Monetary and Financial Developments in the Third Quarter

Long-term yields rose on balance over the third quarter, but most short-term interest rates closed lower after increasing in the early part of the interval. As the quarter began, rates moved up in response to Federal Reserve pressure on bank reserve positions, continued strong demand for funds, inflationary anticipations, and expectations that the Federal Reserve System would continue to pursue a restrictive policy. Private short-term rates rose to record peaks, before stabilizing in mid-July and August. Yields in the Treasury bill market did not rise immediately, as participants in that market awaited foreign demand. When such demand did not materialize and the supply of bills increased in August, Treasury bill yields also increased to record highs.

In September, several developments caused a turnaround in rates. Market participants interpreted declines in the Federal funds rate as indicative that an easing of monetary policy was in progress. A reduction in the marginal reserve requirement on large-denomination certificates of deposit (CDs) having maturity of more than four months was taken also as a sign that policy was becoming less stringent. Expectations that such an easing would continue emerged in light of reports that industrial production was sluggish and the growth of the monetary aggregates had decelerated sharply. In addition, business loan demand for short-term funds was modest in September, after having been exceptionally strong over the first eight months of the year. In the Treasury bill market, strong demand from foreign sources and individual investors emerged and the supply of bills was curtailed by the Treasury. As a result, rates in the short-term debt markets plummeted to close below their end-of-June levels. The overall decline of rates extended to the intermediate portion of the Government securities market. Interest rates on long-term Government securities also dropped significantly from the peaks attained in August, although they closed above their end-of-June levels.

In the corporate and municipal bond markets, yields generally rose over the quarter, with peaks being established in late August and early September. Investors continued to prefer high-quality debt issues and those with shorter maturities. Equity values were buffeted during the quarter by concern over inflation and by investor pessimism and uncertainty regarding the future course of the economy. Measured by the major indexes, stock prices fell about 25 percent during the quarter in moderate trading. Margin credit outstanding fell to its lowest level since early 1971.

Partially in response to the increase in money market rates in preceding months, the growth of the monetary aggregates slowed considerably. The narrow money stock (M_1) grew about 2 percent in the third quarter, after having grown at a rate of 6.4 percent over the preceding three-month period. As a result of the deceleration of M_1 growth, the growth of the broad money stock (M_2) slowed considerably despite only a slight reduction in the rate of advance of its time deposit component. High interest rates and a moderation of the demand for loans caused banks to compete less aggressively for funds in the market for large-denomination CDs. As a result, the growth of CDs slowed sharply from the explosive rate of expansion of the second quarter, thereby prompting a pronounced decline in the growth of the adjusted bank credit proxy. The rate of advance of bank credit dropped substantially in the second quarter, largely as a result of the absence of any increase in bank loans during September and substantial liquidations throughout the quarter of United States Treasury obligations.

Thrift institution deposit growth decelerated further in the third quarter from the already slow pace established in the first half of the year. Deposit flows were adversely affected by keen interest in the Treasury's August refunding operation and the attractiveness of floating-rate securities offered during the quarter. As deposit flows slowed, thrift institutions reduced the volume of their outstanding mortgage commitments to its lowest seasonally adjusted level since June 1971. Actual mortgage disbursements fell sharply, reflecting earlier declines in mortgage commitments.

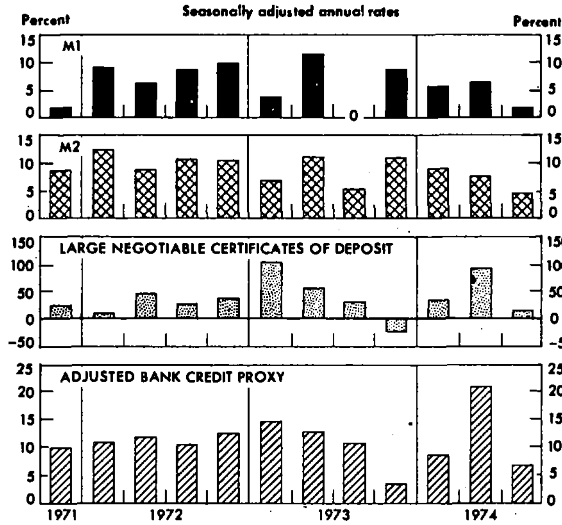
MONETARY AGGREGATES

Growth in the money stock measures decelerated sharply during the July-September period. M_1—private demand deposits adjusted plus currency outside commercial banks—advanced at a seasonally adjusted annual rate of 2.1 percent, down from the 6 percent rate of increase experienced during the first half of the year (see Chart I). This brought the growth of M_1 in the nine-month interval ended September to a 4.8 percent annual rate, in contrast to gains in 1973 and 1972 as a whole of 6.1 percent and 8.7 percent, respectively. The growth of M_2—which adds to M_1 time deposits at commercial banks less large negotiable CDs—also slowed in the third quarter to a 4.9 percent seasonally adjusted rate. Over the first nine months of this year, M_2 rose at an annual rate of 7.3 percent, compared with 8.9 percent in all of 1973.

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.

The slowdown in the growth of the money stock measures during the third quarter resulted, in part, from a lagged response to the sharp increase in interest rates in preceding months. This, in turn, partly reflected System efforts to moderate the growth of the monetary aggregates in view of the fairly rapid expansion experienced during the first half of the year. The slowdown, however, was evidently sharper than desired. For example, at the Federal Open Market Committee meeting of July 16, the most recent meeting for which policy records are publicly available, the Committee adopted a range of tolerance for the growth of M_1 over the July-August period of 2 to 6 percent at a seasonally adjusted annual rate.* The actual M_1 growth rate of 2.1 percent during this period was thus at the bottom end of the tolerance range, and growth remained quite slow in September.

Banks competed less aggressively for funds in the market for large negotiable CDs during the third quarter. Seasonally adjusted, the volume of outstanding CDs rose $2.7 billion, compared with an increase of $15.6 billion in the second quarter. This development notwithstanding, on a seasonally adjusted basis the dollar volume of CDs outstanding rose more in the first nine months of 1974 than in any preceding entire year.

On September 4, Regulation D was amended by the Federal Reserve Board to remove the prevailing 3 percent marginal reserve requirement on CDs having a maturity of more than four months. The action was taken in an effort to encourage banks to lengthen the maturity of their liabilities. The regular 5-percent reserve requirement now applies to all CDs, with the marginal 3 percent reserve requirement applying only to CDs having a maturity of less than four months in excess of the amount outstanding in May 1973. The 3 percent marginal reserve requirement does not apply to banks with a combined total of less than $10 million of CDs and bank-related commercial paper outstanding in May 1973.

The slowing of CD growth in the third quarter, coupled with slower demand deposit growth, caused the rate of advance of the adjusted bank credit proxy—member bank deposits subject to reserve requirements plus certain nondeposit liabilities—to slow to a 6.6 percent seasonally adjusted annual rate. It had grown at a rate of 20.9 percent in the second quarter and 8.5 percent in the first quarter. Reserves available to support private nonbank deposits grew at a rate of 8.2 percent during the July-September period, down from 20.3 percent in the second quarter. Member bank borrowings averaged a record $3.3

*At the time of the meeting, M_1 was estimated to have increased over the first half of the year at a seasonally adjusted annual rate of close to 7 percent. A subsequent revision, to reflect new benchmark data for nonmember banks available from the April 1974 call report, reduced the growth of M_1 over this period by almost 1 percentage point.

billion in the third quarter, reflecting a large volume of lending to the now defunct Franklin National Bank. The operations of this bank have been taken over by the European-American Bank & Trust Company, and its indebtedness to the Federal Reserve System has been assumed by the Federal Deposit Insurance Corporation in its role as receiver for the parent Franklin New York Corporation.

BANK CREDIT, INTEREST RATES, AND THE CAPITAL MARKETS

Bank credit grew at a seasonally adjusted annual rate of 4.2 percent during the third quarter, 7½ percentage points below its rate of advance in the quarter ended in June (see Chart II). Throughout the quarter, banks liquidated considerable amounts of United States Treasury obligations while their holdings of other securities remained virtually unchanged. In September the volume of outstanding business loans rose less than 1 percent on a seasonally adjusted annual-rate basis, after having grown 19 percent in July and August. This reflected an overall slowing of loan demand. Some shifting of borrowers to the commercial paper market apparently also took place, as commercial paper rates late in September fell significantly below the 12 percent prime rate which prevailed over almost the entire quarter. Because of these developments, business loans grew at a seasonally adjusted annual rate of 12.9 percent in the quarter, high by broad historical standards but more than 10 percentage points below the rate of advance in the first six months of the year.

The growth in several other categories of commercial bank loans also decelerated in the third quarter. Notably, real estate loans grew at less than half the pace of the second quarter, as housing activity weakened perceptibly in the July-September period. Starts dropped to an average of 1.2 million units during the period on a seasonally adjusted basis, down from 2 million units in 1973. The growth in agricultural loans also slowed considerably. In contrast, consumer loans at banks advanced sharply, since consumers stepped up their borrowings to finance accelerated acquisitions of 1974 automobiles in anticipation of price rises on 1975 models.

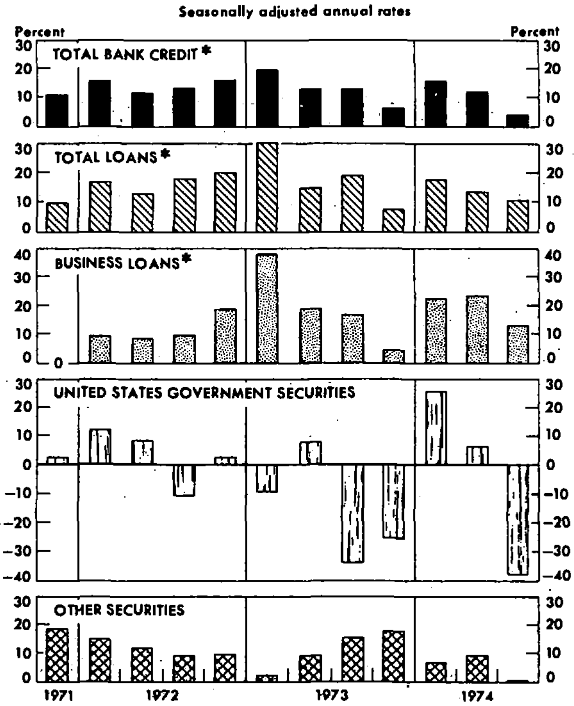
Interest rates on private short-term debt instruments rose sharply at the beginning of the quarter (see Chart III), reflecting investor concern regarding inflation, a highly restrictive monetary posture, and continued strong demand for funds. The historically high prime commercial loan rate of 12 percent became widespread early in July. By the middle of that month, respective record yields of 12.66 percent and 11.95 percent were reached on three-month CDs in the secondary market and prime four- to six-month dealer-placed commercial paper. These latter two rates declined somewhat in late July but rose again in August. In September, the CD rate dropped 1½ percentage points and the four- to six-month commercial paper rate fell 138 basis points from the respective highs reached in July, as the demand for funds receded and investors began to anticipate an easing of monetary policy. The effective rate on Federal funds averaged 11.12 percent in the final statement week of the quarter, 85 basis points below the average effective Federal funds rate in the last statement week of June. Three major banks lowered their prime rate to 11¾ percent by the close of the quarter. Subsequently, a prime rate of 11¼ percent became widespread in late October, with three major banks lowering their prime rate to 11 percent by the end of that month.

In contrast to rates on private short-term credit market instruments, Treasury bill yields displayed no clear pattern in July. They moved sharply upward in August, in part because market participants were disappointed over

Chart II

CHANGES IN BANK CREDIT AND ITS COMPONENTS

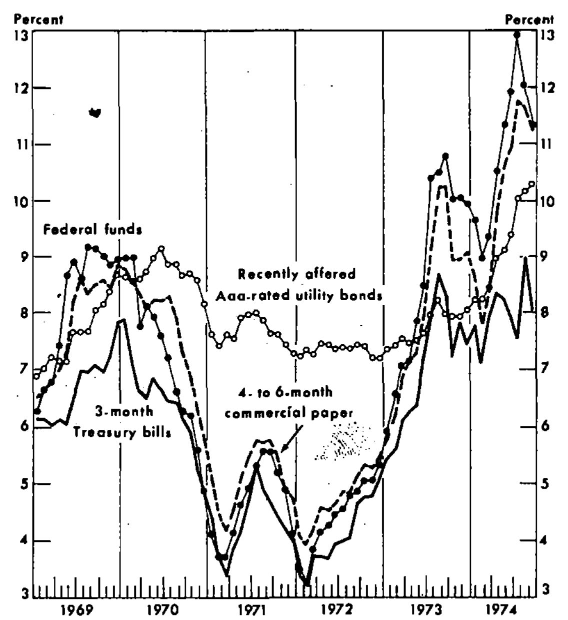
Seasonally adjusted annual rates



*Adjusted for loans sold to affiliates.

Source: Board of Governors of the Federal Reserve System.

Chart 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 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.

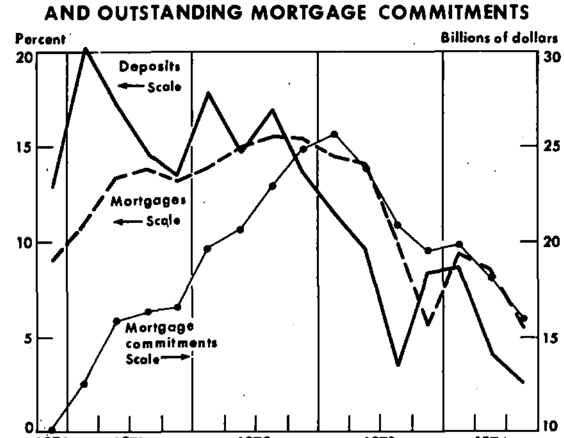
the absence of foreign demand for Treasury obligations and in part because the Treasury borrowed an additional $5.5 billion in the bill market. As a result, the yields on three- and six-month bills rose about 2 percentage points to record highs. Since other money market rates were relatively steady in August, this development narrowed the unusually wide spread between bill yields and other money market yields that had emerged in July. In September, however, bill rates plunged further than other market rates, as the Treasury reduced the supply of bills outstanding by $400 million, a record volume of noncompetitive bids was received at the regular weekly bill auctions, and foreign demand for bills emerged.

Yields in the intermediate portion of the market for Treasury obligations moved in about the same pattern as bill rates. After touching a record peak in late August, the index of yields on three- to five-year Government securities closed the quarter at 8.14 percent, down almost 20 basis points from the end-of-June level. Yields on long-term Government securities, though considerably lower than their August peaks, were up 20 basis points over the quarter as uncertainty regarding inflation inhibited the downward drift of long-term rates.

Interest rates in the tax-exempt and corporate bond markets also rose on balance during the third quarter. Measured by The Bond Buyer twenty-bond index, yields on state and local government obligations rose about 30 basis points over the quarter to 6.62 percent, after touching 6.91 percent in late August. The volume of new tax-exempt offerings was light. A large number of issues were postponed because of statutory interest rate ceilings which precluded the acceptance of any bids received. Many municipalities also postponed issues in anticipation of better market conditions. Reflecting these postponements, the municipal calendar for October and November built up considerably.

In the corporate bond market, concern about the forward calendar worked against any significant decline of rates in September. The yield on recently offered Aaa-rated utility bonds closed the quarter at 10.27 percent, up 45 basis points from the end of June and only 3 basis points below the peak reached in early September. The volume of corporate bond offerings was only slightly lower than during the preceding quarter, as postponements of many utility offerings were largely offset by the addition to the calendar of ten floating-rate note issues. Seven of these issues were offered by bank holding companies. These

Chart IV
DEPOSITS AND MORTGAGES AT THRIFT INSTITUTIONS AND OUTSTANDING MORTGAGE COMMITMENTS



Note: Growth in thrift institution deposits and mortgage loans are expressed at seasonally adjusted annual rates. Mortgage commitments are the sum of the seasonally adjusted levels of mortgage commitments at all savings and loan associations and at mutual savings banks in New York State. Mortgages for the third quarter are based on data available through August.

Sources: Federal Home Loan Bank Board, National Association of Mutual Savings Banks, and Savings Bank Association of New York State.

floating-rate notes generally promised a fixed return for a specified period of time and later a return equal to the three-month Treasury bill rate plus a premium, considerable call protection, and periodic redemption opportunities at par after a specified period of time. The notes gained considerable attention when initially offered, but interest seemed to wane following the success of the first two offerings.

THRIFT INSTITUTIONS AND THE MORTGAGE MARKET

Thrift institution deposit growth slowed to a seasonally adjusted annual rate of 2.6 percent in the third quarter, down 1½ percentage points from the rate of deposit expansion in the second quarter (see Chart IV). The adverse effect of high interest rates upon deposit growth was aggravated by small investor interest in floating-rate notes. Deposit growth was also inhibited by the decline of personal savings in the quarter. Mutual savings bank deposits continued to grow more slowly than savings and loan association deposits. In the nine-month period ended September, mutual savings bank deposits grew at a seasonally adjusted annual rate of 2.2 percent, while savings and loan association deposits grew at a seasonally adjusted annual rate of 6.4 percent. These rates of growth are below those experienced in the latter half of 1973. However, total thrift institution deposits have grown more rapidly this year than during the periods of slow deposit growth in 1966 and 1969.

With deposit flows slowing further, the seasonally adjusted volume of outstanding mortgage commitments at thrift institutions was reduced from $18.1 billion at the end of June to $16 billion at the end of September. The growth of mortgage holdings decelerated substantially during the quarter but still exceeded the growth of deposits. To finance their lending, thrift institutions decreased their liquid asset holdings and increased their borrowings. Savings and loan associations increased their borrowings from the Federal Home Loan Bank (FHLB) system to \$20.5 billion, up \$3.1 billion from the end of June. The constricting effect of slower deposit flows upon mortgage credit availability forced mortgage interest rates to record highs. In September the FHLB Board series on effective rates on new-home conventional mortgages stood at 9.20 percent, up 35 basis points from June.