Monetary and Bank Credit Developments in the Fourth Quarter

During the fourth quarter of 1971, the narrow money supply rose only slightly but the broader monetary and credit aggregates posted relatively large advances. The growth of M_1—adjusted demand deposits and currency held by the public—slowed to a seasonally adjusted annual rate of 1.1 percent in the fourth quarter from 3.7 percent in the third quarter of 1971 (see Chart I). While demand deposits were virtually unchanged in the fourth quarter, the expansion of time deposits accelerated. Consequently, the growth of M_2—which includes M_1 plus commercial bank savings and time deposits other than large-denomination certificates of deposit (CDs)—rose to 8.0 percent at an annual rate during the fourth quarter from 4.4 percent in the previous three-month period. The surge in time deposits was also reflected in the adjusted bank credit proxy. This aggregate consists of total member bank deposits subject to reserve requirements and such nondeposit sources of bank funds as Euro-dollar borrowings and commercial paper sold by bank holding companies and affiliates. The adjusted proxy increased in the fourth quarter of 1971 at a seasonally adjusted annual rate of 9.7 percent, up from the 7.6 percent rate of advance in the third quarter.

Bank credit—total commercial bank loans and investments adjusted for loan transactions with affiliates—increased in the final quarter of 1971 at a seasonally adjusted annual rate of 8.8 percent, virtually the same as the growth registered in the previous quarter. The overall strength in bank credit was paced by a large increase in holdings of tax-exempt securities. However, commercial and industrial loans outstanding remained practically unchanged during the fourth quarter, reflecting the sluggishness in business demands for short-term credit.

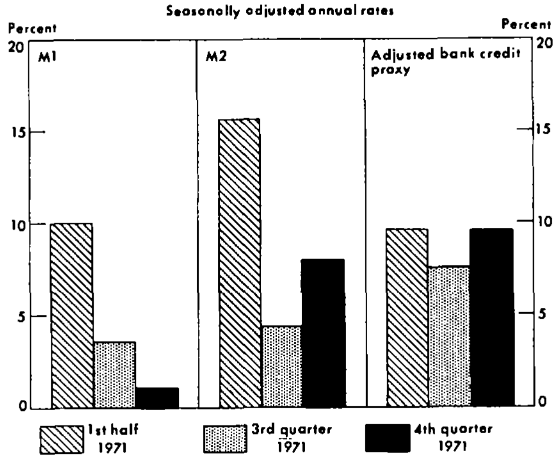
MONETARY AND RESERVE AGGREGATES

The narrow money supply (M_1) began moving higher in December after four months of virtually no growth. The December increase amounted to a modest 2.6 percent at a seasonally adjusted annual rate. This figure, however,

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.

may understate the growth of M_1 because of a change in the regulations of the Office of Foreign Direct Investments covering end-of-year reporting requirements for United States corporations. In the past, corporations had been required to bring their overseas investments into line with ceilings by the last day of the calendar year. One result of this requirement was an inflow of bank deposits in late December. This time, however, the settlement deadline has been deferred until the end of February 1972. Consequently, the inflow during December was smaller than usual. Inasmuch as the precise amount of the shortfall is unknown, no attempt is made to adjust the figures for the new computation rules.

Over 1971 as a whole, M_1 rose by 6.2 percent, compared with 5.4 percent in the previous year (see Chart II). Most of the 1971 gain occurred in the first half of the year, when M_1 grew at an annual rate of 10.0 percent, followed by 2.4 percent in the second half. The leveling-off of the narrow money supply was initially accepted as an offset to the exceedingly rapid growth of earlier months. However, as M_1 remained on a plateau throughout the latter part of the summer and into autumn, the Federal Reserve moved to stimulate its growth. These moves were taken gradually at first, partly in view of the very rapid growth of M_1 earlier in the year.

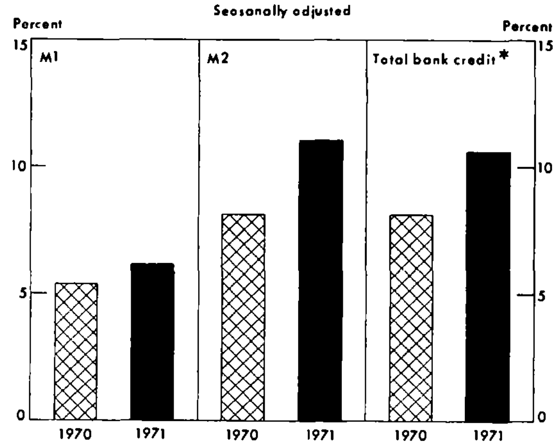
As winter approached and M_1 remained stubbornly flat, the Federal Reserve became increasingly aggressive in seeking to stimulate monetary growth. Nonborrowed reserves were increased at annual rates of 5.8 percent in November and 15.7 percent in December. The Federal Reserve discount rate was reduced by ¼ percentage point in November and again in December to a level of 4½ percent. The average effective rate on Federal funds dropped from 5.55 percent in September to 4.91 percent in November and 4.14 percent in December. With Federal funds generally trading at rates below the discount rate in December, member bank borrowings from the Federal Reserve Banks fell to $108 million on average for the month, down from $501 million in September.

Even though there was little response in M_1 before the end of the year, the easing of money market conditions apparently helped to stimulate the growth of time deposits. Bank offering rates on large CDs were progressively reduced in tandem with market rates, but they remained sufficiently favorable to investors to attract a net of $1.8 billion of CD funds to large commercial banks during the fourth quarter —a 22.8 percent seasonally adjusted annual rate of increase. Other time and savings deposits grew at an annual rate of 14.7 percent over the quarter. Rates generally remained at the ceilings of 4½ percent on savings deposits and up to 5¾ percent on time deposits of less than $100,000 until the end of the year, when a major West

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted



Note: Changes are calculated from December of previous year to December of year indicated.

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

Source: Board of Governors of the Federal Reserve System.

Coast bank announced reductions. A number of other banks have taken similar steps since the beginning of 1972. Reflecting the strong inflows of consumer-type time and savings deposits, M_2 increased at an annual rate of 8.0 percent during the fourth quarter of 1971. This gain was nearly twice the size of the previous quarter's increase but fell considerably short of the very large rise experienced in the first half of the year. Over 1971 as a whole, M_2 increased by 11.1 percent, up from 8.1 percent in 1970.

The growth in the adjusted bank credit proxy at a seasonally adjusted annual rate of 9.7 percent during the three months ended in December was about the same as the growth rate experienced over the year as a whole. The fourth-quarter rise in the proxy was largely the result of the gains in member bank time and savings accounts, while private demand deposits showed little change and Government deposits and liabilities to foreign branches declined slightly.

Since the adjusted proxy includes all member bank liabilities subject to reserve requirements, it may seem anomalous that required reserves actually declined slightly over the quarter while the proxy increased substantially. Indeed, although the growth rates of the proxy and required reserves often differ on a quarterly basis, the fourth-quarter divergence in the behavior of the two series was unusually wide. This apparent paradox can be explained by two factors. One is related to the manner of computation of reserve requirements. Since these lag two weeks behind deposits, a dip in demand deposits in the second half of September was not reflected in required reserves until October. Similarly, part of the December rise in deposits was not reflected in required reserves until January. Hence, the levels of required reserves were high in September and low in December in relation to deposits. A second factor contributing to the disparate behavior of the adjusted bank credit proxy and required reserves was a shift in the composition of deposits. As noted earlier, most deposit growth during the fourth quarter was in the form of time deposits, which have relatively low reserve requirements.

BANK CREDIT AND LIQUIDITY

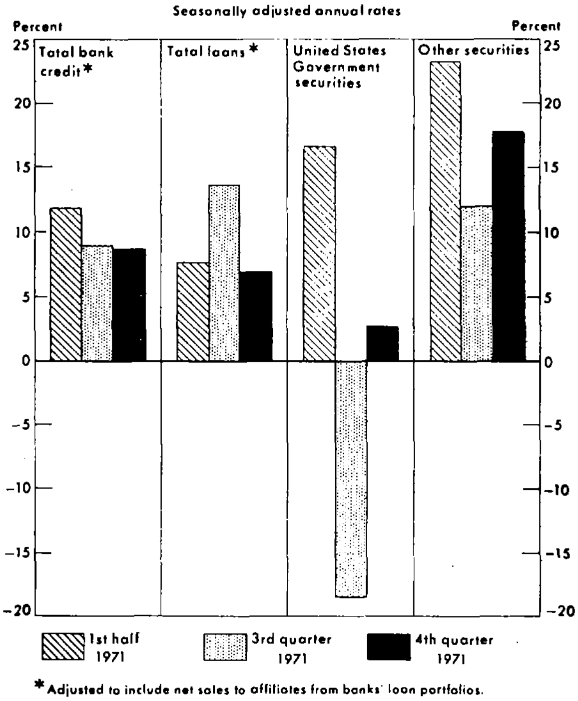
Total bank credit, net of loan transactions with affiliates, rose at a seasonally adjusted annual rate of 8.8 percent in the fourth quarter. This virtually duplicated the advance of the third quarter (see Chart III), though it was below the 10.7 percent gain in 1971 as a whole. Commercial bank holdings of securities grew more rapidly than did bank loans, which was true during most of the year. Total loans, adjusted for transactions with affiliates, advanced at a rate of 7.0 percent, about half the pace of the preceding quarter. As had been the case for much of the year, the increase in total loans was led by consumer and real estate loans. The fourth-quarter moderation in overall bank lending resulted from the slowdown in the business loans component. After a sharp rise in the third quarter resulting from transactions related to the August international financial crisis, business loans were virtually unchanged in the fourth quarter on a seasonally adjusted basis.

The weakness of business loan demand was one of the factors prompting a series of reductions in the commercial bank prime lending rate, which moved from 6 percent in September to 5¼ percent at the end of December. The reductions may have been hastened by the adoption of floating prime rate conventions at a few large banks, since the rules inaugurated in November established a formal link between the prime rate and market rates on such instruments as commercial paper. The prime rate reductions during the last two months of the year were led by declines in commercial paper rates. Other banks generally followed

Chart III

CHANGES IN BANK CREDIT AND ITS COMPONENTS

Seasonally adjusted annual rates

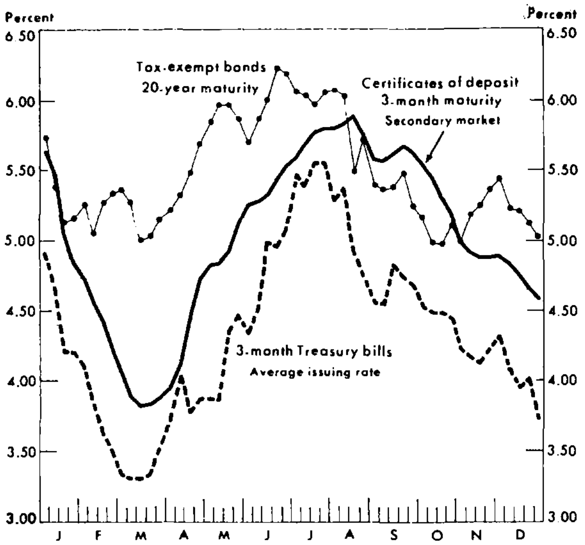


*Adjusted to include net sales to affiliates from banks' loan portfolios.

Source: Board of Governors of the Federal Reserve System.

Chart IV

SELECTED INTEREST RATES



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

displayed in Chart IV. These factors made Treasury bills a relatively unattractive investment for commercial banks, since yields were less than rates paid on most classes of time deposits. Weekly reporting bank data suggest that the limited bank acquisitions of Treasury securities made before December were concentrated in the intermediate maturity ranges, where the fourth-quarter declines in rates were not so precipitous as at the short end of the maturity spectrum.

With overall loan demand relatively weak and time deposit inflows remaining strong, bank liquidity improved in the fourth quarter. As a consequence, conventional measures indicated that banks were in a slightly more liquid position at the end of 1971 than a year earlier (see Chart V). The expanded loan-deposit ratio—a ratio of loans adjusted (other than loans to brokers and dealers) to deposits (less cash items in the process of collection) plus liabilities to foreign branches—decreased by about 1.6 percentage point at weekly reporting commercial banks over the

the pattern thus established, although sometimes with a lag of several days or weeks.

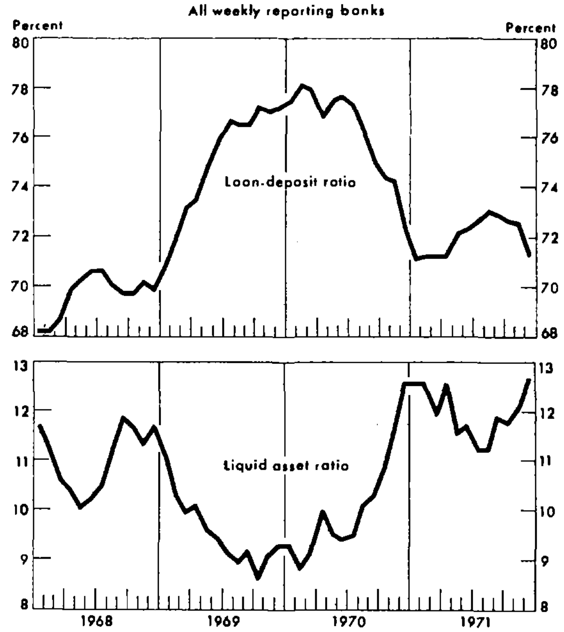
Commercial bank holdings of securities rose at an annual rate of 12 percent over the three months ended in December. During this period, most of the overall rise resulted from acquisitions of tax-exempt securities—a pattern that was dominant throughout much of the year. Over the year, large-scale bank purchases of these securities were instrumental in helping the financial markets to absorb a record $24 billion in new tax-exempt bond issues in a climate of generally declining interest rates. This pattern of behavior reflected both the accommodative stance of monetary policy and the generally sluggish demand for business loans.

Bank holdings of United States Government securities rose, on a seasonally adjusted basis, at a modest rate of 2.7 percent during the fourth quarter. Most of that gain was recorded in December, when the Treasury sold $4.5 billion of tax anticipation bills. The normal pattern by which the banks finance a significant portion of the seasonal Treasury deficit was modified by foreign purchases, which tended to restrict the availability of short-term issues on the domestic markets. Federal Reserve actions added momentum to the downward movement in short-term rates

Chart V

MEASURES OF BANK LIQUIDITY

All weekly reporting banks



Note: The loan-deposit ratio is defined as loans (adjusted) less loans to brokers and dealers as a percentage of total deposits, less cash items in process of collection, plus liabilities to foreign branches. The liquid asset ratio is defined as loans to brokers and dealers, loans to domestic commercial banks, Government securities due within one year, balances with domestic commercial banks, bankers'acceptances,and tax warrants and short-term tax-exempt notes and bills as a percentage of total liabilities excluding capital accounts.

Source: Board of Governors of the Federal Reserve System.

quarter, reaching 71.3 percent in December. Except for the slightly lower readings in the first quarter of 1971, this was the lowest the ratio has been since February 1969. At the same time, the liquid asset ratio[1] showed a similar improvement in the fourth quarter, reaching 12.7 percent in December, the highest such reading in more than five years.

THRIFT INSTITUTIONS

Deposit flows at the nation's mutual savings banks and savings and loan associations continued their strong showing in the fourth quarter, rising at a seasonally adjusted annual rate of about 12½ percent. Over the three months ended in December, mortgage holdings by these institutions rose at an annual rate of about 15 percent, a slightly faster pace than the rise in deposits.

This marked a reversal of the pattern that had prevailed earlier in the year when deposit inflows outpaced mortgage lending as the thrift institutions were rebuilding their liquidity positions and, in the case of mutual savings banks, investing part of their savings inflows in the corporate bond market. Since July, however, corporate bond yields have declined faster than mortgage rates, thereby making investments in mortgages relatively more attractive. For example, in July, secondary market yields on Federal Housing Administration-insured mortgages were about equal to yields on new Aaa-rated corporate bonds. By December, a spread of 50 basis points had opened up in favor of mortgage yields.

For 1971 as a whole, savings and loan associations and mutual savings banks increased their aggregate mortgage holdings by about $28 billion, more than double the increase registered in 1970. Moreover, thrift institutions accounted for more than two thirds of total mortgage lending by financial institutions (including those sponsored by the Federal Government) in 1971, up sharply from 56 percent in 1970. The ability of these institutions to attract deposits and thereby supply this massive volume of mortgage credit was, of course, instrumental in the residential construction boom experienced in 1971.

[1] The liquid asset ratio is defined as loans to brokers and dealers, loans to domestic commercial banks, Government securities due within one year, balances with domestic commercial banks, bankers' acceptances, and tax warrants and short-term tax-exempt notes and bills as a percentage of total liabilities excluding capital accounts.