Monetary and Financial Developments in the First Quarter

Business demand for short-term financing continued strong during the first quarter of 1974. At commercial banks, the growth of business loans surged at a 23.2 percent seasonally adjusted annual rate. The rise in business loans at commercial banks did not appear to come at the expense of other short-term business borrowings since the volume of dealer-placed commercial paper also increased substantially. Along with the burgeoning demand for short-term funds, the growth of the money supply measures remained excessive in the first quarter. The narrowly defined money supply (M_1) expanded at a seasonally adjusted annual rate of 6.7 percent over the January-March interval, an acceleration over the pace of 1973. The more broadly defined money supply (M_2) rose almost as rapidly in the first quarter as in the fourth quarter of 1973. The outstanding volume of large negotiable certificates of deposit (CDs) at weekly reporting banks increased sharply, after declining on balance over the preceding three-month period. Consequently, the growth in the bank credit proxy accelerated in the January-March quarter.

The huge demand for short-term credit, along with a change in market participants' expectations of the future course of monetary policy, prompted a turnaround in short-term interest rates during the quarter. After falling through mid-February, most short-term rates rose over the remainder of the period, experiencing little net change over the quarter as a whole. Short-term interest rates subsequently rose sharply in April.* Meanwhile, long-term bond yields increased rather steadily throughout the quarter. By the end of March, yields in the corporate sector were at their highest levels in more than three years.

Deposits at thrift institutions continued to expand at a moderate pace over the quarter, but inflows appeared to slacken considerably early in April. The slowing of deposit growth at thrift institutions appeared to reflect the rise in short-term rates on competing market instruments, as evidenced by the sharp increase in the volume of noncompetitive tenders at the weekly Treasury bill auctions. Thrift institutions increased their mortgage holdings considerably over the quarter, but their commitments to make new mortgages showed virtually no change.

* Interest rate developments in April are discussed in "The Money and Bond Markets in April", this *Review*, pages 127-31.

THE MONETARY AGGREGATES

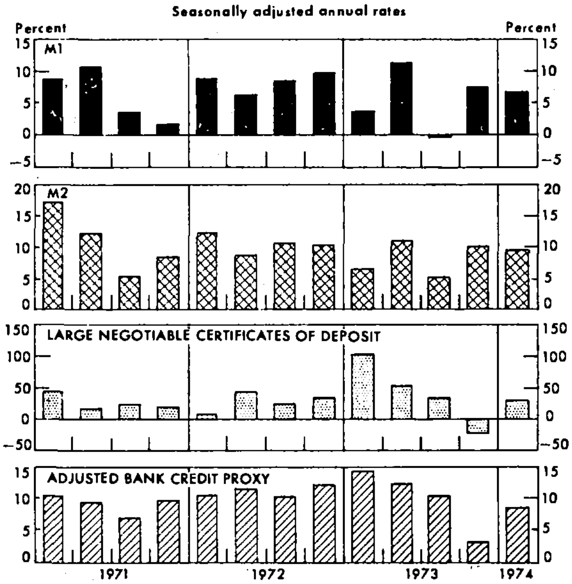
M_1—private demand deposits adjusted plus currency outside commercial banks—expanded in the first quarter at a 6.7 percent seasonally adjusted annual rate (see Chart I). This represents a 1 percentage point increase in growth from that experienced in all of 1973. As usual, the individual monthly growth rates of M_1 exhibited wide fluctuations. In January, M_1 actually declined at an annual rate of about 3½ percent, and then it increased sharply at annual rates of about 13 percent in February and 10½ percent in March. Some of the pronounced increase in M_1 in February can be attributed to relatively large refunds of individual income taxes, which served to reduce United States Government balances and increase private demand deposits. Since Government deposits are not included in M_1 while private deposits are, this transfer works to increase the money stock.

Over the January-March period, the currency component of M_1 rose at a seasonally adjusted annual rate of 11 percent, more than double the rate of increase in demand deposits. Since mid-1972, the expansion of currency has been rapid relative to both its own historical trend and to the growth of demand deposits. Much of the substantial advance of currency during recent months probably reflects large increases in expenditures on items that are exchanged for currency rather than demand deposits. Typically, these items include nondurable goods and services purchased by consumers. These expenditures in the gross national product (GNP) accounts grew sharply in the first quarter, rising by 12 percent as compared with a gain of only 4½ percent in total GNP.

M_2—defined as M_1 plus time deposits other than large CDs—advanced in the first quarter at a seasonally adjusted annual rate of 9.4 percent, compared with a gain of 10.1 percent in the preceding quarter. Over the quarter as a whole, the time deposit component of M_2 continued to rise rapidly—although not quite by so much as in the previous quarter—but its rate of growth decelerated in each succeeding month. In part, the slowdown in the expansion of time deposits less large CDs over the quarter may have reflected the rise in market rates on instruments that compete for consumer funds. It should also be recognized that the time deposit component of M_2 includes some corporate deposit holdings as well. In deriving M_2, only negotiable CDs issued in amounts of $100,000 or more at weekly reporting banks are subtracted from total time deposits. Thus, the time deposit component of M_2, as it is currently measured, includes nonnegotiable CDs in amounts of $100,000 or more at large weekly reporting banks as well as large negotiable and nonnegotiable CDs at other banks.

In contrast to the behavior of the time deposit component of M_2, the growth in large CDs accelerated sharply in the first quarter to a seasonally adjusted annual rate of 31.2 percent, after declining at a 23 percent annual rate in the fourth quarter of 1973. With short-term interest rates generally falling early in the quarter, banks were able to reduce their offering rates and still attract a large volume of funds with this instrument. Moreover, CDs became a less expensive source of bank funds after the Board of Governors of the Federal Reserve System lowered its marginal reserve requirement on CDs and certain other bank liabilities from 11 percent to 8 percent in December. As the quarter progressed, CD rates rose substantially, since banks were marketing such instruments aggressively in an effort to attract sufficient funds to accommodate the tremendous demands for credit and to roll over the large volume of CDs maturing in March.

Chart I
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.

The rapid growth of large CDs during the first quarter contributed to the expansion of the bank credit proxy. The adjusted bank credit proxy—member bank deposits subject to reserve requirements plus certain nondeposit liabilities—advanced at a seasonally adjusted annual rate of 8.5 percent during the January-March period, a substantial acceleration over the pace of the previous quarter. Aside from the decline in Government deposits, all components of the proxy added to its growth. Reserves available to support private nonbank deposits (RPD) exhibited some renewed vigor in the first quarter; after adjustment for seasonal variation, RPD expanded at an annual rate of 6.2 percent over the period, still not so rapid as the growth experienced overall in 1973.

BANK CREDIT, INTEREST RATES, AND THE CAPITAL MARKETS

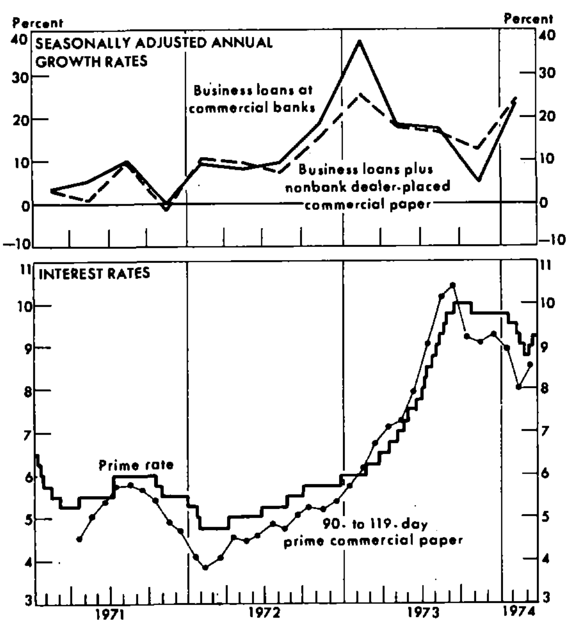
Following four consecutive months of sluggish growth, bank credit expanded sharply over the January-March period. Total bank credit, adjusted for net loan sales to affiliates, rose at a seasonally adjusted annual rate of 16.2 percent in the first quarter of 1974, nearly matching the extraordinary gain experienced over the first eight months of 1973.

An exceptionally large increase in business loans over the quarter provided the major thrust to the rapid expansion in bank credit. When adjusted for net loan sales to affiliates and normal seasonal variation, the growth of business loans spurted at a 23.2 percent annual rate in the January-March period (see Chart II). Business loan demand was broadly based among the manufacturing, wholesale, and retail sectors, although metal firms and commodity dealers were especially heavy borrowers. The huge first-quarter bulge in business loans was probably due in part to the need to finance larger inventories at higher prices. In turn, the inventory building may have reflected fears of rising material prices, raw material shortages, and expectations of future inflation.

The rapid expansion in business loans at commercial banks during the first quarter did not reflect a pronounced slowing in other short-term business borrowing. The volume of nonbank dealer-placed commercial paper outstanding expanded substantially in the first two months of the period, although it declined in March. For the quarter as a whole, business loans plus nonbank dealer-placed commercial paper grew at about the same pace as business loans alone. In contrast, during 1973 the growth in these two series differed substantially. Business loans at commercial banks surged over the first eight months of that year, when pressure from the Committee on Interest and Dividends kept the bank prime lending rate to large business borrowers artificially low relative to other short-term interest rates. The prime rate averaged about 20 basis points below the rate on 90- to 119-day commercial paper over the January-August period. This contrasted with the usual relationship during recent years, when the prime rate had averaged about 50 basis points above the commercial paper rate. With the prime rate relatively low over the first two thirds of 1973, businesses switched some of their borrowing from the commercial paper market to commercial banks. During the last four months of 1973, when commercial paper rates dropped below the prime rate, by about 35 basis points, on average, businesses rechanneled their borrowings to the commercial paper market and business loans at banks grew sluggishly.

Chart II

SHORT-TERM BUSINESS BORROWINGS AND RELATED INTEREST RATES



Note: Business loans are adjusted for loans sold to affiliates. Yields on 90- to 119-day prime 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.

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

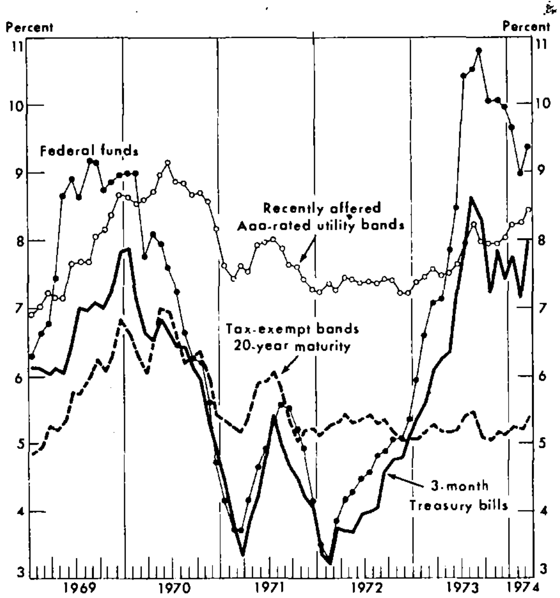
Not all components of bank loans advanced at an accelerated pace in the first quarter, however. Notably, the growth of consumer loans and real estate loans slackened, while securities loans continued to decline. At the same time, banks increased their securities holdings substantially. Total investments rose at a seasonally adjusted annual rate of nearly 12 percent, after showing virtually no change in all of 1973.

During the first quarter, most short-term interest rates moved in a seesaw pattern, declining in the first half of the period and then rising in the latter half, with little net change over the period as a whole. The Federal funds rate, for example, fell in late January through early February and then began rising around mid-March. By the end of the quarter, the effective rate on Federal funds stood at about 10 percent, almost the same level that prevailed in late December. Subsequently, the Federal funds rate advanced in April well above the levels of December. Offering rates on 90- to 119-day dealer-placed commercial paper dropped 125 basis points from the end of December to mid-February and then rose 163 basis points over the remainder of the quarter. The commercial bank prime lending rate for large business borrowers followed the same general pattern but with a lag. The tendency for changes in the prime rate to lag behind movements in other short-term rates is not a new phenomenon. Since early 1973, however, several banks have tied their lending rates directly to past market rates, thus reinforcing this tendency.

Movements in short-term rates during the quarter were especially sensitive to market participants' perceptions of apparent changes in monetary policy. The decline in the Federal funds rate late in January was perceived as a sign of some relaxation in monetary restraint, and market rates dropped sharply. The rally halted in mid-February in the wake of Chairman Burns's Congressional testimony emphasizing the System's concern with the ongoing rate of inflation. Then in March, when available data suggested that inflation was continuing unabated, M_1 was rising rapidly, and economic indicators were pointing to underlying strength in the economy, many market participants

Chart III

SELECTED INTEREST RATES



Note: Rates for Federal funds (effective rate) and three-month Treasury bills (market yield) are monthly averages of daily figures. Yields on recently offered Aaa-rated utility and twenty-year tax-exempt bonds are monthly overoges of weekly figures.

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

apparently reasoned that some tightening of policy was likely. The higher levels at which the Federal funds rate traded in mid-March seemed to confirm these expectations, and market rates increased substantially.

In contrast to the behavior of short-term interest rates, yields on long-term bonds increased rather steadily throughout the quarter (see Chart III). Rates on recently offered corporate bonds—as measured by the Federal Reserve Board index—ended the first quarter 57 basis points above their 1973 year-end levels, while rates in the municipal bond market—according to The Bond Buyer index of twenty municipal bond yields—advanced 41 basis points over the period. Since early 1973, corporate bond rates have increased substantially, and by the end of March 1974 they were at the highest levels in over three years. By comparison, rates on municipal bonds have not risen so noticeably. One of the factors contributing to the divergent behavior between corporate and municipal bond rates over this period has been the sharp rise in the price level. This has pushed individuals into higher marginal tax brackets, thus making tax-exempt securities relatively more attractive.

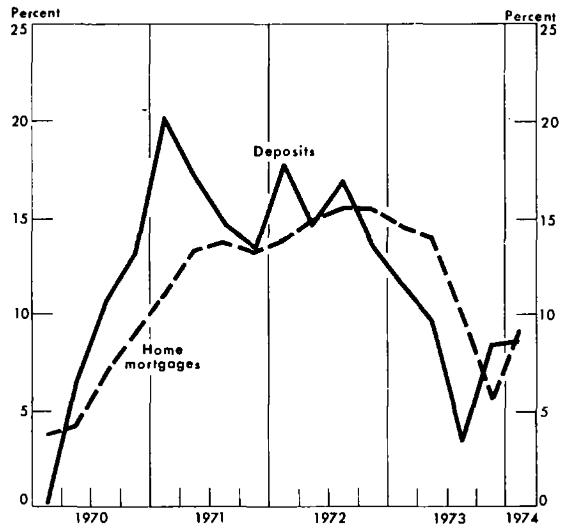
THRIFT INSTITUTIONS

Over the first quarter as a whole, deposits at thrift institutions continued to grow at a moderate pace (see Chart IV). Combined deposits at savings and loan associations and mutual savings banks advanced at a seasonally adjusted annual rate of 8½ percent, the same as the percentage gain experienced in the preceding quarter. However, with the sharp rise of market interest rates experienced in the latter half of March and in April, deposit flows to thrift institutions apparently weakened substantially in April. There was some indication of this in the magnitude of deposit outflows experienced at New York State mutual savings banks in early April. The attraction of market rates to individual savers was also illustrated by the expansion in the noncompetitive tenders at the weekly Treasury bill auctions. In the April 1 auction, the volume of noncompetitive tenders rose to its highest level since July 1970.

Thrift institutions maintained a relatively high volume of borrowings during the first quarter. Net Federal Home Loan Bank Board (FHLBB) advances to savings and loan associations, for example, rose $100 million on average over the January-March interval from the average

Chart IV

GROWTH IN THRIFT INSTITUTION DEPOSITS AND MORTGAGE LOANS



Note: Growth in thrift institution deposits and home mortgage loans are expressed at seasonally adjusted annual rates.

Mutual savings bank mortgages for the first quarter of 1974 are based on January and February data.

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

level sustained in the previous quarter, although borrowings from other sources decreased somewhat. Savings and loan associations seemed to be taking advantage of the relatively low rate on FHLBB advances to pay down their more costly indebtedness. On April 19, the FHLBB announced an increase in the ceiling rate that applies to advances to bring it in closer alignment with other interest rates.

Thrift institutions increased their mortgage holdings considerably over the first quarter, reflecting the heavy volume of commitments made during the first half of 1973, when housing demand was very strong. Thrift institution commitments to make new mortgages, however, remained at virtually the same level as in the final quarter of 1973. After declining for five consecutive months, rates on mortgage commitments for conventional homes in the primary market and insured new homes in the secondary market, as measured by the United States Department of Housing and Urban Development survey, edged upward in March by 5 and 12 basis points, respectively. The final March Federal National Mortgage Association (FNMA) auction of four-month commitments on insured mortgages provided additional evidence of firming in the mortgage market. Moreover, the volume of offerings to FNMA in the final March auction exploded to $1.2 billion, compared with $351 million in the previous auction and an average of $36 million offered in the auctions held in the past five months.