Monetary and Bank Credit Developments in the Third Quarter

During the third quarter of 1971, the growth of both the narrow and the broad money supply measures, M_1 and M_2, showed a marked and progressive deceleration. To some extent, these developments resulted from the efforts of the Federal Reserve System to achieve more moderate growth of these aggregates following the extremely rapid increases posted in the second quarter. Beyond this, the slower rise in M_1—currency plus demand deposits held by the public—may have reflected in part a decline in corporate cash balances during the August speculation against the dollar and a reduction in consumer cash balances in response to the new economic policies which President Nixon announced on August 15. The slower growth of M_2—M_1 plus commercial bank time and savings deposits other than large negotiable certificates of deposit (CDs)—extended further in the third quarter the deceleration experienced in the second quarter. The tapering-off of the growth of consumer-type time and savings deposits may have been in response to the rise in open market interest rates through mid-August and may also have been related to the drop in the rate of personal savings that occurred during the period.

The growth of the adjusted bank credit proxy,[1] on the other hand, accelerated in the third quarter, reflecting strong growth in Government deposits and in CDs which are included in the proxy though not in the money supply measures. Total bank credit measured from the asset side continued to increase rapidly in the third quarter, posting a gain almost equal to that of the first half of the year. Virtually all of the growth in bank credit during the third quarter was in loans, in contrast to the first half of the year when bank credit growth resulted primarily from the expansion of banks' securities portfolios. Interest rates generally declined after the mid-August announcement of the new economic policies, reflecting in part expectations that the rate of inflation would moderate.

THE MONEY SUPPLY MEASURES

The slower expansion of both the narrowly and broadly defined money supplies in the third quarter served to reduce their growth to rates more consistent with the goal of a noninflationary economic recovery. Thus, M_1 grew at a 3.0 percent rate, compared with a second-quarter rate of 11.3 percent, while M_2 grew at a 4.5 percent rate versus 12.6 percent in the second quarter (see Chart I). With this slowdown, the growth of M_1 and M_2 over the six months ended in September amounted to 7.2 percent and 8.6 percent, respectively.

Early in the year, the Federal Reserve had accepted strong money supply growth to compensate for the slow growth in the final quarter of 1970. Expansion of M_1 and M_2 at rates of 6.2 percent and 13.7 percent, respectively, over the six months ended in March did not appear unduly rapid in the early stage of the business-cycle recovery period. However, as the year wore on, it became increasingly apparent that the monetary aggregates were growing at rates that would be excessive if sustained for long.

The Federal Reserve last spring began to increase the pressure on member bank reserve positions in order to slow the expansion of the money supply measures. This pressure was reflected in a curtailment of the growth of nonborrowed reserves by early summer and in increased member bank borrowings at the discount window. The restrained provision of reserves was also mirrored in the increased Federal funds rate. This rate, which averaged 3.71 percent in March, rose to a level of 5.31 percent in July. Whereas nonborrowed reserves had expanded at a seasonally adjusted annual rate of 11.2 percent during the

[1] Total member bank deposits subject to reserve requirements and nondeposit sources of funds, such as Euro-dollar borrowings and the proceeds of commercial paper issued by bank holding companies or other affiliates.

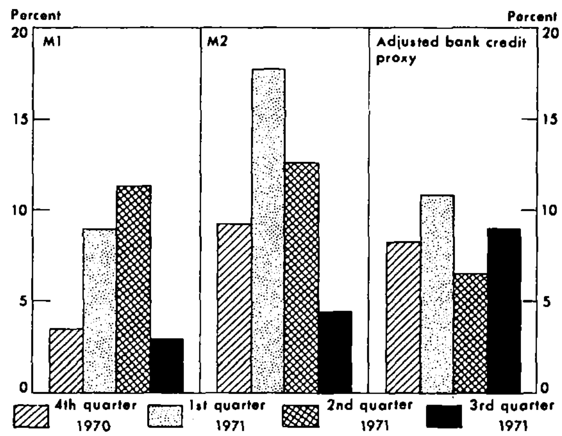
first five months of the year, they actually declined at an annual rate of 9.6 percent in June and July. Deceleration in the growth of the monetary aggregates followed, and the third-quarter increase in M_1 was the slowest quarterly gain since the fourth quarter of 1969.

There was a resurgence in the growth of reserves in August and September even as the expansion of M_1 halted. Nonborrowed member bank reserves increased at a seasonally adjusted annual rate of 23 percent during those two months, while M_1 declined slightly by 0.5 percent at an annual rate. This divergence resulted from a large increase in deposits not included in the money supply measures but subject to reserve requirements. For example, seasonally adjusted United States Treasury deposits at member banks rose by $2.4 billion over the third quarter to $6.3 billion in September. This represented a reversal of the trend in the first half of the year when these deposits—which are subject to the same reserve requirements as private demand deposits—declined by $2.3 billion. In addition, the growth of large CDs accelerated in the third quarter. Such negotiable time deposits are also subject to reserve requirements but at a lower average rate than are demand deposits. CDs grew by $3.8 billion (seasonally adjusted) over the most recent quarter, compared with only $2.6 billion in the first half of the year. The increases in these two types of deposits, especially Government deposits, absorbed a large quantity of reserves. As this experience illustrates, movements in member bank reserves and the money supply measures even over periods of several months are not necessarily closely related. Over the long run, of course, the trend growth of demand deposits in the money supply measures depends heavily upon the System's provision of nonborrowed reserves (adjusted for changes in reserve requirements).

Chart I

CHANGES IN MONETARY AND CREDIT 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 M_1 during the third quarter of this year was not exclusively the consequence of the restraint of reserve availability by the Federal Reserve. It may also have stemmed in part from the massive flow of private dollar balances abroad during August, both before and immediately after the President's decision to suspend the convertibility of the dollar into gold and other reserve assets. This transfer of funds was reflected in the previously noted sharp buildup of United States Treasury deposits at commercial banks, as foreign central banks purchased special Treasury certificates of indebtedness with excess dollars absorbed in the exchange markets. The evidence indicates that this phenomenon was largely confined to the month of August, when Government deposits at member banks (seasonally adjusted) rose by $2.6 billion. These dollar outflows tended to have a negative impact on the growth of M_1, as corporations drew down their demand balances at commercial banks. This may be reflected in the $1.2 billion drop in August of gross demand deposits held by nonfinancial businesses (not seasonally adjusted) at weekly reporting banks. By comparison, such deposits had been unchanged in August of last year. A substantial portion of the funds transferred indirectly to the United States Treasury, however, probably came out of new deposit balances created as a counterpart to the bulge in bank loans to businesses and to foreign banks, rather than out of previously existing money supply deposits. The continued weakness of M_1 in September—when it actually declined at a seasonally adjusted annual rate of 3.7 percent—occurred despite a marked diminution in the flow of dollars abroad and little further buildup in Treasury deposits.

Another factor that may have contributed to the slowdown in the growth of the money supply was a possible trimming of consumer demands for precautionary balances following President Nixon's enunciation of the Administration's new economic policies on August 15. It had become evident earlier this year that the demand for cash balances, particularly by consumers, was unusually strong. For example, the Board of Governors of the Federal Reserve System survey of gross demand deposit ownership at weekly reporting banks showed that, over the twelve months ended in July 1971, consumer deposits advanced at a significantly more rapid rate than did total deposits.[2] Since the strength in consumer deposits was only partially explained by the rising volume of transactions, it appears that part of the growth in demand deposits was motivated by precautionary balance building in the wake of mounting uncertainties over unemployment and inflation. However, the desire to hold these precautionary balances may have been reduced after President Nixon's announcement of the ninety-day wage-price freeze and subsequent statements concerning Phase Two of his program to contain inflation. Some very tentative evidence in support of this view arises from the fact that gross demand deposits (not seasonally adjusted) held by consumers at weekly reporting banks declined by about $1.8 billion in the two-month period ended in September. By comparison, such deposits had risen by $0.6 billion in the similar two-month period last year. It should be noted, however, that survey data indicate a net rise in consumer deposits at all commercial deposits over the third quarter as a whole. (Deposit ownership data for banks other than weekly reporters are available only on a quarterly basis.)

While the reduced rate of growth in M_1 was a significant factor in the slowdown in M_2, the growth of time and savings deposits other than CDs also decreased in the third quarter. Over the three months ended in September, these deposits grew at a 6.0 percent seasonally adjusted annual rate—the smallest quarterly increase since the fourth quarter of 1969 and well below the 20.9 percent growth experienced over the first half of the year. The markedly slower growth in time and savings deposits during the third quarter may have resulted in part from the decline in the rate of personal savings from $60.9 billion in the second quarter to $58.0 billion in the third. In addition, the upward trend of interest rates from March through mid-August may have gradually induced consumers to shift some of their savings away from savings accounts and into open market instruments.

BANK CREDIT PROXY AND NONDEPOSIT LIABILITIES

The adjusted bank credit proxy rose rapidly in the third quarter, growing at a seasonally adjusted annual rate of 9.0 percent as compared with the 6.5 percent rate of advance posted in the second quarter. The strength in the proxy during the third quarter, in contrast to the diminished rates of growth of the money supply measures, reflected the substantial increases in United States Government deposits and in large negotiable CDs, both of which are included in the proxy but not in either M_1 or M_2. In total, these two types of deposits, seasonally adjusted, rose by $6.2 billion over the quarter.

Much of the strength in CDs occurred in July and September. In July, it appeared that a major reason for the large increase in CDs was the reinvestment of the proceeds of a sizable stock financing. The $2.1 billion increase in CDs in September primarily reflected the substantial yield spread of CDs over Treasury bills of comparable maturities. During most of September, three-month CDs, for example, were offered at rates ranging from about ¾ percentage point to a full percentage point above rates on Treasury bills of comparable maturity. Following the sizable influx of funds, a number of major banks began reducing their offering rates on CDs late in September.

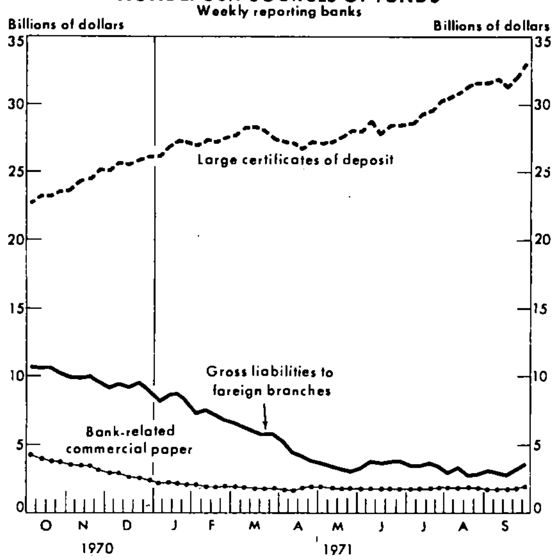
Reflecting the strong inflow of funds in the form of CDs and Government deposits, banks were able to reduce further their reliance on nondeposit sources of funds (see Chart II). The two major nondeposit items are liabilities to banks' own foreign branches and bank-related commercial paper. Liabilities to foreign branches declined by a net of $0.3 billion during the quarter to $3.6 billion.[3] These liabilities fell by $0.6 billion in the third statement week in August, when the cost of such funds shot up as overnight Euro-dollar rates increased sharply in reaction to the uncertain value of the dollar in international exchange markets.

The Treasury decided not to renew its certificates of indebtedness to foreign branches of United States banks

[2] Inasmuch as the survey of demand deposit ownership dates back only to June 1970, no seasonal adjustment factors are available. For a description of the survey, see *Federal Reserve Bulletin* (June 1971), pages 456-67.

[3] The data on liabilities to foreign branches reported here differ from the data printed on page A30 of 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 and also includes certain loans sold to branches outside the United States. 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.

Chart II
LARGE CERTIFICATES OF DEPOSIT AND NONDEPOSIT SOURCES OF FUNDS
Weekly reporting banks



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

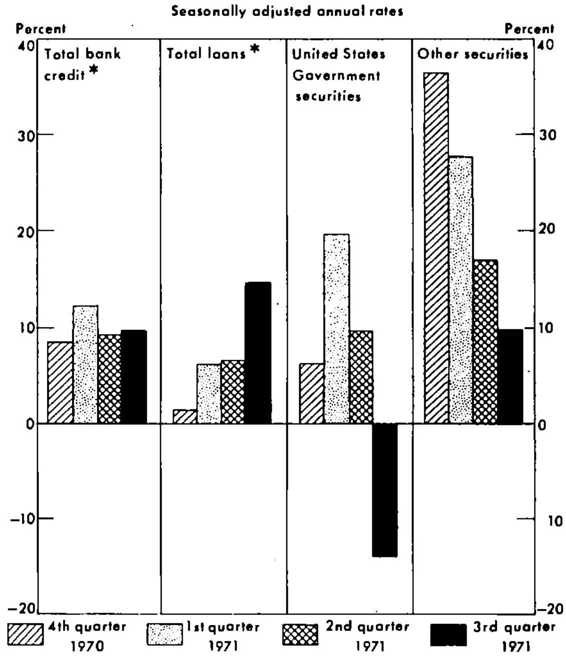
that matured after the middle of August. These instruments had originally been issued to absorb Euro-dollars in an attempt to reduce the flow of dollars to foreign central banks. Bank holdings of these securities had been counted in the calculation of the reserve-free base. Over the remainder of the quarter, $2.1 billion of these issues matured and they were not replaced. To have maintained their reserve-free bases, banks would have had to increase their liabilities to foreign branches by the amount of the maturing issues. However, extraordinarily high Euro-dollar rates prevailed over the rest of August and served to discourage increased borrowing from that market. To be sure, as short-term Euro-dollar rates came down in September, banks partially rebuilt their liabilities to foreign branches but the increase was substantially less than the runoff of Treasury certificates. Thus, on balance, the banks have allowed their reserve-free bases to decline, making future use of this source of funds more costly.

The other major nondeposit source of funds, bank-related commercial paper, has fluctuated in a narrow range since March and remained roughly flat over the third quarter. At the end of September, the total amount of bank-related paper outstanding was $1.9 billion. It should be noted that an increasing share of the commercial paper issued by bank holding companies has been used to finance operations of nonbank subsidiaries rather than to provide funds for the banks themselves. The proceeds of bank-related commercial paper are subject to reserve requirements only if the funds are channeled to an affiliated bank. By the end of September, about half of the total outstanding bank-related commercial paper was nonreservable, compared with about a quarter at the end of March.

BANK CREDIT AND INTEREST RATES

Total bank credit at all commercial banks, adjusted for net sales to affiliates, advanced at a seasonally adjusted annual rate of 9.8 percent in the third quarter (see Chart III), a shade below the gain posted over the first half of the year. The growth in the components of bank credit, however, differed substantially in these two periods. During the six months ended in June, much of the overall strength in bank credit reflected a strong rise in investment holdings while the growth in total loans remained sluggish. In contrast, over the three months ended in September, aggregate investment holdings remained virtually un-

Chart III
CHANGES IN BANK CREDIT AND ITS COMPONENTS
Seasonally adjusted annual rates



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

Source: Board of Governors of the Federal Reserve System.

changed. Indeed, United States Government securities holdings declined at an annual rate of 14 percent, after adjustment for normal seasonal variation, while the gain in other securities holdings, consisting primarily of municipal securities and Federal agency debt, slowed to about 10 percent. The reduction in bank holdings of United States Government securities reflected the reduced need of the Treasury to borrow in domestic markets as foreign central banks provided funds through their purchases of special Treasury certificates of indebtedness. On the other hand, total commercial bank loans, adjusted for loan transactions with affiliates, rose at a seasonally adjusted annual rate of 14.7 percent, the largest quarterly percentage gain since the third quarter of 1968.

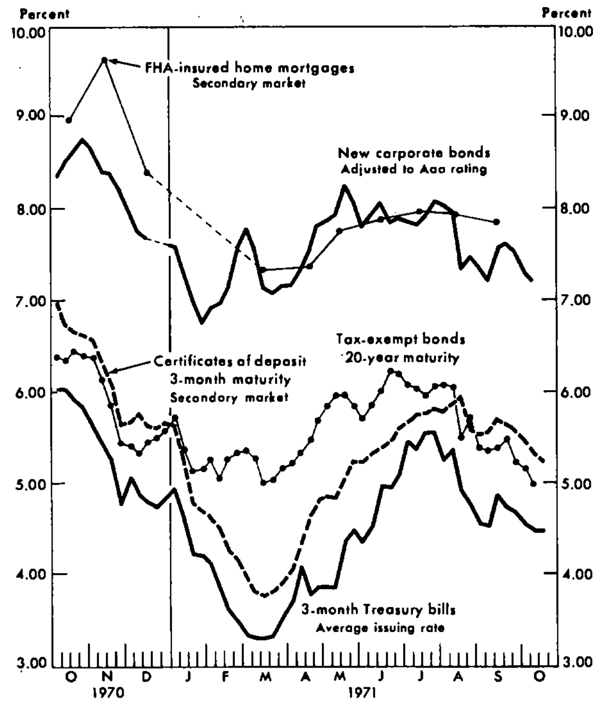
The dominant factor accounting for the growth of overall bank lending during the third quarter was the rapid expansion of business loans. Over the three months ended in September, business loans adjusted for net sales to affiliates advanced by 16.5 percent on a seasonally adjusted annual basis. Much of this rise appears to have been related to the international currency crisis. The bulk of the gain occurred in August when a 29.1 percent rate of expansion was recorded. Indeed, business loans at weekly reporting banks (adjusted for loan transactions with affiliates) rose by $799 million during the week ended August 18 alone. Moreover, almost half of the increase during that week was in bankers' acceptances, most of which were related to foreign transactions, while loans to foreign industrial and commercial businesses and an unusually large unclassified residual accounted for the remainder. Presumably, foreign corporations borrowed dollars to exchange them for other currencies in anticipation of a depreciation of the dollar in foreign exchange markets. Apart from the huge bulge during August, however, it appears that business loan demand has remained sluggish.

Most other major categories of bank lending were relatively strong in the third quarter. Consumer, real estate, and agricultural loans all advanced more rapidly than they had in the first half of the year. On the other hand, loans to nonbank financial institutions declined over the quarter. The strength of consumer loans at commercial banks and the generally strong showing of consumer credit during the quarter were partly related to the surge in automobile buying that followed the August 15 announcement of the price freeze and the recommendation to eliminate the 7 percent excise tax on automobiles.

Prior to the President's mid-August statement outlining the new economic policies, most interest rates had moved higher, reflecting continuing market concern with the persistent inflation, the uncertain position of the dollar in foreign exchange markets, and the Federal Reserve's more restrained provision of nonborrowed reserves. After the President's speech, however, most rates declined and closed the quarter well below the levels that had prevailed in early August (see Chart IV). These rate reductions, particularly those at the intermediate and longer end of the maturity structure, suggest that investors were hopeful that the new economic policies would dampen inflationary forces and would permit a more expansive monetary policy. In the short-term area, Treasury bill rates experienced a sharp drop, partly in response to the sizable increase in demand for bills from foreign central banks. Most other short-term rates were slower to respond to the changed environment but eventually did move lower.

The downward adjustment in corporate bond yields could reduce upward pressures on mortgage rates, thereby improving the prospects for continued strength in the home-building sector. Indeed, there are indications that home-financing costs are coming down. Although rates on conventional new-home mortgages rose again in Sep-

Chart IV
SELECTED INTEREST RATES



Note: In the mortgage yield series, estimates for periods for which the Federal Housing Administration does not provide data were obtained by linear interpolation.

Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, and The Weekly Bond Buyer.

tember, average yields in the more sensitive secondary market for Federally underwritten home mortgages have been declining. Results of the mortgage commitment auctions of the Federal National Mortgage Association suggest that these yields continued to edge lower into November. Moreover, in late October and early November, several banks slashed their rates on home mortgages. Declines in bond rates tend to make mortgages a relatively attractive investment, especially for thrift institutions. Lower market rates also tend to improve the ability of the nation's thrift institutions to compete for savings flows to channel into the mortgage market. The inflows of deposits to these institutions did slacken in the third quarter from the extraordinary pace of the first half of the year but remained very rapid by any other standard. Combined deposits at savings and loan associations and mutual savings banks increased at a 13.4 percent seasonally adjusted annual rate in the third quarter, down from the 22.2 percent and 17.5 percent rates of growth posted in the first and second quarters, respectively.