Monetary and Bank Credit Developments in the First Quarter

The first quarter of 1972 was marked by substantial increases in the monetary and credit aggregates. The large rise in the narrowly defined money supply (M_1), after several months of little growth, was particularly notable. Other measures of money and credit posted strong advances as well. The growth of the broadly defined money supply (M_2) had already begun to pick up during the final three months of 1971, when time deposits other than large certificates of deposit (CDs) recovered from the weakness exhibited in July and August. The subsequent acceleration in the growth of M_2 reflected a further step-up in the expansion of time deposits as well as the faster growth of private demand deposits and currency. Inflows of funds to thrift institutions also accelerated in the first quarter, to near-record rates.

Bank credit gained strength in the early months of 1972, as loans expanded more rapidly than they had in late 1971. Business loans, in particular, achieved a healthy advance as the pace of economic activity quickened. Short-term interest rates generally declined until about mid-February but rose thereafter, while long-term rates tended to drift slightly upward over the quarter. In general, however, interest rates closed the period below the levels that had prevailed before the inauguration of the new economic program on August 15, 1971.

THE MONETARY AGGREGATES

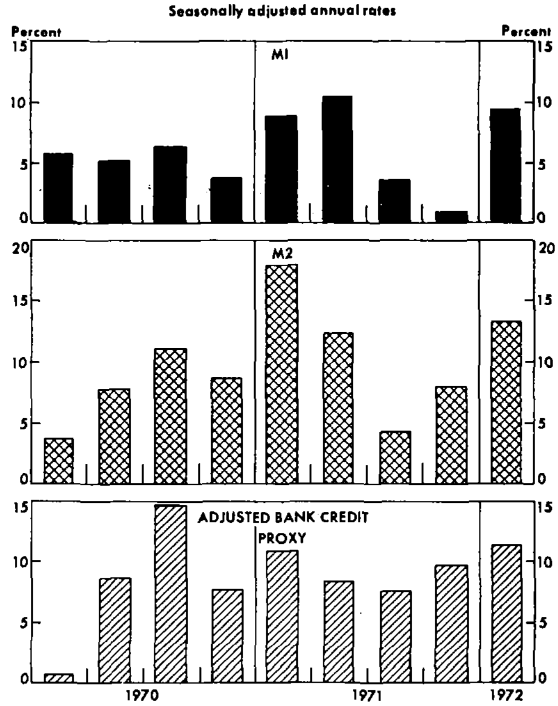
The resurgence in the growth of M_1—adjusted demand deposits and currency held by the public—began late last year. After having advanced at a scant 0.4 percent seasonally adjusted annual rate in the four months from July through November 1971, M_1 moved up at a 3 percent annual rate during the following two months. Then it leaped ahead at a 12 percent rate during February and March. As a result, M_1 rose at a 9.3 percent rate over the quarter (see Chart I). The advance in the first quarter tended to compensate for shortfalls in the second half of 1971. Thus, over the six months that ended in March, M_1 expanded at a 5.2 percent annual rate, compared with an average growth rate of 6 percent over the years 1970 and 1971.

The substantial acceleration in the growth of M_1 during the first quarter reflected a combination of demand and supply factors. On the demand side, the general quickening of economic activity as evidenced by the $30.3 billion advance in nominal gross national product in the first quarter, on the heels of the $19.5 billion rise of the previous quarter, probably increased the transactions de-

Chart I

CHANGES IN MONETARY AGGREGATES

Seasonally adjusted annual rates



MI = Currency plus adjusted demand deposits held by the public.

M2 = MI 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.

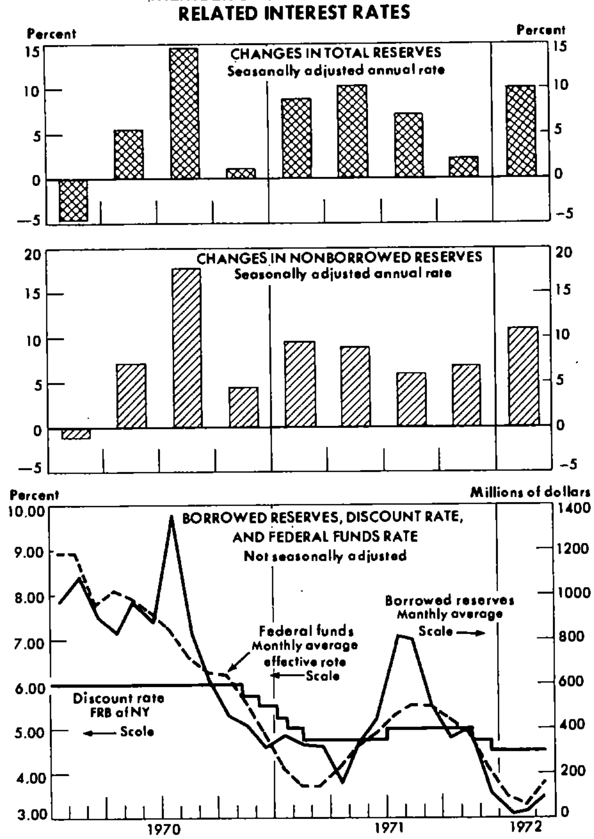
mand for money. This effect was reinforced by the general decline in interest rates, beginning in the latter part of 1971 and continuing into February 1972. Inasmuch as declines in interest rates reduce the cost of holding cash balances in the sense of income sacrificed, they tend to increase the demand for money. However, these effects often occur with considerable time lags. Hence, it is likely that the declines in interest rates that were touched off by the inauguration of the New Economic Policy last August were reflected to some extent in the demand for money in the first quarter.

The pressures for expansion emanating from the demand side were complemented by increased reserve availability—intended, in part, to promote more rapid growth in M_1 in the wake of its persistent sluggishness over the latter half of 1971. The growth of nonborrowed reserves accelerated to a seasonally adjusted annual rate of 11 percent in the first quarter of 1972 from 6.8 percent in the previous quarter (see Chart II). The speedup in the growth of total reserves was even more pronounced. The increase in total reserves had been at an annual rate of only 2.3 percent in the closing quarter of last year, as member bank borrowings from the Federal Reserve Banks fell sharply. Such borrowings shrank from an average of $424 million in the final week of September to $14 million by the end of February. The discount rate was reduced from 5 percent to 4½ percent in two stages in November and December but has remained unchanged since then. Meanwhile, the effective Federal funds rate declined by 138 basis points over the fourth quarter and by a further 71 basis points through the end of February. Under such circumstances, it is not surprising that banks made progressively less use of the discount window. In March, however, the effective Federal funds rate increased by 75 basis points to an average of 4.09 percent in the final week, and borrowings increased to $155 million. As a result of this reversal, the growth rate of total reserves over the quarter as a whole was almost as great as that of nonborrowed reserves.

The growth of M_2—consisting of M_1 plus time deposits other than large CDs—also accelerated, reflecting in part the resurgence in M_1 growth. Over the quarter as a whole, M_2 advanced at a seasonally adjusted annual rate of 13 percent, more than double the rate of increase experienced over the previous six months. Of course, the rise in M_2 during the second half of 1971 had been restrained by the sluggishness in M_1. Indeed, during that period, time deposits other than large CDs rose at a fairly strong 10 percent annual rate. Toward the end of 1971, time deposit growth accelerated appreciably as competing market rates fell relative to the yields on most time deposits. This

Chart II

MEMBER BANK RESERVES AND RELATED INTEREST RATES



Note: Reserve requirements on time deposits over $5 million were lowered from 6 percent to 5 percent on October 1, 1970.

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

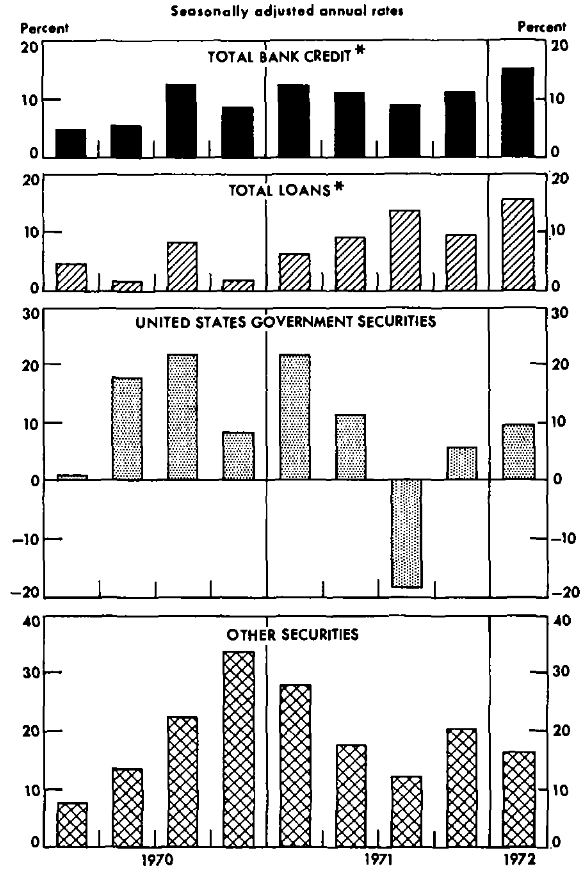
acceleration culminated in the extremely rapid 24 percent seasonally adjusted annual rate of growth in these deposits in January. A few large commercial banks cut their offering rates on passbook savings from 4½ percent to 4 percent in late January and early February. Other short-term interest rates leveled off and then began to rise in February and March. In part as a result of the narrowing of the yield differential in favor of time deposits, the growth of these deposits began to decelerate, first to a 15 percent rate in February and then to an 11 percent rate in March.

The adjusted bank credit proxy rose at an annual rate of 11.3 percent during the first quarter, up from 8.8 percent over the latter half of 1971. It followed a somewhat different pattern of growth over the quarter than either M_1 or M_2, growing moderately in January, slowing in February, and speeding up substantially in March. The pattern of fluctuation in seasonally adjusted Government deposits—which are included in the proxy but not in M_1 or M_2—was largely responsible for this divergent behavior. The Treasury was carrying high balances in December and early January in the wake of the tentative agreement on exchange rates reached at the Smithsonian conference on December 18. At the time, it had been widely expected that the agreement would precipitate a substantial return flow into dollars from abroad. Foreign central banks would then be expected to liquidate a large part of their holdings of Treasury securities to maintain the new exchange rates. By February, however, when it became apparent that the foreign demand for dollars was not imminent and the approach of the debt to the statutory ceiling restricted borrowing possibilities, the Treasury reduced its balances.

The Treasury raised only $660 million in February through $300 million additions to the last two weekly bill auctions and from $60 million in bond sales to individuals in conjunction with the February refunding. That sum was considerably less than the $1.3 billion cash drain from the attrition in the refunding. The Treasury delayed any new cash offering until the beginning of March when it auctioned a $3 billion strip of Treasury bills. Moreover, the additions to the weekly bill auction were discontinued after March 23 because of greater than anticipated tax receipts arising from substantial overwithholding of personal income taxes.

Nondeposit liabilities also dipped temporarily in February, but they have shrunk so much in magnitude that they no longer constitute a major part of the proxy. Large CDs, another component of the proxy, not included in M_1 or M_2, declined in January and March, although they increased sharply in February, thereby tending to mitigate the effects of the movements in Treasury balances on total member bank deposits. On balance, CDs outstanding were little changed over the quarter, after allowance for normal seasonal variation. The sluggishness of CDs appeared to be related in part to their extensive use to meet corporate tax payments in March. Banks did raise offering rates several times during March, indicating some effort to hold on to these funds as rates on competing market instruments rose.

Chart III
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.

BANK CREDIT AND INTEREST RATES

Total bank credit and most of its major components showed considerable strength in the first quarter of 1972. Bank credit, including loans sold to affiliates, increased at a 15 percent seasonally adjusted annual rate over the quarter (see Chart III). The acceleration from the 11 percent growth rate of the fourth quarter reflected a pickup in loans, as total loans, including loans sold to affiliates, advanced at a 15½ percent pace, compared with a 9½ percent rate in the fourth quarter. Increased purchases of Government securities also contributed to the resurgence, but the rate of increase in holdings of other securities slackened somewhat.

A particularly noteworthy development was the strengthening of domestic business loan demand, which reflected the large advance in GNP. With the exception of the third quarter of 1971 when business loans had been inflated by borrowing related to international developments, business loans had been relatively weak in most months since mid-1970. In the fourth quarter of 1971, for example, seasonally adjusted business loans declined slightly.

Interest rates on business loans declined along with other market rates. As the quarter began, the prevailing prime rate stood at 5¼ percent, but by the end of the first week in January most banks had lowered their prime rate to 5 percent. By the third week, declines in commercial paper rates spurred the majority of those banks that have adopted a floating prime rate to drop this rate to 4¾ percent. This move was soon followed by similar reductions at banks that still administer the rate. Further decreases—to 4½ percent—by most of the banks with floating rates were not widely followed by others, and by mid-March most of these banks had returned to a 4¾ percent rate. By the end of the quarter the prime rate had generally been raised to the 5 percent level that had prevailed in early January.

Most other categories of loans were at least as strong seasonally in the first quarter of 1972 as they had been in the final quarter of 1971. Real estate and consumer loans, which had contributed most of the strength in total bank lending in the fourth quarter, continued their healthy advances, albeit with a slight slackening in consumer loans. Loans to nonbank financial institutions and securities loans staged dramatic turnarounds in the quarter, growing particularly rapidly in January. Increased loans to brokers to finance the buildup in their margin stock accounts played a part in the securities loan resurgence. Total margin credit to customers, which is financed in part by bank loans to brokers, increased substantially in each month of the quarter to a record $9,145 million at the end of March.

Total investments of commercial banks grew at a 14 percent seasonally adjusted annual rate in the first quarter. Banks continued to acquire securities other than those issued by the Federal Government at a rapid rate. In the first quarter, holdings of these securities increased at a 16 percent rate, down from 20 percent in the previous quarter.

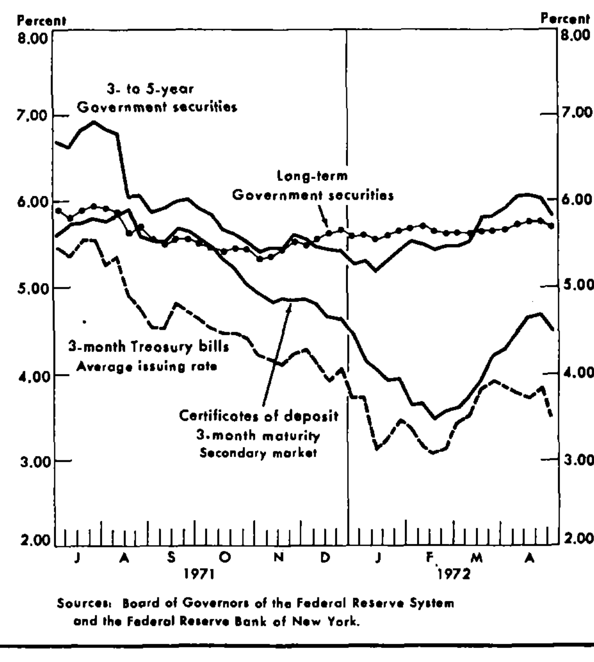
United States Government securities holdings advanced sharply in February and March, after having fallen off in January, and grew at a seasonally adjusted annual rate of 10 percent over the quarter. This acceleration represented an important recovery in these holdings, which had declined in each of the five months, July through November 1971. The last time bank holdings of Government securities had sustained such a lengthy decline was in late 1969, when heavy loan demand in a period of tight credit conditions precipitated the runoff in bank investments. The decline in 1971, however, appears to have been related to the peculiarities of the international situation. Foreign central banks were absorbing dollars and buying Treasury bills as well as special nonmarketable Treasury issues with the proceeds, driving bill rates to unusually low levels. Although foreign central banks continued to purchase Treasury securities in the first quarter, bill rates moved up beginning in mid-February (see Chart IV) under the pressure of an increased supply of Treasury bills and firmer conditions in the money market.

Other short-term interest rates also generally declined until mid-February. After that, most rates turned around and by the end of March were about back to where they had been when the quarter began. Nevertheless, short-term interest rates at the end of March were about 1½ percentage points below those prevailing before August 15.

Intermediate- and long-term rates, on the other hand, dipped early in January, then climbed through the rest of the quarter. Interest rates on intermediate-term Treasury notes rose about 70 basis points over the quarter. Long-term Government bond yields advanced much less—by an average of about 10 basis points. Even so, rates on three- to five-year notes remained more than 80 basis points below their pre-August 15 level, while long-term rates were only about 20 basis points lower than they were before price and wage controls were introduced. Of course, long-term rates are typically less volatile than are shorter term rates, as expectations are revised for the near future more easily than for the distant future. The sharper advance in

Chart IV

SELECTED INTEREST RATES



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

intermediate maturity rates was spurred by aggressive liquidation of dealers' positions in March, in part because of concern about the projections of a large Federal budgetary deficit and expectations that much of the financing of that deficit would probably involve new note issues in the intermediate maturity range.[1]

THRIFT INSTITUTIONS

Deposits flowed into thrift institutions during the first quarter at close to a 21 percent seasonally adjusted annual rate. Although this fell short of the record 22½ percent pace of the corresponding quarter last year, it was still extraordinarily rapid by historical standards. At savings and loan associations, the expansion was greatest in January when, spurred by reductions in interest rates on competing instruments, these deposits grew by a seasonally adjusted $4.1 billion, a record for the month. Deposit inflows remained high in February and March, however, even though market interest rates edged back up. Although there were scattered reductions in interest rates offered on certain classes of time deposits, the preponderance of passbook rates remained at the 5 percent ceiling level. Mutual savings bank deposit advances were spread more evenly through the quarter, with the most rapid advance coming in March.

Mortgage holdings did not keep pace with the deposit inflows in early 1972. The growth in mortgage loans at mutual savings banks actually decelerated slightly in the first quarter of 1972 in spite of an increase in the rate of deposit inflows. Mortgage growth has lagged deposit advances for some time at these institutions, so that this behavior is not at all unusual. At savings and loan associations, mortgages advanced at about the same 15 percent annual pace as in late 1971 notwithstanding much greater inflows of funds and decreases in the effective rates on conventional and Federal Housing Administration-insured mortgages. The savings and loan associations took advantage of these deposit inflows to pay off some of their indebtedness to the Federal Home Loan Banks. Nevertheless, mortgage loan commitments of all savings and loan associations rose strongly over the quarter to a record $10 billion, suggesting that there will be considerable advances in mortgage lending by these institutions in the future.

[1] The Treasury's announcement on April 26 of its plans for the May refunding caused some revision in these expectations and sparked a rally in the market for Government securities. For details see this *Review*, page 124.