# Monetary and Financial Developments in the Second Quarter

During the second quarter of 1973 the growth of most of the monetary aggregates accelerated substantially. The narrowly defined money supply ($M_1$) rose at a 10.3 percent seasonally adjusted annual rate following a sluggish 1.7 percent gain from January to March. The growth in the broad money supply ($M_2$) also climbed significantly above its first-quarter pace. On the other hand, the rate of growth of the adjusted bank credit proxy slowed somewhat as the result of both a less explosive expansion in large-denomination certificates of deposit (CDs) than in the preceding three months and an actual decline in the level of United States Government deposits at member banks. Reserves available to support private nonbank deposits (RPD) expanded more rapidly than in the preceding quarter. Despite this gain in reserves, the effective rate on Federal funds rose sharply over the period as the monetary authorities resisted the rapid growth in the aggregates.

The expansion in bank credit slowed in the second quarter from its very rapid first-quarter pace. Business loans advanced at a very substantial 20 percent rate, but this was still only about half the rate of gain experienced in the first quarter. Commercial banks made a modest addition to their portfolios of United States Government and other securities in the April-June period, in contrast to the liquidation of such investments during the first quarter.

On balance, both short- and long-term interest rates rose over the second quarter. The rise in short-term rates was particularly sharp and was accompanied by successive increases in the Federal Reserve discount rate. Effective July 2, the discount rate was raised to 7 percent, equaling the record high established more than fifty years ago. Simultaneously with the announcement of this increase, the Board of Governors of the Federal Reserve System raised reserve requirements on most demand deposits at member banks. These moves, designed to restrain the continuing excessive expansion in money and credit, contributed to additional steep increases in short-term interest rates. By mid-July, rates on many of these instruments had reached or surpassed their peaks of 1969-70.

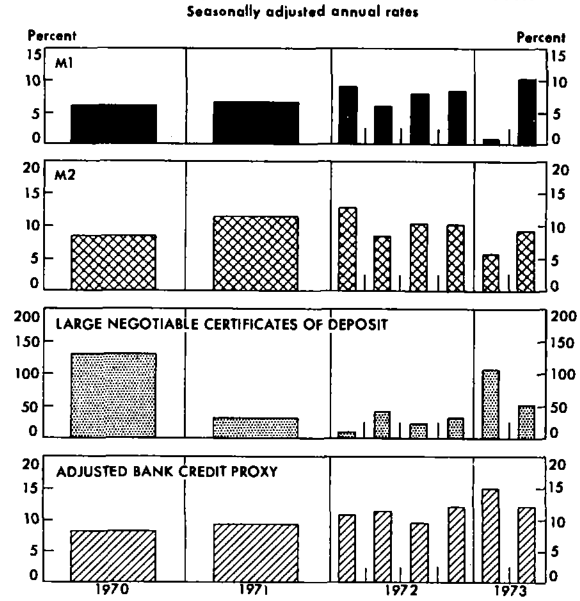
### THE MONETARY AGGREGATES

$M_1$—private demand deposits adjusted plus currency outside commercial banks—grew at a rapid seasonally adjusted annual rate of 10.3 percent during the second quarter of 1973, following a modest gain of 1.7 percent in the preceding quarter (see Chart I). This acceleration brought the growth in $M_1$ for the year ended in June to a strong 7.4 percent. The major source of the second-quarter growth in $M_1$ was a 10.5 percent rise in its demand

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.

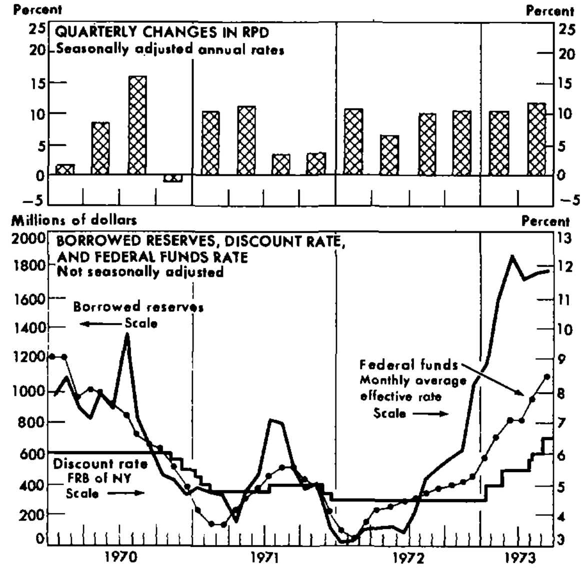
deposit component. These deposits, which were essentially unchanged during the first three months of the year, advanced at an increasingly rapid pace over the April-June period. In addition, the currency component of $M_1$ grew substantially over the quarter. The larger than anticipated Federal income tax refunds during the period may well have been a factor in the strong $M_1$ growth. These funds were transferred from Treasury accounts, which are excluded from $M_1$, to private accounts and may at least in part have been added to checking and currency balances.

The growth of $M_2$—consisting of $M_1$ plus time deposits other than large CDs—also accelerated in the second quarter, though less strongly than $M_1$. Net flows into the time deposit component of $M_2$ have been slowing this year, primarily as a result of the substantial rise in short-term market interest rates in recent months. Compared with an increase of 13.3 percent in 1972, the gain in such time deposits amounted to 9.5 percent and 8.7 percent in the first and second quarters of 1973, respectively. This deceleration was more than offset by the growth in demand deposits, however, and $M_2$ expanded at a seasonally adjusted annual rate of 9.5 percent in the April-June period, up from 5.7 percent in the previous quarter. Over the first half year as a whole, $M_2$ advanced 7.7 percent at a seasonally adjusted annual rate.

In contrast to the money supply measures, growth in the adjusted bank credit proxy—member bank deposits subject to reserve requirements plus certain nondeposit liabilities—slowed somewhat in the second quarter. Nevertheless, the proxy expanded at a rapid 12.2 percent rate over the period after rising at a 15 percent pace for the first three months of the year. In comparison, the proxy grew 11.6 percent in 1972 and 9.4 percent in 1971. United States Government deposits at member banks, seasonally adjusted, fell by some \$2.4 billion over the second quarter as the Treasury made a revenue-sharing payment to state and local governments and refunded an unusually large amount of withheld income taxes. An additional factor contributing to the proxy's slowing was a marked deceleration in the growth of CDs outstanding at member banks. After climbing at an annual rate of 108 percent in the first quarter, CD growth slowed progressively from 83 percent in April to only 5.8 percent in June. CDs became an increasingly expensive source of funds to banks over the period—banks were bidding as high as 8.5 percent for three-month CDs by the end of June. In addition, the cost of CDs to many banks was boosted by the imposition of a marginal reserve requirement against additions to the amounts outstanding. To slow CD growth and thus bank credit expansion, effective June 7 the Federal Reserve applied an 8 percent reserve requirement—the existing 5 percent plus a supplemental 3 percent—to increases in the combined total of CDs and bank-related commercial paper above the level outstanding in a base period.[1] This regulation applies only to banks with such liabilities in amounts of \$10 million or more. The Board also removed Regulation Q ceilings from all maturities of large CDs to enable banks to restore a more balanced deposit structure, but only a small amount of lengthening had occurred by the end of June.

Chart II

**RESERVES AVAILABLE TO SUPPORT PRIVATE NONBANK DEPOSITS AND RELATED INTEREST RATES**




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.

RPD expanded at a fast seasonally adjusted annual rate of 12 percent in the second quarter (see Chart II), following gains of 10.5 percent in the first quarter and 9.7 percent over the year 1972. The growth in RPD from April to June resulted from a substantial increase in nonborrowed reserves rather than from borrowing at the discount window. On a seasonally adjusted basis, nonborrowed reserves grew at a 17 percent annual rate in the second quarter, though the unadjusted rate was a quite

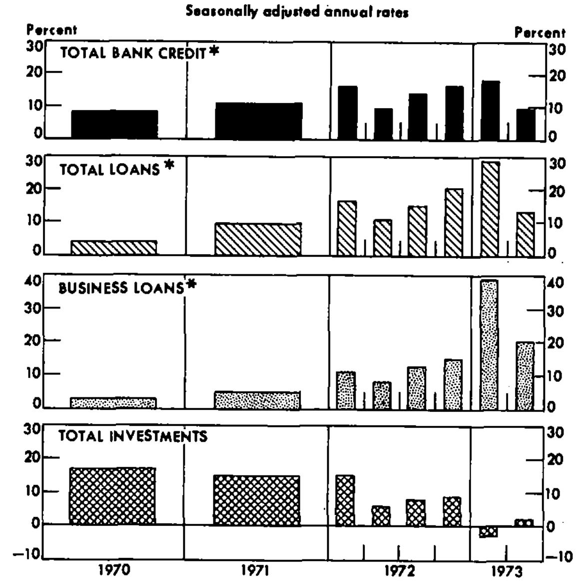
[1] See this *Review* (June 1973), pages 136-37 for details. Later, reserve requirements were also imposed on finance bills. See this *Review* (July 1973), pages 164-65.

modest 1½ percent. Member bank borrowings from the Federal Reserve remained at quite a high level over the period. Despite the rise in the discount rate to 6½ percent early in June, there still was incentive for banks to borrow from the Federal Reserve rather than in the Federal funds market. The average effective rate on Federal funds climbed to 8.59 percent in the statement week ended June 27 from 7.11 percent three months earlier. Over the first six months of this year, the Federal funds rate increased by 3¼ percentage points, compared with a rise of only 1¼ percentage points over all of 1972.

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.

## BANK CREDIT, INTEREST RATES, AND THE CAPITAL MARKETS

Total bank credit grew at a more temperate pace in the second quarter than over the preceding six months. Adjusted to include net loan sales to affiliates, bank credit increased at a 9.8 percent seasonally adjusted annual rate over the April-June interval, compared with rises of 18.4 percent and 16.4 percent in the first quarter 1973 and the fourth quarter 1972, respectively (see Chart III). While remaining quite strong, growth in loans to businesses, nonbank financial institutions, and consumers decelerated somewhat in the second quarter, and loans for purchasing and carrying securities continued the decline that began two quarters earlier.

Business loans rose 20.3 percent at an annual rate in the second quarter, still a very sizable increase but substantially less than the expansion in the preceding three months. On April 16 the Committee on Interest and Dividends approved a dual prime rate system under which the lending rate charged by commercial banks to large businesses is allowed to respond flexibly to changes in money market conditions provided that the changes are made gradually. Under this new system, the large business prime rate rose in several steps from 6½ percent at the end of March to 7¾ percent at the end of June. At the close of the quarter this rate was still ½ percentage point below the rate on prime dealer-placed four- to six-month commercial paper, but the substitution of bank loans for borrowing in the commercial paper market appears to have subsided. After falling by a total of $4 billion over the first four months of the year, nonbank-related dealer-placed commercial paper outstanding increased by $700 million during May and June.

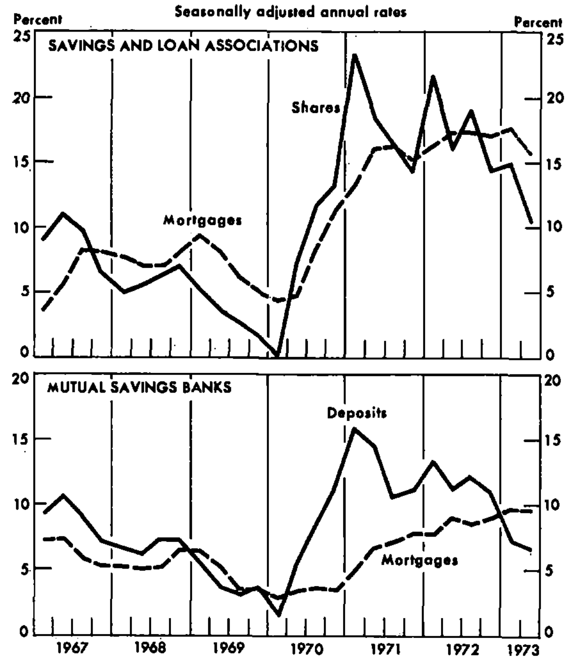
Commercial banks increased their securities holdings at a modest 2.2 percent seasonally adjusted annual rate in the second quarter. This followed a small decline in the preceding three-month period when some holdings of United States Government securities were liquidated to meet the exceptionally strong loan demand. Over the first half of this year, banks reduced their holdings of securities at a 0.6 percent annual rate, compared with an 8.5 percent rise during 1972.

Interest rates on most short-term instruments leveled off or declined during April and early May but then rose steadily over the remainder of the period. After climbing by about 1¼ percentage points in the first quarter, the rate on three-month Treasury bills increased by an additional 1⅛ percentage points over the second quarter (see Chart IV), closing the period at 7.52 percent. The rate on four- to six-month dealer-placed commercial paper also rose by about 1⅜ percentage points from the end of March to the end of June, while the rate on ninety-day bankers' acceptances advanced by 1½ percentage points to 8¾ percent over the interval.

These increases in short-term rates applied further upward pressure upon long-term interest rates, but the relatively modest supply of new long-term bond issues continued to moderate the rise. New corporate bond offerings amounted to $5.6 billion in the second quarter, well under the total of $7.4 billion in the same quarter a year ago. State and local government bond issues totaled $5.4 billion in the three months ended in June, somewhat lower than the

$6.2 billion raised in the comparable period of 1972. However, new issues of Federal agency securities were well above the borrowing of a year earlier. Rates on long-term United States Government bonds rose about 19 basis points in the second quarter. Corporate bond rates—as measured by the Federal Reserve Board's index of yields on recently offered utility bonds adjusted to an Aaa basis—rose 22 basis points over the quarter to 7.72 percent, reflecting a sharp rise in June. Rates in the municipal bond market were essentially unchanged, however, as The Bond Buyer index of twenty municipal bond yields was 5.25 percent at the end of June, compared with 5.26 percent in March.

Chart V
THRIFT INSTITUTION DEPOSIT FLOWS AND HOME MORTGAGE LENDING
Seasonally adjusted annual rates



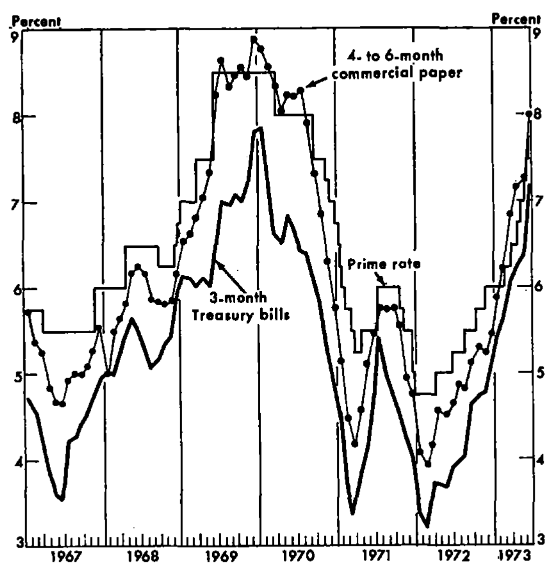

Note: Mutual savings bank mortgage statistics for the second quarter of 1973 are based on April and May data.
Sources: Federal Home Loan Bank Board and National Association of Mutual Savings Banks.

## THRIFT INSTITUTIONS

With the continued rise in market interest rates above those paid on deposits at savings and loan associations and mutual savings banks, deposit flows to these institutions slowed further during the second quarter (see Chart V). Deposit gains at savings and loan associations were at a seasonally adjusted 10.4 percent annual rate over the period, while deposits at mutual savings banks grew 6.6 percent. These increases were considerably smaller than the gains registered in the corresponding quarter a year earlier, but they are decidedly more rapid than in 1969 when market rates were only slightly higher than in the second quarter of this year. Early in July the interest rate ceilings on passbook accounts and other consumer-type time deposits at thrift institutions and commercial banks were raised,[2] but the spread between these and market rates remains quite large.

Despite the slowdown in deposit flows, there was little deceleration in the growth of mortgage holdings at the thrift institutions in the most recent quarter. In fact, mortgage holdings at savings banks rose more rapidly during the first half of 1973 than in 1972. Savings and loan

Chart IV
SHORT-TERM INTEREST RATES




Note: Yields on three-month Treasury bills and four- to six-month commercial paper are monthly averages of daily figures. The prime rate is the interest rate posted by major commercial banks on short-term loans to their most creditworthy large business borrowers.
Source: Board of Governors of the Federal Reserve System.

[2] See "The Money and Bond Markets in July", Table I (this *Review*), page 198.

associations increased their mortgage lending at a substantial pace in the second quarter as well, and outstanding mortgage commitments at savings and loan associations remain very high. To maintain the high level of mortgage lending activity, the associations reduced their liquid asset holdings and raised their borrowings from the Federal Home Loan Banks to record levels.

Mortgage interest rates increased modestly in the second quarter. The effective rate on conventional mortgage loans rose from 7.68 percent to 7.76 percent over the period. Ceiling rates on Federal Housing Administration (FHA)-insured and Veterans Administration-guaranteed mortgages were increased by ¾ percentage point in early July, and some states have recently raised the permissible maximum rates for conventional mortgages. The higher rate on FHA-insured mortgages was not immediately effective, however, because of a Congressional delay in extending the agency's authority for providing such insurance.