Monetary and Financial Developments in the Second Quarter

Interest rates on all forms of private debt instruments moved substantially higher during the second quarter. Yields on short-term Government securities declined, however, and the rates on intermediate- and long-term Government obligations changed very little. Firm monetary policy, together with inflationary expectations and a continuing high demand for business loans, pressed most interest rates upward throughout the quarter. Yields received an added boost during the second half of the period from the successive announcements that a large commercial bank had sustained heavy financial losses and that a major utility company was experiencing liquidity difficulties and was omitting a dividend payment. For the period as a whole, the yield on four- to six-month commercial paper rose 2½ percentage points, and the prime rate at most commercial banks reached 11¾ percent by the end of June. In contrast, the return on three-month Treasury bills registered a moderate decline, as investors appeared willing to surrender a substantial yield advantage for the added safety of Government obligations. During the last week of April, the twelve Federal Reserve Banks increased the discount rate on member bank borrowings by ½ percentage point to a record 8 percent.

Despite rising interest rates, the monetary aggregates continued to expand rapidly during the April-June period. The narrowly defined money stock (M_1) grew at a seasonally adjusted annual rate of 7 percent, only slightly below the gain experienced in the first quarter but still excessive. The more broadly defined money stock (M_2) grew at a 7.8 percent annual rate during the second quarter, off somewhat from the pace of the first quarter. The volume of large certificates of deposit (CDs) expanded very rapidly, and consequently the growth rate of the bank credit proxy accelerated.

Commercial banks continued to extend huge amounts of credit to their corporate customers during the second quarter, as business loan demand showed persistent strength. The volume of business loans outstanding advanced at a 23 percent annual rate over the period, while total bank credit grew at a rate of 11.5 percent. Deposits at thrift institutions expanded at a very modest rate during the quarter. Mortgage loans, however, continued expanding at nearly their first-quarter rate, but new loan commitments, in reaction to the weaker deposit inflows and record high interest rates, were off sharply from their level at the end of March.

THE MONETARY AGGREGATES

M_1—private demand deposits adjusted plus currency outside commercial banks—grew at a 7 percent seasonally adjusted annual rate during the second quarter (see Chart I). This pace was slightly slower than during the first quarter* and brought monetary growth for the first half of 1974 to a 7.1 percent rate. Some of the expansion of M_1 in the second quarter was provided by currency, which increased at an 8.8 percent annual rate. Increases in currency often reflect a larger dollar value of ordinary household expenditures on nondurable goods and services, which typically are paid for with cash. These expenditures have been increasing rapidly for the past several quarters, in part because of rising food prices.

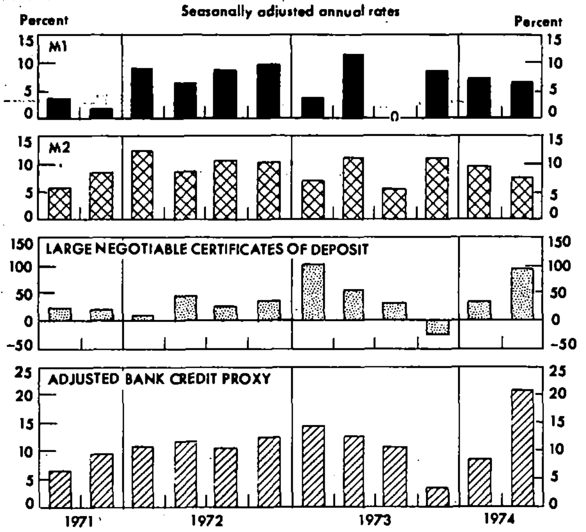
During the quarter, the Board of Governors began to publish the short-run numerical specifications that guide open market operations in the period between Federal Open Market Committee (FOMC) meetings, along with the policy records of the meetings. The policy records continue to be published with a three-month lag, and hence publication of the numerical specifications involves a similar lag. At the FOMC meeting of April 15-16, the most recent meeting for which notes are publicly available, the Committee concluded that the economic situation and

*In May, the Board of Governors of the Federal Reserve System announced revisions of the money stock measures to incorporate data on nonmember bank deposits obtained from the December call reports and recent data on deposits of domestic agencies and branches of foreign banks. The revisions boosted the growth of seasonally adjusted M_1 over that previously reported by 0.4 percentage point in the first quarter to 7.1 percent at an annual rate and 1.4 percentage points in the fourth quarter of 1973 to 8.9 percent. Similar upward adjustments were announced for the growth of M_2.

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.

outlook continued to call for moderate growth in monetary and credit aggregates over the long run. However, the desired long-run growth rate of M_1 was revised upward slightly since staff analysis suggested that attainment of the previous goal would likely involve sizable declines in net inflows of deposits to banks and nonbank thrift institutions. Staff analysis also indicated that progress toward achieving the Committee's long-run objectives could be achieved even if rates of expansion of M_1 in the short run were temporarily high, and it was decided to aim for a 3 percent to 7 percent growth of M_1 during the April-May period.

M_2—defined as M_1 plus time and savings deposits other than large CDs at commercial banks—grew at a fairly rapid 7.8 percent seasonally adjusted annual rate during the quarter. This was 2.1 percentage points slower than it grew during the first quarter of this year and 3.3 percent off the pace of the second quarter of 1973. The time and savings component of M_2 advanced at an 8.5 percent rate, which—while below the 12.5 percent pace of the first quarter—was still quite rapid for a period of high market interest rates. The continued rapid growth of the time deposit component of M_2 may reflect increases in nonnegotiable large CDs at weekly reporting banks and large negotiable and nonnegotiable CDs at other banks which are currently included in M_2.

The adjusted bank credit proxy—total member bank deposits subject to reserve requirements plus certain nondeposit liabilities—rose at approximately a 21 percent annual rate during the April-June period. This rapid advance resulted from a very large increase in the volume of CDs outstanding; CDs grew at nearly a 92 percent annual rate in the second quarter. Attempting to satisfy the expanding demand for loans, commercial banks competed actively for CDs and, except for a short period in early June, they succeeded in attracting sizable amounts of funds. These funds came at the price of a higher interest rate, however, and by the end of June the yield on CDs in the secondary market increased to over 12 percent.

Total bank reserves rose at a 20.3 percent annual rate during the second quarter. Member bank borrowings from the Federal Reserve reached a record high of \$2.4 billion; however, much of this increase was the result of loans to Franklin National Bank. RPD—reserves available to support private deposits—increased at a 20.3 percent rate, substantially above the 6.2 percent rate of the first quarter.

INTEREST RATES, BANK CREDIT, AND THE CAPITAL MARKETS

Interest rate movements throughout the second quarter were largely dominated by a combination of inflationary expectations, restrictive monetary policy, and continued strong demand for business loans. Under these influences, most short-term interest rates rose steadily until the second week of May, at which time they leveled off somewhat. However, late in May the cumulative effects of the omission of a dividend payment by Consolidated Edison Company, the announcement of financial losses at Franklin National Bank, and reports that several foreign commercial banks were also experiencing financial difficulties added a strong note of uncertainty. The influence of these events, in conjunction with already existing market pressures, forced interest rates on most private debt instruments sharply upward, and by the end of the quarter many rates reached record levels (see Chart II). Among them was the effective rate on Federal funds which averaged 11.97 percent in the final week of June, up 236 basis points from its average in the final week of March. Secondary rates on CDs with three months' maturity and offering rates on 90- to 119-day commercial paper also rose to record highs, increasing over the quarter by about 2.5 percentage points. At the same time, commercial banks raised their prime lending rates for large business borrowers in ten ¼ percentage point steps to a record level of 11¾ percent.

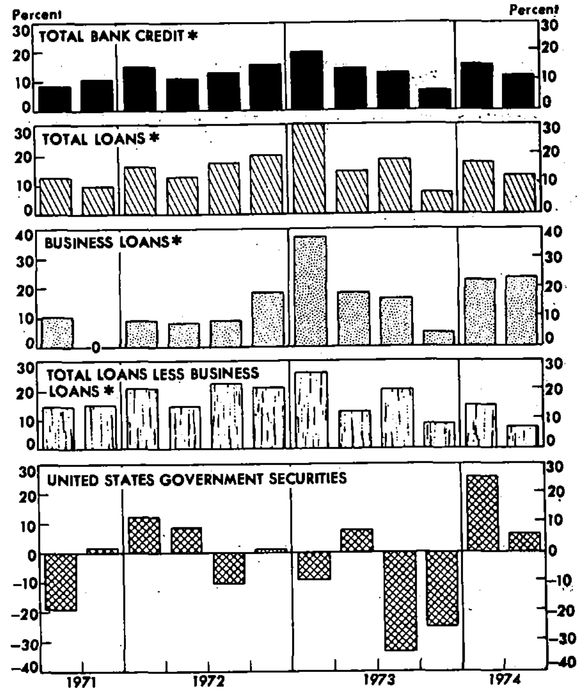
In the capital markets, yields on corporate bonds rose fairly steadily throughout April and May and then the advance accelerated in June. The volume of new issues was quite heavy, but in the early weeks of the quarter investor demand was forthcoming as yields increased. The situation changed noticeably after the middle of May, however, and the market became appreciably tighter. The announcement of Consolidated Edison's dividend cancellation sharply intensified the concern over the financial health of many firms in the utility industry. The pessimistic tone spread to other industries, as rising short-term interest rates led some market observers to question the liquidity of many firms. Consequently, as the period drew to a close, investors resisted long-term commitments to all but the highest quality borrowers. The rates on lower quality issues rose to the point where, in several instances, borrowers found them unacceptable and sales were either postponed or canceled. By the end of the quarter, rates on recently offered utility bonds—as measured by the Federal Reserve Board's index—had risen 115 basis points to a record 9.82 percent and the increases were somewhat larger on intermediate quality issues. New offerings in the tax-exempt sector met good receptions throughout most of the quarter, albeit at rising interest rates. However, by mid-June the effects of general market uncertainty and the large volume of new offerings had raised rates to levels at which some offerings were canceled because the available terms exceeded legal interest rate ceilings. Over the period as a whole, The Bond Buyer index rose 76 basis points to 6.33 percent.

In contrast to the movement of rates on private debt instruments, rates on short-term Treasury securities declined during the quarter while yields on longer term issues changed little. As a consequence, an unusually wide spread developed between rates on Treasury obligations, particularly bills, and other market instruments. In the last half of June, for example, the rate on three-month bills averaged more than 4 percentage points below rates available on CDs and commercial paper with the same maturity. By comparison, the spread between rates on these instruments averaged less than 1½ percentage points

Chart III

CHANGES IN BANK CREDIT AND ITS COMPONENTS

Seasonally adjusted annual rates

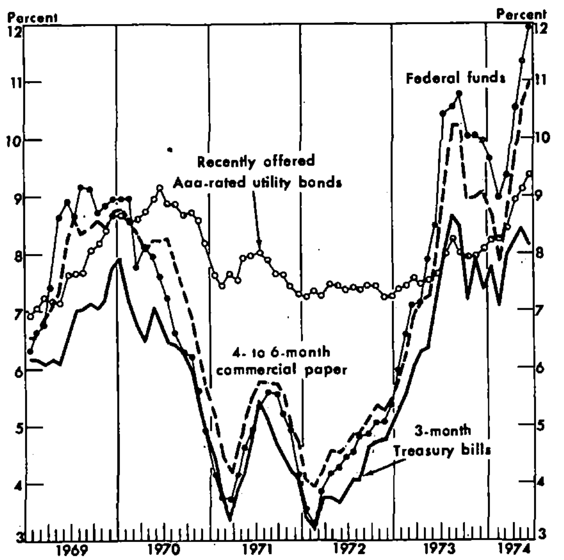


* Adjusted for loans sold to affiliates.

Source: Board of Governors of the Federal Reserve System.

Chart II

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 recently offered Aaa-rated utility and four- to six-month commercial paper are monthly averages of weekly figures.

Source: Board of Governors of the Federal Reserve System.

in 1973. In part, this wide spread in rates was attributable to heavy foreign central bank purchases of bills during the quarter, but it also reflected increased investor preference for the additional security of Government obligations in response to the liquidity problems that had come to light.

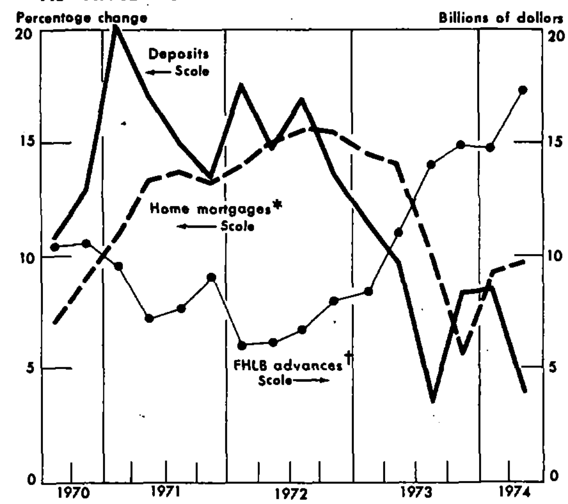
The pace of bank credit expansion moderated somewhat during the second quarter to a still strong 11.5 percent annual rate, down from the 15.9 percent rate of advance of the first quarter. The business loan component of bank credit, adjusted for loan sales to bank affiliates and seasonal variation, continued to advance at a very brisk 23 percent rate, however. The more moderate growth of total bank credit reflected mostly the easing of loans other than business loans (see Chart III).

The April-June period marked the second consecutive quarter of extremely rapid expansion of business loans, after the relatively sluggish experience of the fourth quarter of 1973. Inflation and inventory accumulation were again strong motivating forces behind the demand for loans. However, loan demand reflected also the financing needs of utility companies that experienced imbalances in their flows of funds, as revenues lagged behind rising operating costs. Some loan demand also came from firms in the resource industries that acquired leases on oil-producing properties late in May. Since resource firms and utility companies tend to borrow from money center banks in New York and Chicago, loans were concentrated at banks in these areas. In addition, there were reports that regional banks experienced difficulty in acquiring funds through CDs, and this may have contributed further to a concentration of business loans at money center banks.

Nonfinancial corporations tapped the commercial paper market for substantial amounts of funds during most of the second quarter. Market participants frequently expressed concern over the general state of corporate liquidity, and there was added emphasis on quality paper. For the quarter as a whole, the outstanding volume of nonbank-related, dealer-placed commercial paper increased by approximately $385 million.

Chart IV

DEPOSITS AND MORTGAGES AT THRIFT INSTITUTIONS AND ADVANCES TO SAVINGS AND LOAN ASSOCIATIONS



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

* Mutual savings bank mortgages for the second quarter of 1974 are based on April and May data.

† Advances represent short-term loans from the Federal Home Loan Banks to savings and loan associations.

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

THRIFT INSTITUTIONS

Reflecting the rise in interest rates on most competing market instruments, deposit growth at thrift institutions was sharply reduced during the second quarter. For the April-June period, the rate of expansion of combined deposits at savings and loan associations and mutual savings banks fell to a 4 percent seasonally adjusted annual rate from an average of 8.5 percent during the two immediately preceding quarters. Mutual savings banks were hit harder than savings and loan associations, experiencing deposit growth at only a 1 percent rate over the quarter and net deposit outflows during the month of May. The volume of mortgages at thrift institutions, however, did not show the effects of the decline in deposit growth (see Chart IV). Mortgage expansion at savings and loan associations proceeded at a 9.9 percent annual rate, compared with 10.6 percent during the first quarter. At mutual savings banks, mortgages grew at a 5.4 percent rate during April and May, only slightly below the 5.5 percent pace of the first quarter.

As a means of financing mortgage demand, thrift institutions reduced their liquid asset holdings, and savings and loan associations increased their borrowing from the Federal Home Loan Banks to $17.5 billion. The mortgage advance was accompanied by rising interest rates; by the end of June, the average effective rate on conventional mortgages, as measured by the Federal Home Loan Bank Board, had reached a record level of 8.84 percent. In reaction to the high interest rates and the reduced deposit inflows, mortgage commitments at thrift institutions declined sharply during the quarter.