Monetary and Financial Developments in the First Quarter

Private demands for short-term credit remained sluggish in the first quarter of 1975, while credit availability became more plentiful. As a result, short-term interest rates fell sharply through most of the quarter, although the declines moderated as the period drew to a close. In addition, the monetary authority's restrictions on the banking system eased considerably, and the average effective rate on Federal funds dropped from 8.53 percent in December to 5.54 percent in March, the lowest monthly level since December 1972. Similar declines were registered in rates on commercial paper, bankers' acceptances, large-denomination certificates of deposit (CDs), and on most other money market instruments as well. On three separate occasions during the quarter, the Board of Governors of the Federal Reserve System approved reductions of ½ percentage point in the discount rates charged at the twelve Federal Reserve Banks, and by mid-March the discount rate had reached 6¼ percent. During the quarter the Board also reduced reserve requirements on net demand deposits at member banks by between ½ and 1 percentage point.

In the long-term debt markets, yields fell initially but turned around in late February and by the end of the period were at levels approximately equal to those in early January. Long-term yields were strongly affected by both huge Treasury borrowing during the quarter and the prospects of even heavier borrowing over the remainder of the year. This development encouraged many corporations to advance their financing plans so as to fulfill their foreseeable needs for funds at prevailing interest rate levels. The result was a record quarterly volume of corporate borrowing on top of an unusually heavy Treasury schedule. In the municipal sector, the volume of new borrowing was moderate, but developments in other long-term debt markets put upward pressure on yields over the second half of the quarter. In addition, yields on some tax-exempt securities were affected by the financial difficulties of the New York State Urban Development Corporation and by concern over the financial position of New York City.

The overall growth of the narrowly defined money stock (M_1) remained about as sluggish in the first quarter as it had been in the final quarter of 1974. However, in the last two months of the period, M_1 rose at a relatively rapid pace after declining sharply in January. The further drop in short-term-market interest rates induced substantial increases in consumer-type time deposits at commercial banks during the quarter. Consequently, the more broadly defined money stock (M_2) continued to expand at a faster pace than M_1. Lower market interest rates also resulted in a dramatic increase in deposit flows into thrift institutions during the first quarter. These, however, failed to be reflected fully in mortgage lending, as the growth in both mortgage holdings and commitments outstanding remained modest.

THE MONETARY AGGREGATES

Over the first quarter as a whole, M_1—private demand deposits adjusted plus currency outside commercial banks—advanced at a seasonally adjusted annual rate of 3.5 percent, down slightly from the 4.6 percent gain registered during the preceding three-month period. Growth in M_1 was erratic over the quarter, as it often is over brief periods. In January, M_1 fell at a seasonally adjusted annual rate of 8.9 percent. This was followed by rates of expansion of 6.8 percent in February and 12.7 percent in March. The erratic behavior of M_1 during the quarter mainly reflected sharp changes in the growth of its demand deposit component. The monthly fluctuations in the public's currency holdings followed a pattern similar to that of demand deposits, although the changes were less pronounced.

The growth in consumer-type time deposits at commercial banks accelerated further in the first quarter, as interest rates on competing market instruments continued to decline. Time deposits less large negotiable CDs rose at a seasonally adjusted annual rate of 12.7 percent, up from the 9 percent gain registered in the final quarter of 1974. As a result, the growth in M_2—which includes these deposits plus M_1—also accelerated over the period and remained considerably above the rate of expansion in M_1.

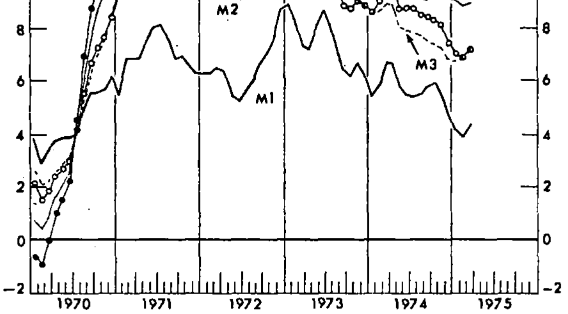
During the quarter, the Board of Governors modified slightly its M_3 measure of money and also added two new money stock concepts to its list of regularly published monetary statistics. The M_3 measure—previously defined as M_2 plus deposits at mutual savings banks and shares at savings and loan associations—now also includes credit union shares. These, however, constitute only a small fraction of the M_3 measure, so that its growth pattern was only slightly affected by the change. For example, in January 1974, the public held credit union shares of \$27.9 billion, or 2.8 percent of M_3. The Board also began computing two additional money concepts which include large negotiable CDs. M_2 plus CDs now constitute the Board's M_4 measure of money, while M_3 plus CDs now comprise M_5.

Abstracting from differences in their long-term trends, movements in the Board's five money stock measures in the past several years have been generally similar (see Chart I). All five measures, for example, advanced at a relatively rapid pace in 1972, but subsequently grew more modestly in both 1973 and 1974. The decline in the rate of expansion of M_1 over these last two years, however, was proportionately greater than that of the broader monetary aggregates.

Chart I

GROWTH OF SELECTED MONETARY AGGREGATES

Seasonally adjusted annual rates



Note: See text for definitions of M1, M2, M3, M4, and M5.
Source: Board of Governors of the Federal Reserve System.

The adjusted bank credit proxy increased relatively slowly in the first quarter of 1975, continuing its performance of the previous three months. This measure, which includes total member bank deposits subject to reserve requirements plus certain nondeposit sources of funds, rose at an annual rate of 3 percent in the January-March interval, following a gain of only 4.2 percent in the preceding three-month period. By way of contrast, during the first nine months of 1974, the proxy rose at an annual rate of more than 10 percent.

A contributing factor to the slow rate of expansion in the credit proxy during the first quarter was the sharp deceleration in the growth of large negotiable CDs. From a seasonally adjusted annual rate of growth of 25.9 percent in the fourth quarter of last year, the volume of CDs outstanding actually declined at a rate of 2.2 percent in the first quarter of 1975. During much of 1974, heavy loan demands on the banking system encouraged banks to bid aggressively for deposit funds and the outstanding volume of CDs rose sharply. With sluggish loan demand in the first quarter of this year, however, banks chose to allow some runoff in CDs by offering relatively low rates on such deposits. Member banks also repayed a considerable amount of borrowing from the Federal Reserve System during the quarter. Such borrowings dropped from \$801 million in December to an average of \$113 million in March.

BANK CREDIT, INTEREST RATES, AND THE CAPITAL MARKETS

Seasonally adjusted total bank credit, including loans sold to affiliates, resumed positive growth in the first quarter after declining in the fourth quarter of last year (see Chart II). The increase, 5.8 percent at an annual rate, was almost entirely attributable to a dramatic increase in investments and to a rise in securities loans. Banks were particularly heavy purchasers of United States Treasury obligations during the first quarter, as they found reserve positions becoming more comfortable and overall loan demand diminishing.

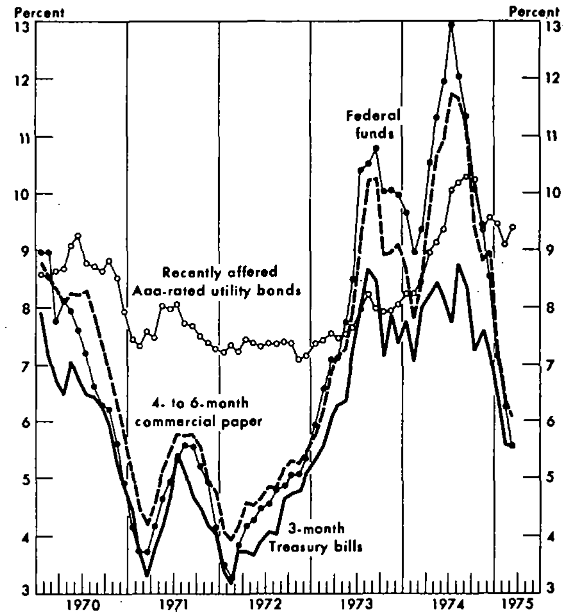
Almost every loan category decreased in the January-March period, and overall loan demand was weak for the second quarter in a row. Business loans at all commercial banks, for instance, fell at a rate of 3.7 percent in the first quarter, in comparison with a decline of 0.7 percent in the fourth quarter of last year. This accelerating decline in business loan volume coincided with the deepening economic slump. Indeed, the only loan category to register a substantial gain was securities loans. As the volume of Treasury borrowing picked up during the quarter and as business loan demand fell off, securities dealers found banks more willing to accommodate their increased credit needs.

With few exceptions, short-term interest rates fell steeply through almost the entire first quarter before leveling off at the end (see Chart III). The rate on 90-day CDs, for example, fell about 3 percentage points over the quarter to close at 6.1 percent. Similar decreases were recorded on many other instruments. However, some rates began to back up around the middle of the quarter, partly as a result of heavy Treasury borrowing. Such a pattern was evident in Treasury bill rates. After falling 136 basis points from the end of December to mid-February, the rate on one-year bills subsequently proceeded to rise by 51 basis points to close the quarter at 5.89 percent. A similar but less pronounced end-of-quarter rise was exhibited by shorter term bill rates.

Reductions in commercial bank prime lending rates during the first quarter followed the decline in other money market rates with a substantial lag. As a result, unusually large spreads developed between the prime rates and other short-term rates. By the end of January, for example, the prime rates being quoted by most of the major banks exceeded the rates on commercial paper by almost 3 percentage points, very high by historical standards. This gap, which narrowed somewhat to around 1⅜ percentage points by the end of the quarter, induced a considerable degree of switching of corporate borrowing from banks to the commercial paper market. By the end of the quarter, most major banks were quoting prime rates of between 7¼ percent and 7¾ percent, down from the range of 10¼ to 10½ percent at the close of 1974. By way of comparison, the rate on 90- to 119-day commercial paper fell steadily from 9⅜ percent at the end of December to 6⅛ percent at the end of March.

Chart III

SELECTED INTEREST RATES



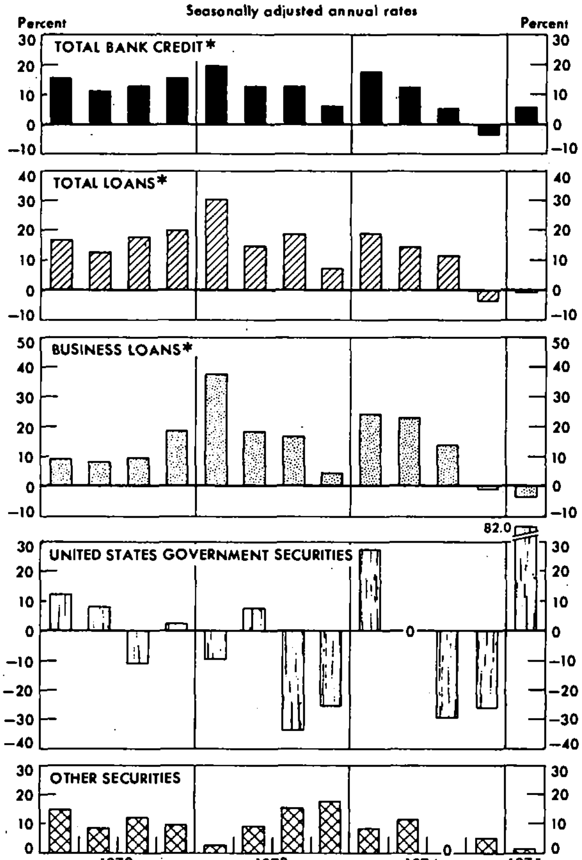
Note: Rates for Federal funds (effective rate) and three-month Treasury bills (market yield) are monthly averages of daily figures. Yields on recently offered Aaa-rated utility bonds and four- to six-month commercial paper are monthly averages of weekly figures.

Source: Board of Governors of the Federal Reserve System.

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.

Intermediate- and long-term interest rates fell during the first half of the quarter before moving upward sharply in March. A contributing factor to this reversal was new Treasury borrowing during the quarter of $11.2 billion in coupon issues. In addition, the continued reevaluation during the quarter of Treasury borrowing needs over the course of the year was a source of concern. Investor apprehension about the size of these needs coupled with a heavy corporate calendar, as firms rushed to float new debt issues at attractive yields, contributed to the rise in long-term interest rates. The index of yields on three- to five-year Treasury securities, for example, fell about 60 basis points from the end of December to late February and then rose 57 basis points, closing the quarter at 7.25 percent. A similar pattern was evident in yields on longer term obligations as well. In the corporate market the estimated total of public and private placements, seasonally adjusted, was around $14 billion in the first quarter, a new record. New corporate bond issues in January amounted to the highest monthly total in almost four years. Volume records were set despite a significant number of postponements late in the quarter resulting from the rapid rise in long-term yields. The volume of Federal agency offerings declined somewhat over the first quarter, reflecting the improved financial position of thrift institutions. The $3.6 billion of new Federal agency issues was well below the quarterly average volume of $6.2 billion in 1974.

The market for municipals was buffeted by two significant developments during the quarter. In February the New York State Urban Development Corporation (UDC) was unable to redeem $104.5 million in maturing short-term notes. The failure to carry out its financial responsibilities with regard to these issues generated substantial doubt in the market concerning the status of "moral obligation" bonds. Moral obligation bonds are basically revenue bonds that carry a tacit assurance by a political subdivision that the issuing authority's obligations to the bondholders will be met. This event precipitated an increase in yields on outstanding moral obligation issues as investors became somewhat more wary of such issues. New flotations of moral obligation bonds were made more difficult by the increased investor apprehension. In addition, the continuing budget problems of New York City were another source of concern in the municipal market. The UDC difficulties could not help but focus renewed investor attention on the city's problems as the city continued to approach the market with sizable short-term offerings. By March the city was forced to pay a rate of 8.69 percent for $537 million of bond anticipation notes, the highest rate ever paid by the city for such borrowing. Later in the quarter, however, the city announced a reduced short-term borrowing schedule, which in turn contributed to a more constructive market atmosphere.

The volume of tax-exempt bond offerings in the first quarter rose to $6.5 billion, up from the quarterly average volume of $5.7 billion in 1974. Yields in this market behaved much like those in the other long-term markets, as The Bond Buyer index fell 81 basis points in the first half of the quarter before rising 68 basis points to end the quarter at 6.95 percent.

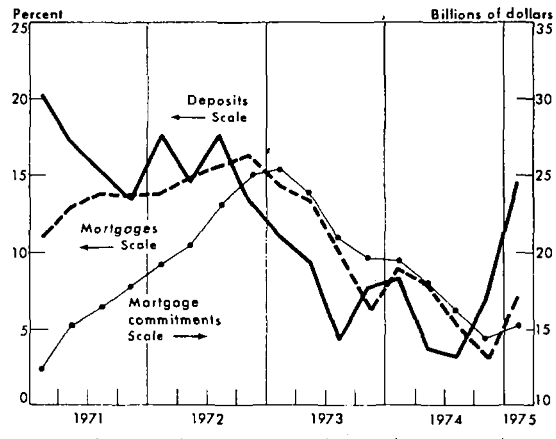
THRIFT INSTITUTIONS AND THE MORTGAGE MARKET

Deposit flows into thrift institutions increased sharply in the first quarter (see Chart IV). Combined deposits at savings and loan associations and at mutual savings banks advanced at a seasonally adjusted annual rate of 14.9 percent, more than double the fourth-quarter growth and the most rapid expansion since November 1972. The increased thrift deposit inflows at least partially reflected the increased attractiveness of such deposits, as rates on competing short-term instruments declined sharply over the quarter. Thrift institutions, on the other hand, actively encouraged deposit inflows by maintaining the rates paid on their deposits at the highest levels permitted by law.

The sharply increased inflow of deposits to thrift insti-

Chart IV

DEPOSITS AND MORTGAGES AT THRIFT INSTITUTIONS AND OUTSTANDING MORTGAGE COMMITMENTS



Note: Thrift institution deposit and mortgage loan growths 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 all mutual savings banks in New York State. Mortgages for the first quarter are based on data available through February.

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

tutions did not result in a similar increase in mortgage holdings in the first quarter. Over the two-month period ended in February, mortgage holdings grew at a 7 percent rate, somewhat above the 3.3 percent rate of growth of the previous three months but only slightly above the 6.5 percent expansion over all of 1974, a year of slow mortgage growth. Similarly, commitments for new home mortgages failed to reflect fully the improved thrift deposit situation. Although the seasonally adjusted volume of outstanding mortgage commitments did rise over the first quarter by $800 million, it still remained more than $10 billion below the peak level recorded in early 1973.

The general easing in interest rates was reflected in mortgage yields as well. In the secondary mortgage market, the average yield set at the last Federal National Mortgage Association auction in March was 8.85 percent, 62 basis points below the average yield at the last auction in December. Most of this decline took place early in the quarter, when yields in both the short- and long-term markets were declining. In the primary market, a similar situation existed, with the Federal Home Loan Bank (FHLB) Board series on effective rates on new-home mortgages falling 29 basis points over the quarter to 9.08 percent. Since deposits were more plentiful, thrift institutions reduced their level of borrowing. The volume of outstanding FHLB advances to member savings and loan associations fell by $3.6 billion over the first quarter to $17.9 billion.