Monetary and Financial Developments in the Third Quarter

A broad range of monetary policy measures was implemented during the July-September period to restrain the persistently excessive expansion in money and credit. Following five increases during the first half of 1973, the Federal Reserve discount rate was raised twice during the quarter to reach a record 7½ percent effective August 14. In another step, reserve requirements on most demand deposits were raised by ½ percentage point effective July 19. In the second quarter, an 8 percent reserve requirement was applied to the total of large negotiable certificates of deposit (CDs), bank-related commercial paper, and finance bills outstanding in excess of a specified base. Effective September 20, this reserve requirement was increased to 11 percent. Most short-term interest rates increased over the first two months of the quarter in the wake of these developments. However, rates fell sharply in the second half of September, as participants concluded that monetary policy was no longer becoming more restrictive, and might even turn easier. Long-term interest rates rose irregularly over the first half of the period, but fully retraced these movements and closed somewhat lower on balance.

The growth of the monetary aggregates moderated during the third quarter of 1973. The narrowly defined money stock (M_1) expanded at a seasonally adjusted annual rate of less than 1 percent, as demand deposits adjusted actually declined. In comparison, M_1 increased at a 6 percent annual rate over the first half of the year and by 8.3 percent in 1972. While growth of consumer time and savings deposits at commercial banks remained substantial in the third quarter, the expansion of the broad money supply (M_2) slowed, reflecting the weakness in M_1. The adjusted bank credit proxy also grew at a somewhat slower pace in the July-September period than it had over earlier months of the year.

Business demand for short-term financing continued strong during the third quarter. Business loans at commercial banks expanded sizably in July and August, and businesses also began to turn to the commercial paper market for financing in September. Total bank credit rose at an 11½ percent annual rate over the interval, as banks liquidated holdings of United States Government securities to meet the robust loan demand. Corporate and municipal borrowing in the capital market remained relatively modest in comparison with recent years. While continuing to make mortgage loans to meet previously established commitments, thrift institutions—which experienced very little growth in deposits over the period—curtailed further commitments.

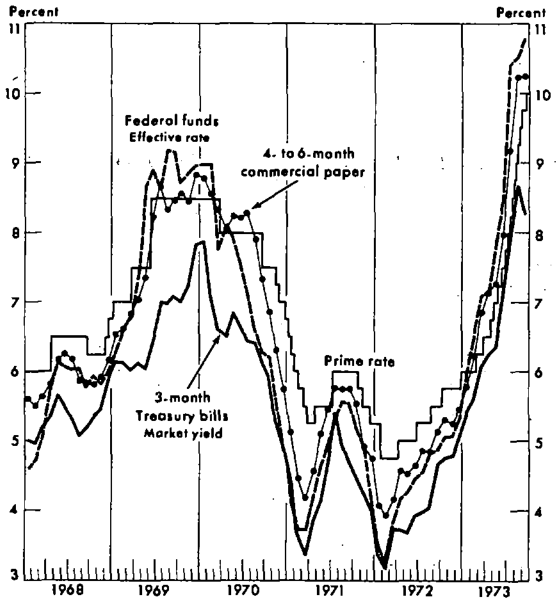
BANK RESERVES, INTEREST RATES, AND THE MONETARY AGGREGATES

Intense demand for reserves and a restrictive Federal Reserve posture fostered tight money market conditions throughout the July-September quarter. During the period, required reserves exceeded nonborrowed reserves by $1.4 billion on a daily average basis. As a result, commercial banks consistently borrowed heavily from the Federal Reserve and continued to bid aggressively for Federal funds. The effective rate on Federal funds climbed to a 10.78 percent average in September (see Chart I), 229 basis points above the June average.

Most other short-term interest rates increased over the first two months of the quarter before declining dramatically during the second half of September. Expectations that monetary restraint had reached or passed its peak prompted the sharp declines. While the rate on three-month Treasury bills rose by about 1½ percentage points over the first six weeks of the quarter to nearly 9 percent, at the close of the period the rate had fallen to about 7 percent. Similarly, the increase in commercial paper rates halted around mid-September and rates subsequently moved lower. Movements in long-term interest rates generally paralleled those on short-term instruments. After rising over the first half of the quarter, rates on long-term United States Government bonds declined, closing somewhat below the end-of-June levels. Corporate bond rates—as measured by the Federal Reserve Board's index of yields on recently offered utility bonds adjusted to an Aaa basis—ended the period about unchanged. Rates in the municipal bond market declined on balance, as The Bond Buyer

Chart I

SHORT-TERM INTEREST RATES



Note: Yields on Federal funds, 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 large business borrowers.

Source: Board of Governors of the Federal Reserve System.

index of twenty municipal bond yields was 5 percent at the end of September, compared with a final June reading of 5.25 percent and a high of 5.59 percent in early August.

M_1—private demand deposits adjusted plus currency outside commercial banks—expanded very slowly in the third quarter of 1973 at a 0.3 percent seasonally adjusted annual rate (see Chart II). This was well below the pace of the second quarter and of the first half of the year as a whole. Over the first three quarters of 1973, M_1 grew at an annual rate of 4.1 percent. The high rates of return available on many short-term instruments may have encouraged holders of demand deposits to shift into interest-bearing alternatives, thus contributing to the third-quarter weakness in M_1. Demand deposits adjusted declined at a 1.2 percent rate over the July-September period, while currency outside commercial banks increased at a 4.7 percent annual pace.

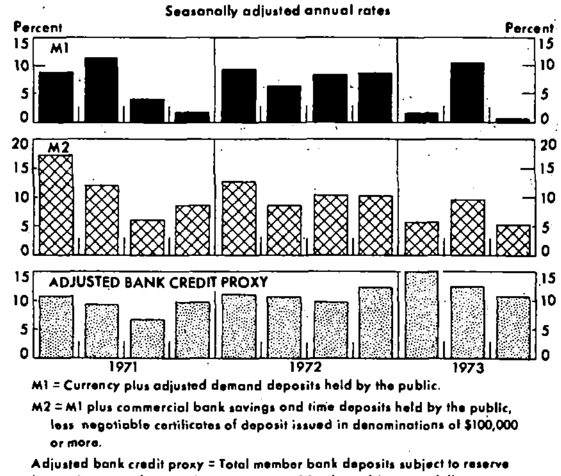
Changes in July in interest rate ceilings on consumer-type time deposits, including the introduction of no-ceiling "wild-card" deposits of four or more years' maturity, provided commercial banks with additional flexibility to compete with market instruments. Banks attracted a substantial quantity of such deposits, as consumer time and savings deposits grew at a 9.1 percent rate during the third quarter, about the same pace as that experienced over the first half of 1973. With this expansion countering to some extent the slow M_1 growth, M_2—consisting of M_1 plus time deposits other than CDs—rose at a moderate 5.1 percent seasonally adjusted annual rate during the third quarter. In comparison, M_2 grew at a 7.7 percent pace in the first half of 1973.

The adjusted bank credit proxy—total member bank deposits subject to reserve requirements plus certain nondeposit liabilities—increased at a 10.6 percent rate during the third quarter, a modest deceleration from its pace of the first half of the year. Time deposit flows, including substantial growth in CDs during July and August, and an increase in nondeposit liabilities more than offset small declines in private demand and Government deposits. In June, the Board of Governors of the Federal Reserve System raised the effective cost to banks of CDs, bank-related commercial paper, and finance bills by imposing an 8 percent reserve requirement on amounts issued above a specified base, defined as the amount of such liabilities outstanding in the week ended May 16. Nevertheless, banks continued to rely heavily on these liabilities; large weekly reporting banks issued a net \$5 billion of CDs during the first two months of the third quarter. On September 7, the Federal Reserve announced a 3 percentage point

Chart II

GROWTH IN MONETARY 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.

increase to 11 percent in the reserve requirement applicable to CDs, bank-related commercial paper, and finance bills above the May base.* This action appeared to contribute to the decline in CDs outstanding during September.

Total bank reserves rose at a 10.2 percent seasonally adjusted annual rate during the third quarter. Nonborrowed reserves expanded at a 12.3 percent rate, considerably below the pace of the second quarter. RPD—reserves available to support private nonbank deposits—increased at a 13.5 percent rate over the period. (These measures have been adjusted to remove the effects of changes in legal reserve requirements.)

BANK CREDIT AND THE CAPITAL MARKETS

Business demand for bank credit continued to advance at a brisk pace during most of the third quarter. Business loans at all commercial banks, adjusted to include net loan sales to affiliates, expanded at a 17.3 percent seasonally adjusted annual rate over the period (see Chart III), bringing business loan growth during the first three quarters of 1973 to a very strong 25.9 percent rate. Other bank lending, especially real estate and consumer loans, kept pace with the growth in business loans in the three months ended in September, and total loans increased at a 17.8 percent rate over the interval. As has occurred throughout the year, banks relied primarily on liquidation of securities holdings and CD issuance to assemble the funds to meet loan demand. Net divestiture of Government securities was at a substantial 34.4 percent rate in the third quarter. However, with bank holdings of other securities increasing at a 12.3 percent annual rate, total investments declined at only a 3.5 percent pace. Over the third quarter total bank credit increased at an 11.4 percent pace, down from the 12.7 percent of the April-June period. (The data are based on the recent revision of the historical bank credit series.)

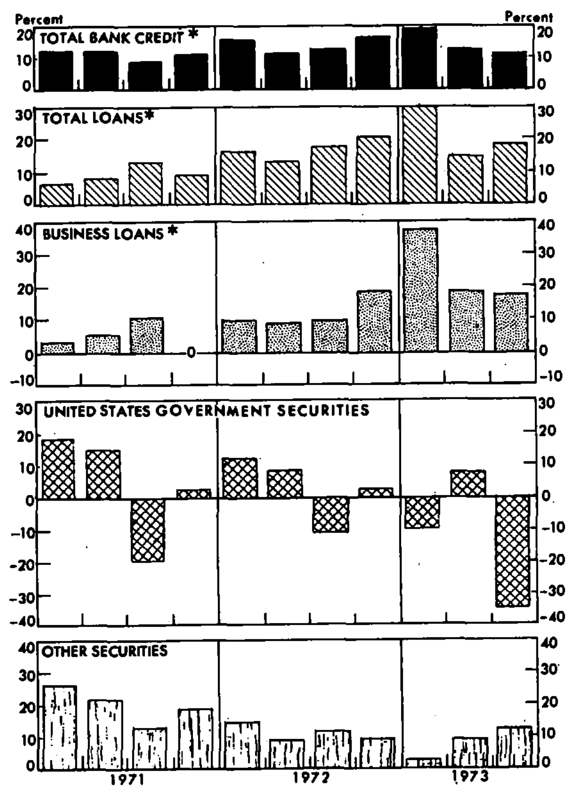
Commercial bank loans have comprised the major source of short-term financing for business during most of 1973. Indeed, dealer-placed nonbank-related commercial paper outstanding dropped appreciably early in the year and then remained fairly constant through August. However, in a succession of increases, most banks raised their prime lending rate for large business borrowers to 10 percent by mid-September. At the same time, commercial paper rates began to decline and, as a consequence, commercial paper financing became relatively more attractive. As a result, dealer-placed nonbank commercial paper outstanding rose by about $1 billion in September.

Corporate borrowing in the bond market was relatively modest over the first three quarters of 1973 following three years of a heavy volume of new long-term financing. Increased corporate earnings together with dividend payout limitations and funds acquired in previous years have probably served to reduce corporate needs. New corporate bond offerings were a modest $4.4 billion in the third quarter and $15 billion for the first three quarters of this year. Such borrowings in the comparable periods of 1972 were $6.1 billion and $20.4 billion, respectively. Revenue-sharing payments and increased tax collections have bolstered the financial position of many state and local governments. New state and local government bond issues have been moderate as well, totaling $5 billion in the three months

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.

*For details of these changes in reserve requirements, see this *Review* (June 1973), pages 136-37; (July 1973), pages 164-65; and (October 1973), pages 251-52.

ended in September compared with $5.4 billion in the same period in 1972. In contrast to these demands, new financing by Federal agencies has been very substantial over the first three quarters of 1973.

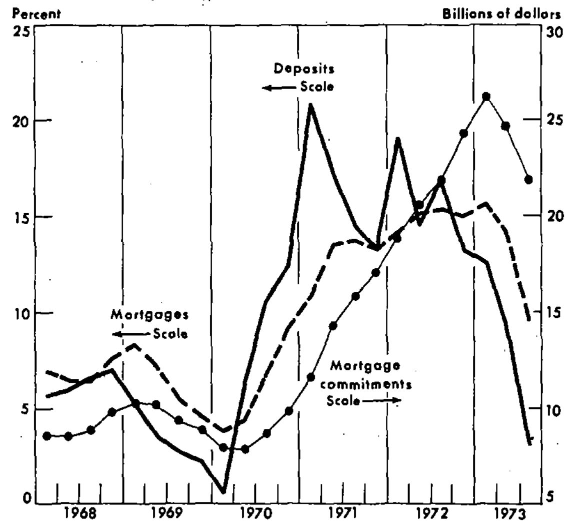
THRIFT INSTITUTIONS

Deposit inflows to savings and loan associations and mutual savings banks slowed markedly in the third quarter (see Chart IV). As high rates of return on alternative investments attracted funds, net deposits at thrift institutions grew at only a 3.1 percent seasonally adjusted annual rate, with virtually all of this increase at savings and loan associations. In comparison, thrift deposits expanded at a 16.8 percent rate during all of 1972 and at 12.6 percent and 9.4 percent rates during the first and second quarters of 1973, respectively.

The substantial deposit growth of 1971 and 1972 encouraged thrift institutions to meet the demand for increased mortgage commitments. As borrowers have taken down these commitments, mortgages at thrift institutions have continued to grow fairly rapidly, recording an estimated 9.5 percent rate of expansion in the third quarter. This was, however, a slackening from the 15 percent growth of mortgage holdings over the first half of the year. Strong demand for mortgages and weak deposit growth have propelled mortgage interest rates upward. The effective rate on conventional mortgage loans rose from 7.79 percent to 8.13 percent over the period. Insufficient funds from deposit flows forced thrift institutions to reduce their liquid assets to meet mortgage demand as well as to trim mortgage commitments. Mortgage commitments outstanding were reduced on average by $1.5 billion in the second quarter and by $2.8 billion in the third quarter. In addition, member savings and loan associations increased borrowings from the Federal Home Loan Banks by $3 billion over the quarter.

Chart IV

THRIFT INSTITUTION DEPOSIT FLOWS, MORTGAGE COMMITMENTS, AND HOME MORTGAGE LENDING



Note: Thrift deposits and mortgages are expressed as seasonally adjusted annual rates. Mutual savings bank mortgages for the third quarter of 1973 are based on July and August data.

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