Financial Developments in the Second Quarter

During the second quarter of 1972, the narrow money supply (M_1) grew at a seasonally adjusted annual rate of 5.3 percent, 4 percentage points below its rate of advance in the first three months of the year. At the same time, the broad money supply (M_2) and the volume of reserves available to support private nonbank deposits (RPD) expanded at far slower rates than had been witnessed in the January-March interval. However, aggressive bank marketing of large negotiable certificates of deposit (CDs) allowed the more comprehensive measure of member bank liabilities—the adjusted bank credit proxy—to expand at virtually the same rate as in the first quarter. On the asset side of the commercial banking system's balance sheet, bank credit growth slowed over the quarter, although the extent of the slowing may have been exaggerated by the manner in which bank credit is measured.

Despite the slowdown in the expansion of the monetary and reserve aggregates, upward movements in interest rates were quite moderate. To be sure, those money market yields most closely tied to the availability of funds to the banking system—the Federal funds rate, the rate on large negotiable CDs, and the prime loan rate—advanced somewhat over the interval. However, Treasury bill rates were virtually stable, as were commercial paper rates following an initial upward surge in this latter rate in April. At the longer end of the maturity spectrum as well, there was only a slight upward drift in yields, reflecting in part the easing of the demand for funds by the Federal Government and private corporations.

The healthy tone of the capital markets manifested by these interest rate developments was further reflected in the performance of the nonbank depository institutions as suppliers of funds to the residential mortgage market. The inflow of deposits to these institutions continued strong, though the rate of growth decelerated substantially from that witnessed in the first quarter. However, the data available through May suggest that despite the slowdown of deposit growth the combined rate of acquisition of mortgages by these institutions accelerated.

MONETARY AGGREGATES

Following its rapid first-quarter growth at a rate of 9.3 percent, M_1—defined as currency outside banks plus private demand deposits—expanded at a more moderate rate of 5.3 percent in the second quarter (see Chart I). As a result, the growth rate of M_1 for the entire six-month period ended June 1972 was 7.4 percent. Moreover, from November 1970—which the National Bureau of Economic Research has tentatively dated as the trough of the current business cycle—through June of this year, M_1 grew at a seasonally adjusted annual rate of 6.8 percent, a rate only slightly above that regarded by many as commensurate with the goal of viable economic recovery.

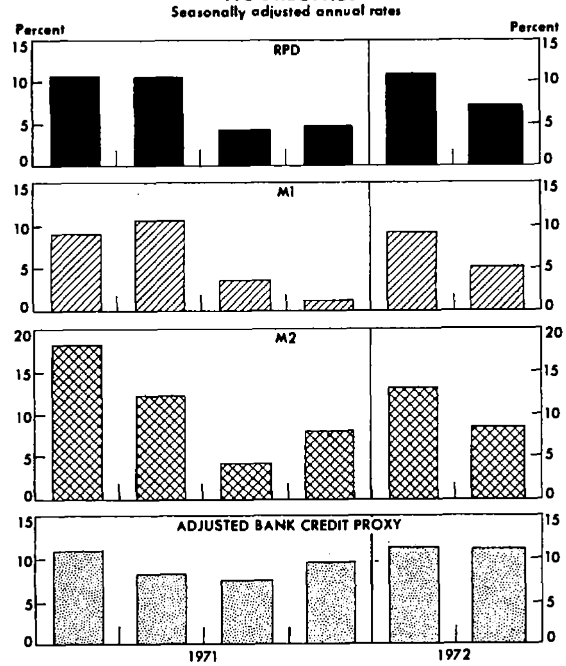
The decline in M_1 growth over the quarter was accompanied by reductions in the rate of advance of RPD and M_2—which adds to M_1 commercial bank savings accounts and time deposits except negotiable CDs in denominations of $100,000 or more. In the April-June interval, the seasonally adjusted annual rate of growth of RPD slowed to 7.4 percent, compared with 11 percent in the first three months of the year. Growth of M_2 took place at a rate of 8.6 percent through the April-June period, in contrast to its first-quarter rate of 13.3 percent. This decline in M_2 growth was attributable not only to the slowing of M_1 expansion, but also to a marked decline in the rate of advance of consumer-type savings deposits from 17.1 percent in the first quarter of the year to 11.8 percent in the second. As a result, the growth rate of M_2 over the six months ended June 1972 was 11.1 percent, the same as its rate of growth over all of 1971.

Despite this deceleration in the growth of private deposits, a broader measure of liabilities of banks that are members of the Federal Reserve System—the adjusted bank credit proxy—increased at a rate of 11.1 percent in the second quarter, a rate of growth only 0.2 percentage point below that realized in the first quarter. To a large extent the continued strength of the bank credit proxy in contrast to the slowdown in the growth of the deposit aggregates reflected the ability of commercial banks to

Chart I

CHANGES IN THE RESERVE AND MONETARY AGGREGATES

Seasonally adjusted annual rates



RPD = Total member bank reserves less those required to support United States Government and interbank deposits.

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.

attract funds through the use of large-denomination CDs. Over the quarter, the rate on three-month CDs in the secondary market rose from 4.28 percent at the beginning of the quarter to 4.67 percent by its end. The volume of CDs outstanding expanded over the quarter by $3.7 billion seasonally adjusted, an annual rate of increase of 44 percent. At the outset of the period, this CD growth was accompanied by large increases in the level of Treasury deposits in Tax and Loan Accounts. However, the accounts were drawn down sharply in June and showed a small net decline over the quarter.

BANK CREDIT, INTEREST RATES, AND THE BOND MARKET

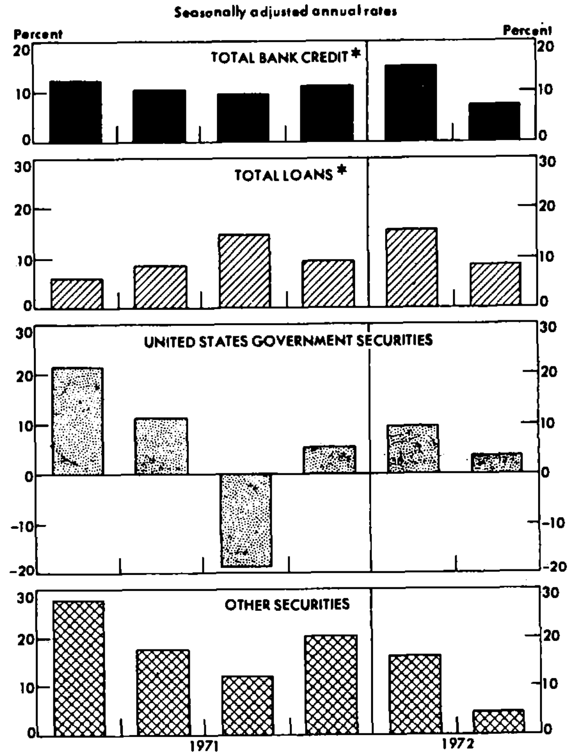
Although the sources of bank funds, as indicated by the adjusted bank credit proxy, grew at virtually the same rate during both of the first two quarters of 1972, bank earning assets—measured as loans and investments adjusted for loan sales to affiliates—displayed a marked slowing in their rate of growth during the second quarter of the year. After having expanded at an annual rate of 15.1 percent over the January-March period, bank credit increased at a rate of 7.3 percent during the second quarter of 1972 (see Chart II). The slowing in bank credit growth resulted in part from a lower rate of purchase of securities, both United States Government and others. It also reflected a June decline in business loans, which had grown rapidly over the first two months of the second quarter. In contrast, the growth of real estate and consumer loans accelerated in the second quarter from their already rapid growth in the first three months of the year.

To some extent, the disparate growth patterns of bank credit and the proxy during the second quarter reflect the

Chart II

CHANGES IN BANK CREDIT AND ITS COMPONENTS

Seasonally adjusted annual rates



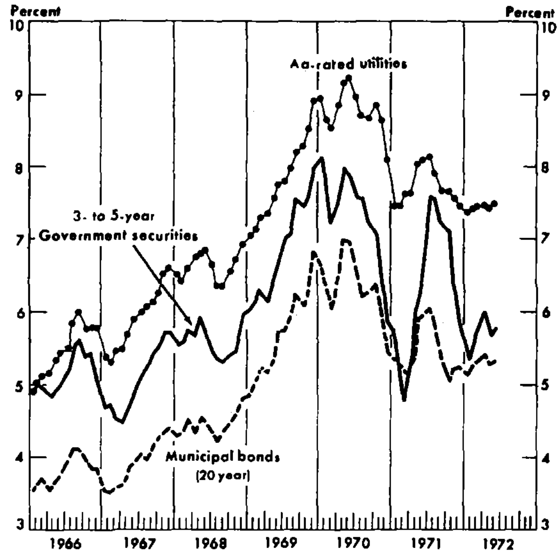
* Adjusted for loans sold to affiliates.

Source: Board of Governors of the Federal Reserve System different methods used in calculating these aggregates. To place this matter in proper perspective, it should be recalled that the bank credit proxy as well as the other monetary aggregates, when calculated monthly or weekly, are obtained on a daily average basis. In contrast, seasonally adjusted bank credit is reported monthly at its level on the last Wednesday of the month. Judging from the data available on a nonseasonally adjusted basis for weekly reporting banks, it appears that bank credit dropped temporarily in the last statement week in June, a week in which bank credit had been rising seasonally in recent years.

There was moderate upward pressure on short-term interest rates during the second quarter (see Chart III). For example, the average effective rate on Federal funds rose from 3.83 percent in March to 4.46 percent in June. CD rates also rose over the quarter. As the cost of funds to banks drifted upward, the prime business loan rate at most major commercial banks was raised from 4¾ percent at the end of March to 5¼ percent by the end of June.

Chart IV

LONG-TERM INTEREST RATES

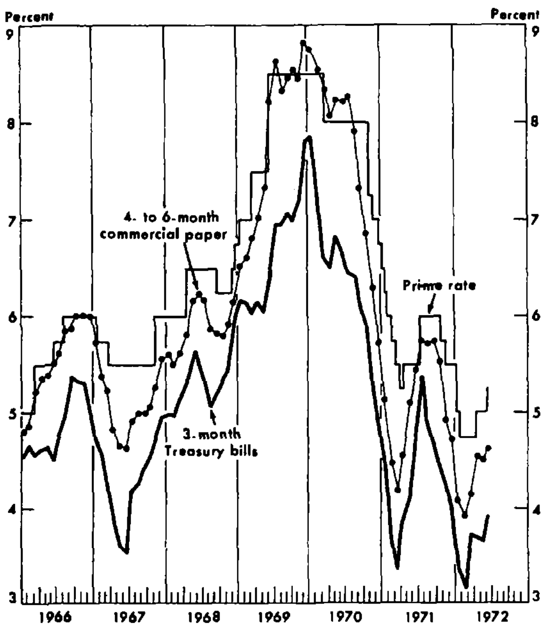


Note: The Aa-rated utility yields are taken from Salomon Brothers indexes of yields on newly issued Aa-rated utilities with deferred call. Beginning and end of month quotes have been averaged to form monthly yields. Yields on three- to five-year Government securities are monthly averages of daily figures. Yields on twenty-year municipal bonds are monthly averages of Thursday figures.

Sources: Salomon Brothers, Board of Governors of the Federal Reserve System, and The Bond Buyer.

Chart III

SHORT-TERM INTEREST RATES



Note: Yields on three-month Treasury bills and four- to six-month commercial paper are monthly averages of daily figures. The prime rate is the interest rate posted by major commercial banks on short-term loans to their most creditworthy business borrowers.

Source: Board of Governors of the Federal Reserve System.

Treasury bills were firmer than the rest of the market, with rates on three-month bills rising only about 20 basis points over the quarter.

Yields on intermediate- and long-term securities were for the most part little changed during the second quarter, with modest increases outnumbering slight declines. Interest rates etched an irregular pattern over the quarter, generally rising through most of April, declining in late April and through May, and then rising again in June (see Chart IV). One particularly interesting development during the quarter was the strengthening of the intermediate sector of the market for United States Government coupon obligations. Although yields in this sector had declined in general concert with the downward movement of interest rates following President Nixon's announcement of the new economic program, the decline in rates on three- to five-year Governments ended earlier than those on instruments in other sectors of the market, as investors became concerned about the financing implications of the prospective Federal deficit for the fiscal year 1973. Consequently, the first-quarter average yield on three- to five-year Government securities was higher than it had been in the first quarter of last year at the same time that most other securities were yielding less than they had during the same period last year. With the announcement of the Treasury's May refunding plans on April 26, which disclosed that a portion of the maturing securities would be redeemed, market expectations for this sector of the market brightened considerably and yields dropped sharply throughout May. Although rates backed up slightly in June, the average yield on three- to five-year Governments over the entire quarter was below that witnessed in the second quarter of last year.

The relative stability of intermediate- and long-term interest rates during the second quarter reflected in part the absence of heavy demands for funds in the capital markets. The United States Government repaid a net of $6 billion of debt, in contrast to the $1.6 billion raised during the second quarter of 1971. The Federal budgetary deficit for the fiscal year that ended June 30, 1972 was $23 billion—large historically but far below the $38.8 billion projected in the Budget document submitted by the Administration last January. Outlays were $5 billion below the January estimates, while receipts exceeded the estimates by $10.8 billion. The larger than expected tax revenues reflected not only overwithholding of individual income taxes but also the impressive strength of the recovery in economic activity during the fiscal year. In addition, the Treasury obtained during the second quarter $2.5 billion through the sale of special nonmarketable securities to foreign central banks which had acquired dollars in foreign exchange markets in an effort to prevent the exchange rates of their currencies against the dollar from exceeding the limits specified in the Smithsonian Agreement of December 18, 1971.

The corporate bond market was bolstered by a relatively light calendar of securities offerings. In part, this reflected the buildup of corporate liquidity that was accomplished through the record volume of bond offerings during 1970 and 1971 and the recent increases in cash flow as a result of increasing profits and accelerated depreciation allowances. Consequently, nonfinancial corporations floated only $10 billion of securities in the corporate bond market in the first six months of 1972, after having raised $15 billion through bond flotations over a comparable period last year. At the same time, state and local governments raised $12 billion in the bond market during the first half of this year. While it was almost equal to the record $12.5 billion in funds during the first half of 1971, a larger part of this year's gross proceeds have gone toward retirement of outstanding debt.

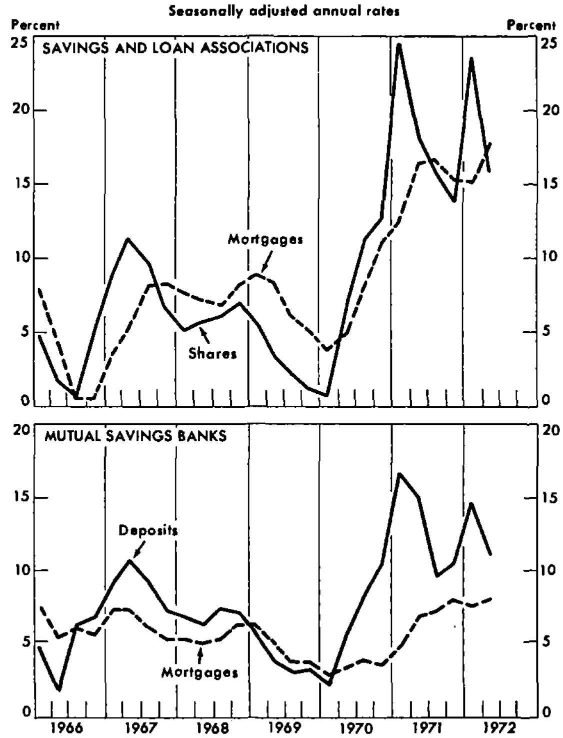
THRIFT INSTITUTIONS

The slowdown in the growth of small-denomination time deposits at commercial banks was paralleled at thrift institutions. Savings and loan association shares grew at an annual rate of 16 percent during the April-June interval, compared with the near-record rate of growth of savings and loan association capital of 23½ percent in the first quarter, while mutual savings bank deposit growth decelerated from its 14½ percent rate in the first quarter to 11 percent during the second (see Chart V). As a result of the total buildup of savings and loan association capital during the previous five quarters, however, the growth of mortgage holdings by savings and loan associations accelerated to a rate of 18 percent, compared with a growth rate of 15 percent in the first quarter of the year. At mutual savings banks, data available through May suggest

Chart V

THRIFT INSTITUTION DEPOSIT FLOWS AND HOME MORTGAGE LENDING

Seasonally adjusted annual rates



Note: Mutual savings bank mortgage statistics for the second quarter of 1972 are based on April and May data.

Sources: Federal Home Loan Bank Board and National Association of Mutual Savings Banks.

that the growth of mutual savings bank mortgage holdings accelerated to an 8 percent annual rate in the second quarter, after having been 7½ percent in the first quarter. With this continued strong participation of thrift institutions in the mortgage market, yields on new home conventional mortgages averaged 7.53 percent, 11 basis points below their average in the first quarter.

The deceleration of thrift institution deposit growth in the second quarter of this year notwithstanding, the overall performance of these deposits over the eighteen-month interval ended June 1972 was unusually strong. Over that period of a year and a half, savings and loan association capital grew at a seasonally adjusted annual rate of 21 percent, while mutual savings bank deposits increased at a rate of 14 percent. To be sure, much of this growth occurred in a period when the ratio of personal savings to disposable income was unusually high and when rates on competing market instruments were relatively low. However, it was also attributable to the aggressiveness with which thrift institutions have been offering higher yielding certificate-type accounts as a means of attracting deposit liabilities.