Monetary and Financial Developments in the Fourth Quarter

During the fourth quarter of 1973, growth in the money supply measures accelerated substantially. The narrowly defined money supply (M_1)—as recently revised to reflect new bench-mark data for nonmember bank deposits—expanded at a seasonally adjusted annual rate of 7.5 percent, after showing virtually no change in the third quarter. The more broadly defined money supply (M_2) also rose more rapidly than in the previous quarter, although the time deposit component advanced at only a slightly faster pace. The outstanding volume of large negotiable certificates of deposit (CDs) fell appreciably, on balance, over the quarter. Consequently, growth in the bank credit proxy was much lower than the gains experienced in the first three quarters of the year.

Total bank credit advanced very slowly over the October-December period as loan demand, particularly from businesses, slackened. The weak demand for business loans stemmed, in part, from a shift of corporate borrowings to open market instruments, especially commercial paper. This, in turn, reflected a lagged response to the sharp declines in late September in short-term interest rates relative to banks' prime lending rates. During the fourth quarter, most short-term interest rates fluctuated over a broad range but showed no discernible trend. In contrast, movements in intermediate-term and long-term interest rates were mild. New corporate bond offerings, however, were significantly higher in the fourth quarter than in the first nine months of the year, and new issue activity is increasing further in the early months of 1974.

Following a three-month period of restrained growth, deposits at thrift institutions increased at a moderate rate in the fourth quarter. Deposit inflows were stimulated by the sharp September declines in rates on several competitive market instruments as well as by changes in regulations which allowed these institutions to increase their issuance of long-term consumer-type certificates of deposit.

THE MONETARY AGGREGATES

M_1—private demand deposits adjusted plus currency outside commercial banks—advanced in the fourth quarter at a seasonally adjusted annual rate of 7.5 percent, following a decline of 0.2 percent in the preceding three-month period (see Chart I). Some of the fourth-quarter gain can be explained by policy actions taken during the early part of the period that were designed to step up the growth in the money stock to a moderate pace. The strenghtening of the dollar in foreign exchange markets contributed to the advance, since it led to higher foreign central bank balances at the Federal Reserve Banks and expanded foreign bank demand deposit holdings at commercial banks. An increase in precautionary demand for cash balances, stimulated by uncertainties concerning the energy situation and employment, may also have played a role.

For 1973 as a whole, M_1 is now estimated to have grown by 5.7 percent, compared with an increase of 8.7 percent in 1972. These data reflect the latest annual revisions of the money stock figures, which boosted the growth in M_1 over what was previously reported by 0.4 percentage point in 1972 and 0.7 percentage point in 1973. The revisions included the annual reestimates of seasonal adjustment factors and also incorporated data from new monthly reports filed by internationally oriented banking institutions. The principal changes, however, resulted from upward adjustments of the estimates of demand deposits at nonmember domestic banks. Because deposits at such institutions are not available on a current basis, they are estimated initially from data for "country" member banks. Estimates are adjusted annually to incorporate figures reported by nonmember banks on call dates. In the current revision, nonmember domestic bank estimates were "benchmarked" to the March and October 1973 call reports in addition to the usual June and December calls. This was the first year since the early 1960's that call report data appropriate for money supply bench marks were available for the spring and fall call dates. The Board of Governors of the Federal Reserve System noted that the current revisions incorporating the largest nonmember bench-mark adjustments in the history of the series point up the serious need for more timely and more complete nonmember bank data.

M_2—defined as M_1 plus time deposits other than large CDs—expanded in the fourth quarter at a seasonally adjusted annual rate of 10.1 percent, substantially higher than the 5.2 percent rate of increase experienced in the previous quarter. The acceleration was primarily attributable to the sharp rise in currency and demand deposits; the time deposit component advanced at only a slightly faster pace than in the preceding three-month period. According to the revised data, M_2 is estimated to have increased 8.6 percent in 1973, up 0.7 percentage point from the figure previously reported. New bench-mark levels for nonmember banks led to upward revisions of the time deposit component similar in magnitude to the corresponding adjustments of the demand deposit component.

Contrary to the behavior of the money supply measures, the adjusted bank credit proxy—member bank deposits subject to reserve requirements plus certain nondeposit liabilities—rose at a relatively slow pace in the fourth quarter. After adjustments for seasonal variations, the proxy grew at an annual rate of only 3.3 percent. For the year as a whole, however, it increased 10.6 percent, 1 percentage point below the growth experienced in 1972.

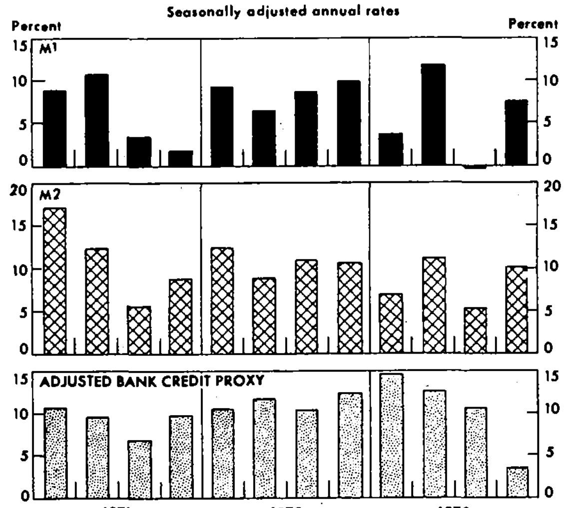
The slow growth of the proxy during the fourth quarter reflected primarily a sharp decline in CDs. Earlier in the year, CDs had risen very rapidly as banks aggressively sought funds to finance a strong demand for business loans. During the fourth quarter, however, business loan demand was weak and banks tempered their CD sales efforts. Moreover, CDs had become an increasingly expensive source of bank funds. Effective early in June, the Board of Governors had imposed a supplemental reserve requirement of 3 percent, in addition to the existing 5 percent requirement, on CDs and certain other bank liabilities above their mid-May base levels, and subsequently had raised the new requirement an additional 3 percentage points effective mid-September. These moves were intended to help curb the rapid expansion of bank credit. During the fourth quarter, the growth of bank credit turned very sluggish and, effective December 13, the supplemental reserve requirement was lowered back to 3 percent.

Reserves available to support private nonbank deposits (RPD) grew very slowly in the fourth quarter in conformity with the behavior of the credit proxy. After adjustments for normal seasonal variations and the effects of changes in reserve requirements, the annual rate of increase amounted to only 1.4 percent. The volume of borrowed reserves declined by $563 million over the quarter, as the Federal Reserve supplied nonborrowed reserves more readily in relation to deposit growth.

Chart I

GROWTH 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.

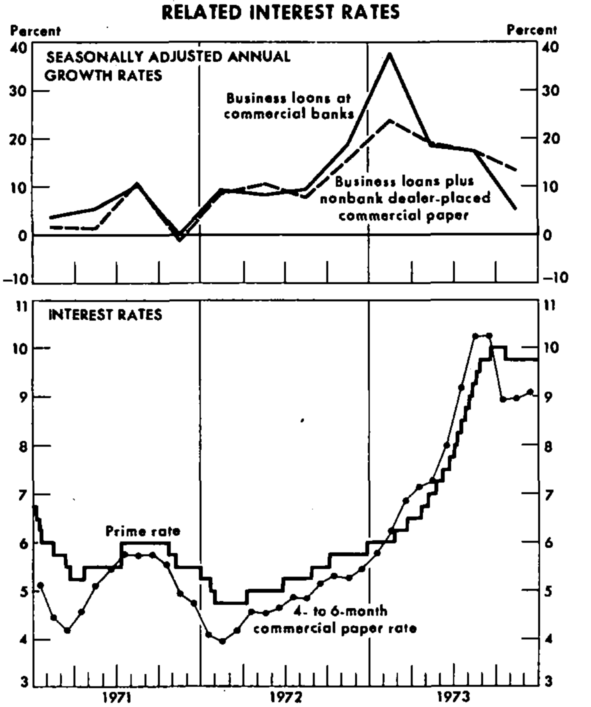
BANK CREDIT, INTEREST RATES, AND THE CAPITAL MARKETS

The rate of growth in total bank credit fell sharply during the October-December period. When adjusted for net loan sales to affiliates, bank credit increased at only a 4.4 percent seasonally adjusted annual rate, compared with a 15.2 percent annual rate in the first nine months of the year. Banks continued to make only modest additions to their securities holdings. Total loans, however, which had expanded rapidly during the first nine months of 1973, advanced at the slowest rate in three years. Virtually all the major loan components registered somewhat smaller gains, or larger declines, than earlier in the year, but business loans were particularly sluggish.

During the first three quarters of 1973, business loans had increased very rapidly (see Chart II). In part, this reflected strong demands for funds brought on by the heady economic expansion and the acceleration in the rate of inflation. To some extent, however, the increase represented merely a redirection of business borrowings to banks from other credit sources, particularly the commercial paper market. Interest rates on commercial paper rose sharply from January through August, along with other short-term market rates. However, because banks were restricted by the Committee on Interest and Dividends

Chart II

SHORT-TERM BUSINESS BORROWINGS AND RELATED INTEREST RATES



Note: Business loans are adjusted for loans sold to affiliates. Yields on 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.

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

from raising their lending rates to large business borrowers too rapidly, the prime rate did not keep pace. For example, the rate on four- to six-month prime dealer-placed commercial paper averaged about 30 basis points above the prime rate during the February-August period (see Chart II). This contrasted with the usual relationship during recent years when the commercial paper rate had averaged about 50 basis points below the prime rate. Consequently, the volume of nonbank dealer-placed commercial paper fell by $3.9 billion over the first quarter, and then remained essentially flat through August. Meanwhile, the volume of business loans at commercial banks surged, spurting during the first quarter and continuing to rise rapidly for the next five months. Over the January-August period as a whole, business loans adjusted for loan sales to affiliates rose at a seasonally adjusted annual rate of 28.7 percent.

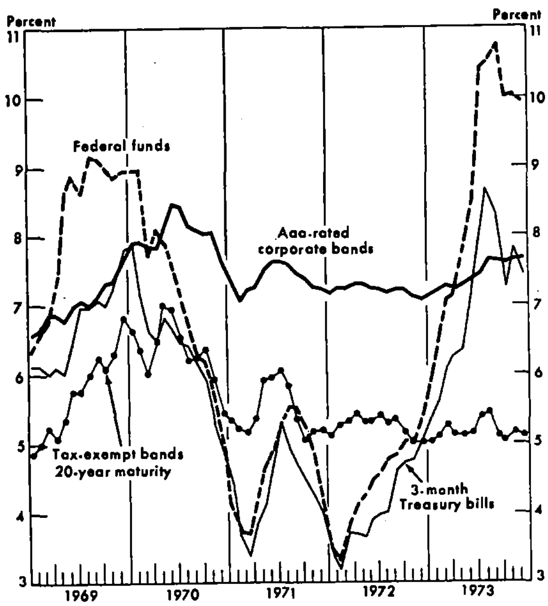
In September, credit markets began to ease. Late that month, rates on commercial paper started to fall, moving below the prime rate for the first time since February. In mid-October, most major banks reduced their prime lending rates from 10 percent to 9¾ percent, retaining that rate for the remainder of the quarter, although several boosted their rates back to 10 percent early in December. Over most of the period from late September through December, the more usual relationship between the prime rate and commercial paper rate prevailed, and corporations returned to the commercial paper market to finance their short-term borrowing needs. Reflecting these developments, the volume of commercial paper rose $4.6 billion from the end of August to the end of November. In December, however, there was a small decline, presumably indicating that most of the switch back to commercial paper had been completed in the prior month. During these last four months of the year, business loans at commercial banks increased at a seasonally adjusted annual rate of only 4.6 percent.

Several other major loan components of bank credit, including consumer loans and real estate loans, also grew less rapidly in the fourth quarter than earlier in the year. Securities loans fell sharply, continuing the trend set in the preceding three quarters. Decreased loans to brokers, reflecting the rundown in their margin stock accounts, undoubtedly played a major part in the year-long slump in securities loans. Total margin credit to customers, which is financed in part by bank loans to brokers, declined about 30 percent in 1973. In recognition of the sharp reduction in stock market credit, the Board of Governors lowered its margin requirements for purchasing or carrying stocks from 65 percent to 50 percent, effective January 3, 1974.

Most short-term interest rates moved irregularly over the fourth quarter, after falling dramatically in the last half of September. The Federal funds rate, however, declined about 75 basis points to 10 percent in mid-October, and then hovered around that level for the remainder of the period (see Chart III). Intermediate-term and long-term interest rates fluctuated in a very narrow range throughout the quarter, despite a sharp increase in new bond offerings. In the corporate market, public and private placements, seasonally adjusted, totaled $7.1 billion, considerably above the January-September quarterly average of $5.1 billion. New corporate bond issues in January amounted to one of the largest monthly totals in nearly three years, and the calendar of issues scheduled for February is about as heavy. State and local government bond issues also increased in the fourth quarter of 1973, to $6.2 billion, seasonally adjusted, up from an average volume of $5.6 billion during the first three quarters. Federal agency offerings, on the other hand, declined slightly over the quarter, reflecting the improved financial position of thrift

Chart III

SELECTED INTEREST RATES



Note: Rates for Federal funds (effective rate) and three-month Treasury bills (market yield) are monthly averages of daily figures. Yields on Aaa-rated corporate and twenty-year tax-exempt bonds are monthly averages of weekly figures.

Sources: Board of Governors of the Federal Reserve System, Moody's Investors Service, Inc., and The Bond Buyer.

institutions. Nevertheless, the $5.9 billion total of new Federal agency issues was about $2½ billion greater than in the final quarter of 1972.

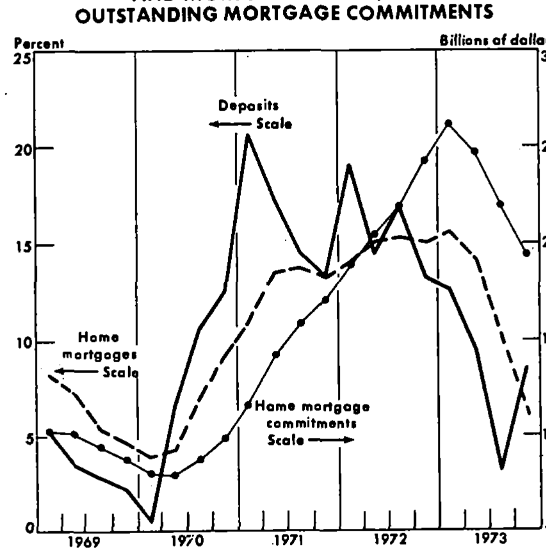
THRIFT INSTITUTIONS

Deposit flows into thrift institutions showed a marked recovery in the fourth quarter of 1973 (see Chart IV). Combined deposits at savings and loan associations and mutual savings banks advanced at a seasonally adjusted annual rate of 8 percent, following a gain of only 3 percent during the preceding three-month period. The increased thrift deposit inflows reflected, in part, a delayed response to the declines in late September in interest rates on competing market instruments, particularly Treasury bills. Moreover, thrift institutions benefited from changes in the regulations on consumer-type certificates of deposit with maturities of four years or more. The previous modification of regulations in July 1973, which had permitted the introduction of no-interest-rate-ceiling "wild card" deposits by banks and thrift institutions, had resulted in intense competition. The situation became acute in September when many thrift institutions—particularly mutual savings banks—reached the legal limits on the amounts of these deposits that they could offer (5 percent of total deposit liabilities at insured commercial banks, savings banks, and savings and loan associations, with an additional 5 percent allowed at savings and loan associations for certificates issued by September 7 and subsequently renewed). New regulations, effective November 1, removed all restrictions on the volume of these consumer-type certificates that may be issued and imposed interest rate ceilings on such certificates of 7.50 percent for thrift institutions and 7.25 percent for commercial banks.

Reflecting the improved performance of deposit flows in the fourth quarter, thrift institutions increased their liquid asset holdings and sharply reduced their rate of borrowing. Net Federal Home Loan Bank Board advances to savings and loan associations, for example, rose $841 million during the October-December period as compared with an increase of about $3 billion in the preceding quarter. The growth in mortgages held by thrift institutions, however, as well as commitments by these institutions to make new mortgage loans, continued to slacken.

Chart IV

GROWTH IN THRIFT INSTITUTION DEPOSITS AND MORTGAGE LOANS, AND OUTSTANDING MORTGAGE COMMITMENTS



Note: Growth in thrift institution deposits and home mortgage loans are expressed at seasonally adjusted annual rates.

Sources: Federal Home Loan Bank Board and National Association of Mutual Savings Banks.