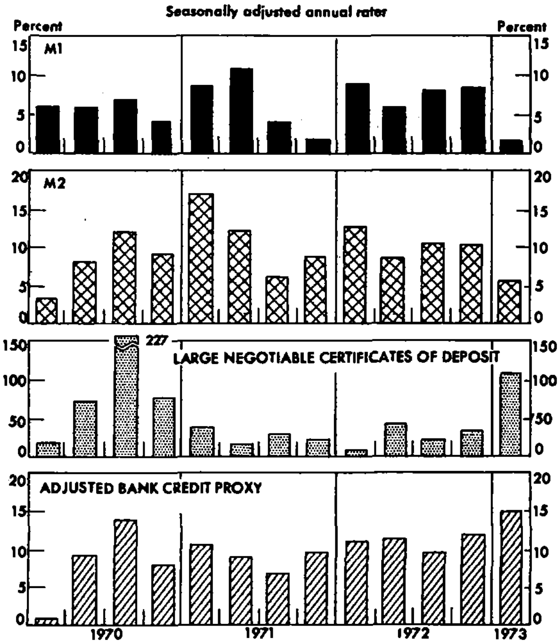
RPD = Total member bank reserves less those required to support United States Government and interbank deposits.

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

Chart I

CHANGES IN MONETARY AND CREDIT 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.

BANK CREDIT, INTEREST RATES, AND THE CAPITAL MARKETS

Total bank credit advanced very rapidly in the first quarter of 1973, as loan demand continued strong in almost all categories. Adjusted to include net loan sales to affiliates, bank credit grew at a 20.3 percent seasonally adjusted annual rate in the first quarter, up substantially from 14.4 percent in the fourth quarter of 1972 (see Chart III). Business loans, real estate and agricultural loans, and loans to consumers and nonbank financial institutions continued to expand vigorously, though securities loans were reduced. The powerful economic expansion of the first quarter was probably the most important factor encouraging commercial and industrial credit demands, which were broadly based among industries. Business loans advanced at a 39.1 percent annual rate, compared with 15.2 percent in the previous quarter. Business lending was especially strong at large banks which have ready access to the CD market.

Another source of business borrowing was the demand for funds with which to purchase foreign currencies for the purpose of hedging against dollar devaluation losses. Moreover, a significant part of the nearly explosive climb in business loans resulted from substitution out of the commercial paper market as outstanding nonbank dealer-placed commercial paper declined by an estimated $4 billion on a seasonally adjusted basis in the January-March interval. Corporations took advantage of the relatively low level of bank prime lending rates, compared with other short-term sources of funds, to shift demands for credit to the commercial banks. After discussions in March, the Committee on Interest and Dividends in April approved a dual prime rate system (see page 123) which may lessen the tendency of business borrowers to shift their credit demands to the banks.

These combined business loan demands, well in excess of the growth of deposit sources, have pushed the banks' loan-deposit ratio sharply upward. Furthermore, in order to raise funds to meet loan demand in the face of the restraint on nonborrowed reserves exercised by the Federal Reserve System, banks made net sales of securities from their investment portfolios. The sale of short-term United States Government securities contributed to the upward pressure on Treasury bill interest rates. By the end of the period, the three-month bill rate had risen to 6.40 percent from 5.14 percent three months earlier.

As short-term interest rates rose, the Federal Reserve increased the discount rate ½ percentage point in January and another ½ percentage point in February. The discount rate at most of the Reserve Banks was raised ¼ percentage point in late April. The Federal Reserve Bank of New York took similar action in early May, thereby establishing a uniform discount rate of 5¾ percent throughout the System.

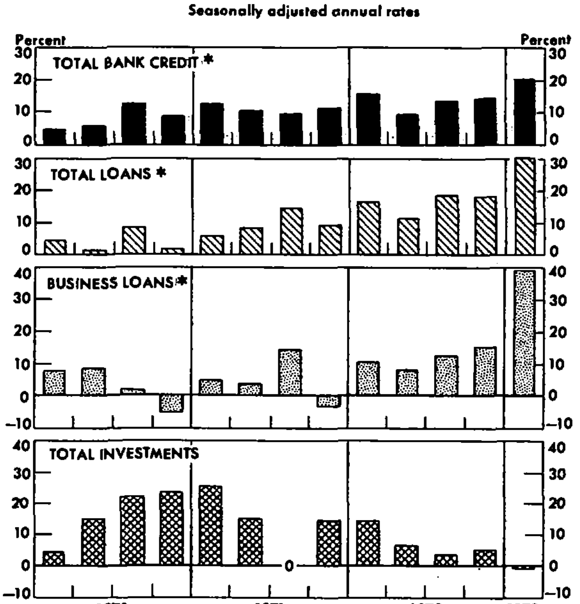
Rising short-term rates and fears of resurging inflation placed upward pressure on long-term interest rates during the first quarter. These pressures were moderated, however, by a light new-issue calendar of corporate bonds. In the corporate bond market, total public and private placements were $4.4 billion in the first quarter of 1973, almost 40 percent less than in the same quarter of 1972. State and local government bond issues totaled $5.5 billion in the first three months of this year, somewhat below the $5.9 billion sold during the corresponding period in 1972. During the first quarter, the Federal Reserve Board's index of yields on newly issued utility bonds adjusted to an Aaa basis rose gradually from 7.15 percent in December to 7.49 percent in March (see Chart IV). Yields in the municipal bond market also moved upward from 5.05 percent in December to 5.29 percent in March, as measured by The Bond Buyer index of twenty tax-exempt bonds.

On the other hand, Federal agency offerings maturing in one year or more were a substantial $5.1 billion in the January-March 1973 interval, compared with $3.1 billion in the same period last year. United States Treasury financing requirements have been reduced by the improved tax receipts of the expanding economy and by the purchase of nonmarketable Treasury debt by foreign central banks

Chart III

CHANGES IN BANK CREDIT AND ITS COMPONENTS

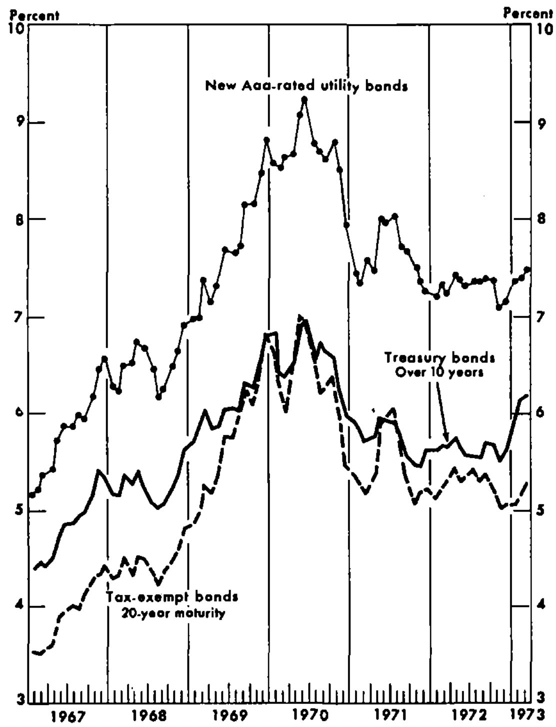
Seasonally adjusted annual rates



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

Chart IV

LONG-TERM INTEREST RATES



Note: Yields on the long-term Treasury bonds are monthly averages of daily figures. Yields on Aaa-rated utility and twenty-year tax-exempt bonds are monthly averages of weekly figures.

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

with the dollars accumulated in defending fixed foreign exchange rates during the quarter. The average yield on Treasury bonds maturing in ten years or more rose from 5.71 percent at the end of December to 6.19 percent at the end of March.

THRIFT INSTITUTIONS

Deposit flows to savings and loan associations and mutual savings banks continued to slacken in the first quarter, as they paralleled the slowdown in the growth of consumer-type savings deposits at commercial banks. The decline in the ratio of savings to personal disposable income, as well as the higher interest rates available on alternative short-term investments, contributed to the tapering of deposit flows to the thrift institutions.

Although deposit flows slowed, thrift institutions continued to increase their mortgage holdings substantially during the first quarter. Their commitments to make mortgage loans in the future, moreover, remained high. To support the expansion of mortgage lending, the savings and loan associations increased their borrowing from the Federal Home Loan Banks. Furthermore, the Government National Mortgage Association and the Federal National Mortgage Association have been very active in packaging Government agency-insured mortgage loans for institutional and other long-term investors. Mortgage financing and strong housing demand have been further encouraged by the 95 percent loan-to-value ratio mortgages now available to some home buyers through the use of private mortgage insurance.

As mortgage demand continued strong, mortgage rates tended very gradually upward. For example, secondary-market yields on mortgages insured by the Federal Housing Administration ended the first quarter of 1973 at 7.63 percent, up only 7 basis points since December and 18 basis points since March of last year.