Recent Monetary and Bank Credit Developments

During the second quarter of 1971, the growth rate in the narrow money supply, M_1,[1] accelerated while the rates of expansion of most other major monetary aggregates became more moderate. The quickened growth of M_1 reflected a step-up in demand deposit growth, although this may have been exaggerated somewhat by data-reporting and seasonal adjustment problems. On the other hand, time and savings deposit growth at both commercial banks and thrift institutions tailed off from the record-shattering pace of the first quarter, partly because rising market interest rates induced investors to channel funds into—or not to switch out of—alternative investments. As a consequence, the rate of growth of the broader money supply measures, M_2 and M_3, slowed somewhat. On balance, however, the rates of growth in all the money supply measures remained relatively high by historical standards.

The adjusted bank credit proxy and total bank credit, like M_2 and M_3, advanced more moderately in the second quarter, with the slowdown in the proxy resulting principally from the deceleration in both CDs and other time and savings deposits. The growth rate of the proxy, however, was considerably less than the growth rates of the money supply measures. This was attributable primarily to the fact that the proxy—unlike the other measures—includes nondeposit sources of funds and Government deposits, both of which declined during the quarter. As in earlier quarters, most of the strength in total bank credit reflected increases in bank holdings of securities, although bank purchases of tax-exempt securities slowed considerably. Business loan demand remained sluggish, as corporate borrowers continued to raise large amounts of funds in the capital markets.

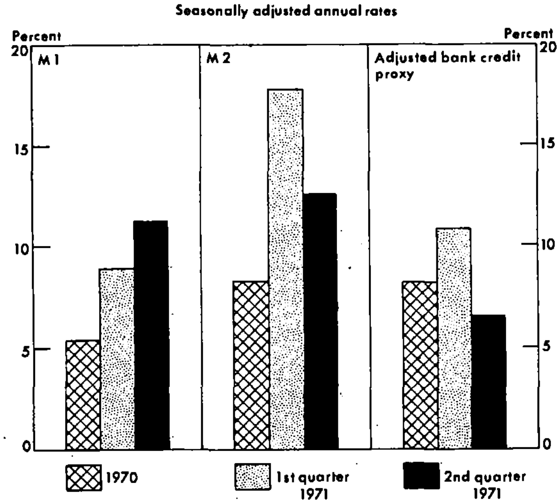
THE MONEY SUPPLY MEASURES

During the second quarter of 1971, the narrowly defined money supply, M_1, expanded at a seasonally adjusted annual rate of 11.3 percent (see Chart I). This advance, coming on the heels of the 8.9 percent gain registered in the first quarter, pushed the rate of growth in M_1 for the first six months of the year to 10.3 percent. The rise in the money supply over the first half of this year has been extraordinarily rapid. As a comparison, over the decade of the 1960's the narrow money supply expanded at a compound rate of only 3.6 percent per year. Of course, some acceleration in the growth of the money stock may be desirable in the early stages of business recoveries, but the rise in M_1 since November has been much stronger than that experienced in similar intervals following the three previous recessions. On the other hand, the income velocity of money has not increased so much in this recovery as it did in the early stages of the

Chart I

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates



M1 = Currency plus demand deposits held by the public.

M2 = M1 plus commercial bank savings and time deposits held by the public, less negotiable certificates of deposit 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.

[1] For definitions of M_1, M_2, and the adjusted bank credit proxy, see Chart I. M_3 equals M_2 plus mutual savings bank deposits and savings and loan association shares.

three preceding recoveries. Part of the advance in M_1 can be explained by policy actions during the first quarter, which were designed to bring about a more rapid growth in the money stock in order to compensate for the shortfall in growth that occurred during the fourth quarter of 1970 in the wake of the General Motors strike. While this factor may explain part or all of the acceleration in the growth in M_1 during the first quarter, the reasons for the further step-up in growth over the April-June interval are not so apparent.

The complexities involved in the measurement of the money supply are such that a clear explanation of the reasons for the rapid growth of M_1 in the second quarter is difficult to establish, even in retrospect. There is some evidence that much of the growth in demand deposits materialized at "country" member banks and at nonmember banks. Data-reporting problems are particularly troublesome at nonmember banks, since complete reports of deposit levels are made only twice a year. Complications arising from the removal of seasonal variations from the money stock data may be another source of error.

The new Federal Reserve Board survey of demand deposit ownership[2] sheds some additional light on the recent behavior of the money supply. Data from this survey report levels of gross demand deposits held by financial businesses, nonfinancial businesses, consumers, foreigners, and all others. Since these data are not seasonally adjusted, and are available only for one year, meaningful analysis of quarterly changes in the pattern of deposit ownership is quite difficult. Over the full year ended June, the data do indicate that demand deposits held by consumers rose considerably faster than total deposits, accounting for more than 50 percent of the aggregate deposit increase. The more rapid rise in consumer demand deposit holdings is consistent with the stepped-up pace of consumer transactions that emerged over this period. However, the rapid increase in these deposits may also reflect some precautionary deposit building, as consumers reacted to the uncertainties of rising unemployment and inflation.

Whatever the role of these various factors in contributing to the advance in the money supply, it must be recognized that the growth of member bank reserves—at least through May—was also rapid, thereby facilitating a sharp rise in the money stock. For example, in the period between March and May, nonborrowed reserves and total reserves expanded by 11.1 percent and 10.0 percent, respectively, little changed from the rates of growth that prevailed in the first quarter. The growth of reserves was particularly strong in May in the face of the uneasy financial market conditions that emerged at the time of the Treasury's May refunding. The international financial crisis and investor concern about the size of upcoming Government and corporate financing needs, along with renewed worries about inflation, amplified the pressures in the financial markets. In June, however, member bank nonborrowed reserves declined at a seasonally adjusted annual rate of 6.2 percent, as the Federal Reserve sought to counteract the unexpectedly rapid increase in the money supply in the preceding months. Consequently, for the quarter as a whole the growth rates in nonborrowed reserves and total reserves were 5.3 percent and 6.7 percent, well below the first-quarter rates of 11.0 percent and 10.9 percent.

The acceleration in the rate of growth of the narrow money supply, and particularly its demand deposit component, at the same time that the growth of member bank reserves was slowing down can be explained in part by the concentration of the increase in demand deposits at country banks. Required reserve rates are almost always lower at country banks than at reserve city banks, so that a given input of reserves can support a larger volume of demand deposits at country banks than at reserve city banks. A second factor explaining the development was a shift in the mix of new deposits in the second quarter relative to the first quarter (see Chart II). In the January-to-March period, the demand deposit component of M_1 expanded by 8.9 percent while time and savings deposits other than large CDs grew by 27.0 percent. Thus, a relatively large share of the growth in reserves was used to support the huge increase in time deposits. In the second quarter, the growth of time deposits tailed off sharply to 13.5 percent while demand deposit growth accelerated somewhat to 11.8 percent. As a consequence, in the three months ended June, a substantially larger share of the additional reserves was supporting demand deposit growth than in the previous period.

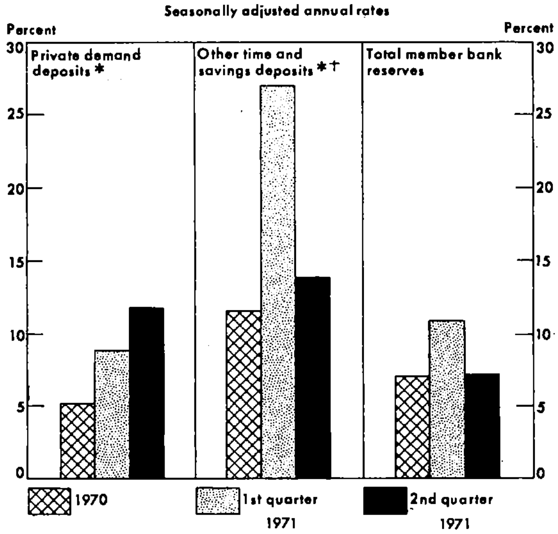
Because of the slowdown in the rate of growth of time and savings deposits, there was also some reduction in the rate of expansion of M_2. This measure posted a 12.6 percent seasonally adjusted annual rate advance during the three months ended June. In the first quarter, M_2 had advanced 17.8 percent. Although the increase in time and savings deposits other than CDs remained strong by historical standards, the second-quarter 13.9 percent seasonally adjusted annual rate of growth was significantly below the rates of gain experienced in the first quarter.

[2] Details of this survey are reported in the *Federal Reserve Bulletin* (June 1971), pages 456-67.

Chart II

CHANGES IN DEPOSITS AND RESERVES

Seasonally adjusted annual rates



* Deposits at all commercial banks.

† Excluding negotiable certificates of deposit in denominations of $100,000 or more.

Source: Board of Governors of the Federal Reserve System.

This more moderate growth probably in part reflected increases in market interest rates during the quarter that induced investors to channel savings into other instruments. In response to these developments, a number of major commercial banks increased the rates paid on passbook and term savings to the maximum permitted under Regulation Q ceilings.

Deposit inflows to the thrift institutions were also less strong during the second quarter relative to the first quarter. According to the preliminary estimates, deposit inflows at savings and loan associations and mutual savings banks during the three months ended June expanded at a 17.6 percent seasonally adjusted annual rate. While this growth rate was very strong compared with past years, it represented a considerable slowing from the first quarter when thrift institution deposits rose by 24.0 percent. Reflecting the slower growth of time deposits, M_3 posted a 14.8 percent gain in the quarter, compared with a rise of 19.0 percent in the first three months of the year.

ADJUSTED BANK CREDIT PROXY AND NONDEPOSIT LIABILITIES

The adjusted bank credit proxy grew moderately in the second quarter, rising at a seasonally adjusted annual rate of 6.5 percent. This followed a gain of 10.9 percent during the first three months of the year. Thus, for the six months ended June the growth rate in the proxy was a shade under 9 percent. In light of the very rapid growth in M_1 and M_2 over this same period, the slower growth rate in the proxy may appear inconsistent. However, virtually all of the disparity can be explained by the behavior of United States Government deposits and of nondeposit sources of funds, primarily commercial bank liabilities to foreign branches and bank-related commercial paper. In total, these items declined by $9 billion on a seasonally adjusted annual rate basis over the first six months of the year. Since they are included in the proxy but excluded from M_1 and M_2, the declines in these components retarded the growth of the proxy relative to the money supply measures.

The deceleration in the rate of growth of the proxy in the second quarter from its pace in the first quarter can be traced in part to the previously noted slowdown in the growth rate of commercial bank time and savings deposits other than large CDs. Beyond this, however, the growth of large CDs continued to slacken, Government deposits declined, and the runoff of nondeposit liabilities persisted. Over the quarter as a whole, CD growth at weekly reporting banks totaled $800 million, seasonally adjusted, the smallest such quarterly gain since Regulation Q ceilings on these deposits were suspended last summer (see Chart III). The overall growth in CDs for the quarter was held down as a result of their absolute decline in April, when many corporations apparently used maturing CDs to meet their tax obligations. Rising market interest rates forced banks to raise their CD offering rates substantially in order to attract such funds. The rate most often quoted for maturities of sixty to eighty-nine days increased by 175 basis points over the quarter.

Reflecting in part the strength in private deposit flows, bank reliance on nondeposit sources of funds continued to diminish (see Chart III). Liabilities to foreign branches, the major nondeposit source of funds, fell in April and May by $1,858 million and $735 million, respectively.[3] The decline in April was, to a large extent,

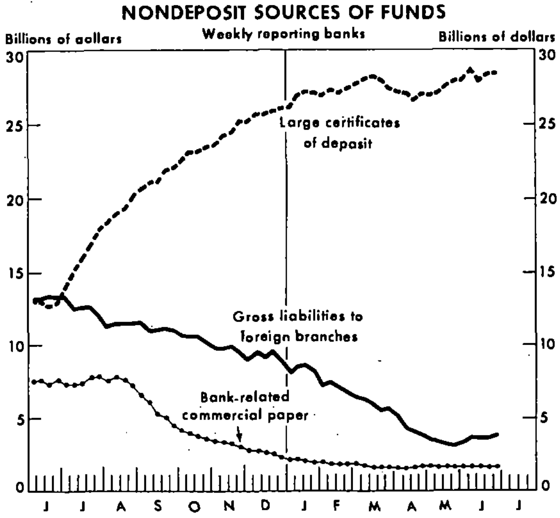
[3] The data on liabilities to foreign branches reported here differ from the data printed in the *Federal Reserve Bulletin* in several ways. The series used in this article is based on weekly averages of daily figures rather than Wednesday levels. Moreover, it includes liabilities to branches in United States possessions, territories, Puerto Rico, and overseas military installations. These and other minor adjustments yield a series of liabilities that are subject to the reserve provisions of Regulation M. The series in the *Bulletin*, on the other hand, is directed toward the balance-of-payments impact of the liabilities.

a reflection of the Treasury's $1.5 billion issue of three-month certificates of indebtedness to foreign branches of United States banks. These instruments, like the two special note issues sold earlier by the Export-Import Bank, were designed to absorb Euro-dollars in order to reduce any adverse international developments resulting from the rundown of liabilities to foreign branches. Holdings of these securities issues can be counted in the calculation of the reserve-free base. This allows the banks to run down their liabilities to foreign branches by the amount of the securities purchased without incurring a future reserve penalty should they start to rebuild such liabilities. Since April 9, the outstanding volume of special securities has remained at $3 billion, as the first Export-Import Bank note issue of $1.0 billion was rolled over on April 26 and the second $0.5 billion Export-Import Bank note issue was replaced by a Treasury certificate of indebtedness on June 1.

In June, liabilities to foreign branches reversed direction, growing by $782 million during the month to $3,870 million. This represented the first monthly increase since the middle of 1970. The reversal presumably occurred because Euro-dollar rates declined over the month, as foreign exchange speculative pressures eased and some dollars flowed from foreign official coffers back into the market, while at the same time domestic short-term rates continued to rise. This eliminated much of the rate disadvantage of Euro-dollars; indeed, at times Federal funds rates exceeded Euro-dollar overnight rates by a substantial amount. In most cases, banks were able to increase their borrowings of Euro-dollars without being subject to the 20 percent marginal reserve requirement, inasmuch as they were permitted to use the cushion provided by their holdings of special note issues. The second major nondeposit source of funds, bank-related commercial paper, showed little change over the quarter. At the end of June, the total amount of bank-related paper outstanding was $1,733 million, $616 million below the 1970 year-end level.

Chart III

LARGE CERTIFICATES OF DEPOSIT AND NONDEPOSIT SOURCES OF FUNDS



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

BANK CREDIT

The total volume of all commercial bank credit outstanding posted a moderate gain over the three months ended June, advancing at a 7.4 percent seasonally adjusted annual rate after adjustment for loan transactions with affiliates (see Chart IV). Although this increase was not so rapid as the 12.2 percent rate of the first quarter, it was roughly in line with the behavior of bank credit in 1970 as a whole, when an 8.0 percent expansion was recorded. Following the pattern of other recent quarters, much of the overall strength in bank credit reflected a rise in securities holdings by the commercial banks, the latest expansion amounting to 13.6 percent. On the other hand, total loans remained decidedly on the sluggish side. Indeed, total commercial bank loans adjusted for net sales to affiliates from banks' loan portfolios rose at a seasonally adjusted annual rate of about 4 percent (see Chart IV).

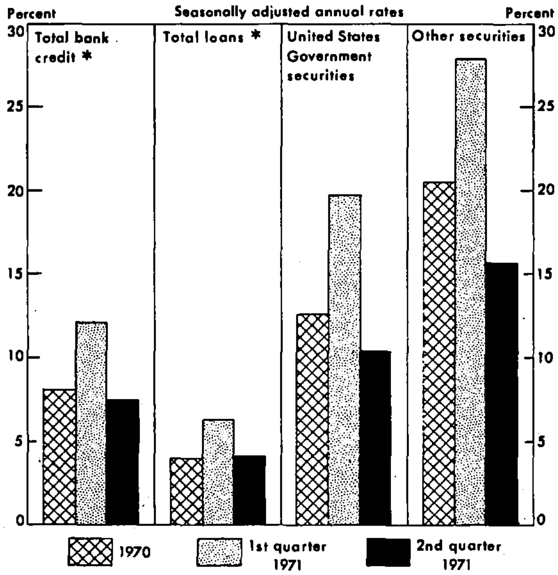
The dominant factor holding down the rate of advance of overall bank lending has been the continued weakness in business loans. Over the three months ended June, business loans adjusted for net loan sales grew by slightly less than 3 percent. Moreover, in the seven months following the November 1970 business-cycle trough, the rise in business loans was only 1.8 percent, and even this growth rate may be overstated since the level of loans in November was probably artificially depressed by the automobile strike. Sluggishness in the behavior of business loans in the early months of a recovery is not, however, unusual. For example, over the seven months following the business-cycle troughs of April 1958 and February 1961, business loans expanded at seasonally adjusted annual rates of 2.0 percent and 2.8 percent, respectively.

The recent weakness in business loans has several causes. On the one hand, the recovery in business activity to date has been of modest proportions. Beyond this, corporate tax liabilities have been depressed by the low levels of corporate profits. Perhaps more importantly, it appears that the cash flows provided by maturing CDs

Chart IV

CHANGES IN BANK CREDIT AND ITS COMPONENTS

ALL COMMERCIAL BANKS



* Adjusted to include net sales to affiliates from banks' loan portfolios.

Source: Board of Governors of the Federal Reserve System.

and maturing tax anticipation bills, especially in the month of April, were large enough relative to tax liabilities to reduce business dependence on bank loans for funds to pay taxes. The single most important consideration, however, has been the continued corporate preference for bond financing. While the volume of new corporate bond flotations in the second quarter dropped below the record-shattering pace of the first three months of the year, the $7.2 billion (seasonally adjusted) of new corporate offerings was still very high by past standards.

Aside from business loans, most other major categories of bank lending showed some strengthening in the second quarter. Indeed, consumer, real estate, and agricultural loans all advanced more rapidly than in either of the two preceding quarters. The only absolute decline was posted in the usually volatile securities loan category.

Investment holdings of the commercial banks continued to advance in the second quarter, but at a substantially slower pace than was experienced in the preceding several quarters. For the three months ended June, investment holdings grew at a 13.6 percent seasonally adjusted annual rate, whereas the rate of gain over the preceding three months had been 24.6 percent. United States Government securities holdings advanced by 10.4 percent over the quarter (see Chart IV). However, this advance was primarily a reflection of their strong rise during the last statement week in June, when the Treasury sold $2¼ billion of 6 percent notes with full Tax and Loan Account privileges.

The reduction in the pace at which banks acquired "other securities", primarily tax-exempt state and local government issues, was particularly dramatic. From the end of July 1970 to March 1971, these securities holdings had advanced at a seasonally adjusted annual rate in excess of 30 percent as banks absorbed a major share of the massive volume of new issues of tax-exempt state and local securities. In contrast, during the second quarter of 1971 the increase in bank holdings of other securities tailed off to 15.7 percent, and the 8.9 percent June advance was the smallest monthly increase in almost a year.