Monetary and Financial Developments in the Fourth Quarter

Most short-term interest rates fell substantially during the fourth quarter of 1974, extending the downtrend that began toward the end of the summer. The average effective rate on Federal funds dropped from 11.34 percent in September to 8.53 percent in December, its lowest monthly average in a year and a half. Similarly, sharp declines were registered over the quarter as a whole in rates on commercial paper, bankers' acceptances, and large certificates of deposit (CDs), although some rates experienced periods of upward pressure. In early December, the Board of Governors of the Federal Reserve System approved the first reduction in discount rates in three years. These rates were cut by ¼ percentage point to 7¾ percent, and shortly after the start of the new year an additional ½ point reduction was approved. The discount rates were lowered to 6¾ percent in early February. In the early weeks of 1975, the Federal funds rate and other short-term rates continued to fall.

Yields on long-term debt instruments dropped over the quarter with the exception of municipal bond yields. In the Government coupon sector the declines were fairly sharp and steady. Corporate bond yields, on the other hand, rose as the year drew to a close, reversing part of the earlier declines. The unseasonably large volume of offerings plus a substantial buildup of the forward calendar for early 1975 weighed heavily on the market. The municipal bond market came under pressure and yields rose sharply. The weakness of bank demand for municipal securities and the financial difficulties of state and local governments placed upward pressures on yields of municipals. The Bond Buyer index rose over the quarter by 46 basis points.

In the fourth quarter, the growth of the money stock measures accelerated a bit from the sluggish pace of the third quarter. However, in the final month of the period the narrowly defined money stock (M_1) rose very slowly, and preliminary data indicate that it fell in the early weeks of 1975. The sharp decline in market interest rates encouraged flows into commercial bank time and savings deposits. As a result, the more broadly defined money stock (M_2) grew more rapidly in the fourth quarter and continued to rise early in 1975.

Lower market interest rates also encouraged flows into thrift institutions, and deposit growth accelerated significantly during the fourth quarter from its extremely slow pace over the previous six months. At the same time, however, the growth of mortgage loans outstanding continued to decelerate, reflecting in part previous declines in commitments. Outstanding commitments dropped again in the fourth quarter. With overall credit conditions easing, secondary mortgage market rates moved sharply lower. Primary rates, however, as measured by the Federal Home Loan Bank (FHLB) Board effective yields series, continued to advance as investors took down loans that had been committed in earlier periods when rates were still rising.

Reserve requirements on member bank time and demand deposits were amended and reduced twice in recent months. In November, the Board of Governors lowered reserve requirements on long-term time deposits and raised reserve requirements on short maturities. The requirements on net demand deposits in excess of $400 million were lowered ½ percentage point. At the same time, the marginal reserve requirement on short-term CDs and related instruments instituted a year and a half earlier was removed. The requirements on net demand deposits were lowered ½ to 1 percentage point in January to facilitate moderate growth in the monetary aggregates. In addition, the Board permitted the establishment of "investment certificates", a new type of long-term consumer-type time deposits on which member banks are allowed to pay up to 7½ percent annual interest. The Federal Deposit Insurance Corporation (FDIC) and the FHLB Board took similar actions during December to allow their member institutions to issue these higher yielding time deposits.

MONETARY AGGREGATES AND SHORT-TERM INTEREST RATES

After rising very slowly during the summer months, M_1—private demand deposits adjusted plus currency outside banks—advanced over the fourth quarter as a whole at a somewhat faster pace. The growth of M_1 accelerated to a 4.3 percent seasonally adjusted annual rate, up from the 1.6 percent rate of expansion experienced during the previous three-month period (see Chart I). M_1 growth, however, was concentrated in the first two months of the quarter, when it rose at an annual rate of 5.3 percent. In December, M_1 grew very slowly and, according to preliminary data, it declined in the early weeks of January.

For the year as a whole, M_1 advanced by 4.5 percent, down substantially from the 6.1 percent increase experienced in 1973 and the rapid 8.7 percent gain registered in 1972. An unusually large part of the growth of M_1 in 1974 was concentrated in the currency component. The public's holding of currency rose about 10 percent, more than triple the rate of expansion in the public's demand deposit balances. Increases in currency seem to be directly related, in part, to the dollar volume of ordinary household expenditures on nondurable goods and services, which are often paid for with cash. These expenditures rose sharply in 1974 in contrast to a marked slowdown in the rate of advance in many of the other components of GNP.

The expansion of M_2—which adds to M_1 time deposits other than large CDs—also accelerated in the fourth quarter to an annual rate of 6.8 percent, compared with an increase of 4.6 percent in the preceding three-month period. The speedup in M_2 growth during the quarter reflected the more rapid advance in M_1 as well as a greater increase in M_2's time deposit component. Growth in the latter was probably boosted, in part, by the decline in interest rates on most competing market instruments. Over the year as a whole, M_2 rose 7.3 percent. This also represented a substantial slowdown from the rates of expansion experienced over the previous two years.

In contrast to the money stock measures, the bank credit proxy—member bank demand deposits subject to reserve requirements plus certain nondeposit liabilities—grew at a slower pace in the fourth quarter than in the preceding three-month period. The disparity between the growth of the proxy and that of the monetary aggregates arose mainly because banks did not completely offset a sharp decline in Government deposits by issuing CDs. Major New York City banks did market these instruments more aggressively toward the end of the year, in part to finance a temporary buildup of loans at that time. At banks outside New York City, credit demands were not strong and loan growth was weak over the quarter.

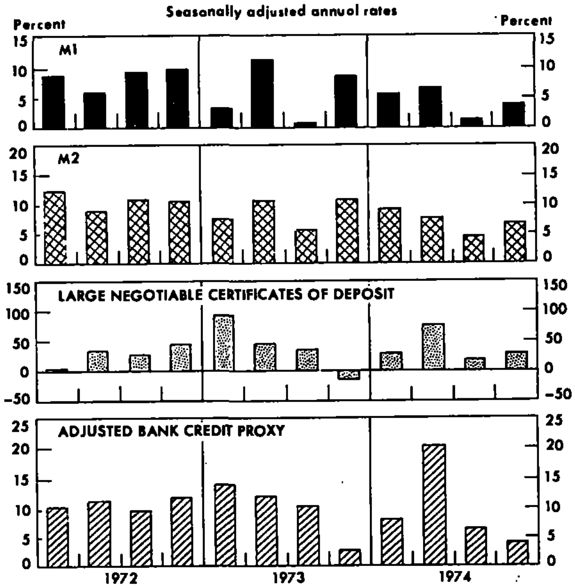
Member bank borrowings from the Federal Reserve dropped \$2.6 billion in the fourth quarter to an average of \$0.7 billion in December, the lowest level since November 1972. About \$1.75 billion of the decline represented the assumption by the FDIC of advances by the Federal Reserve Bank of New York to Franklin National Bank, while the remainder reflected the increased availability of nonborrowed reserves relative to requirements.

Over the fourth quarter, most short-term interest rates fell substantially, although this general trend was interrupted at times (see Chart II). In many cases, the largest declines occurred at the start of the quarter; indeed, some rates retraced part of their downward movement as the year drew to a close. The rate on four- to six-month commercial paper, for example, fell about 1¾ percentage points from the end of September to the end of October and then rose about ¼ percentage point by the close of the quarter. A similar pattern was exhibited by the rate on 90-day CDs in the primary and secondary markets. The backup in these rates was caused, in part, by reevaluations by some market participants who had expected the Federal funds rate to fall much farther rather than to remain about constant during November and, in part, by enlarged demands for funds which reached the markets in the closing months of the year. In December the Federal funds rate resumed its downward trend, and it continued to

Chart I

GROWTH IN MONETARY AGGREGATES

Seasonally adjusted annual rates



M1 = Currency plus adjusted demand deposits held by the public.

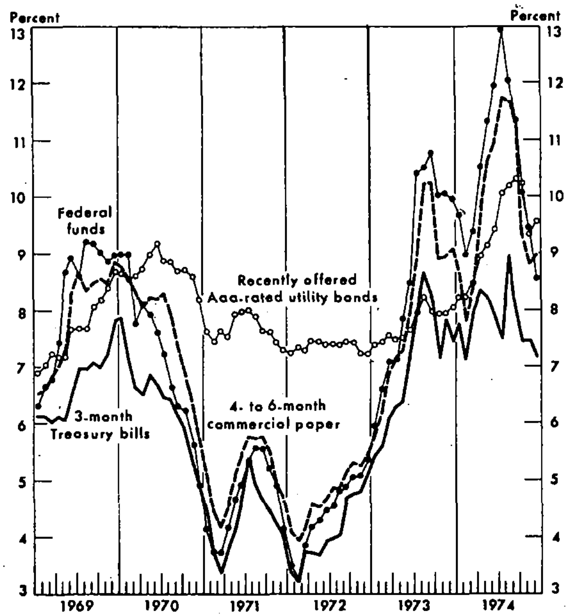
M2 = M1 plus commercial bank savings and time deposits held by the public, less negotiable certificates of deposit issued in denominations of \$100,000 or more.

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.

Chart II

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 bonds and four- to six-month commercial paper are monthly averages of weekly figures.

Source: Board of Governors of the Federal Reserve System.

fall early in January along with other short-term interest rates.

During the quarter, commercial banks cut their prime lending rates in several steps from the record high of 12 percent which prevailed over the July-September period. However, these reductions lagged the fall in other short-term market rates, generating unusually wide spreads and leading borrowers to shift their financing activity away from banks. By the year-end, major banks were about evenly divided between those posting a 10¼ percent prime rate and a 10½ percent rate. Subsequently, most major banks further reduced their prime rates in January.

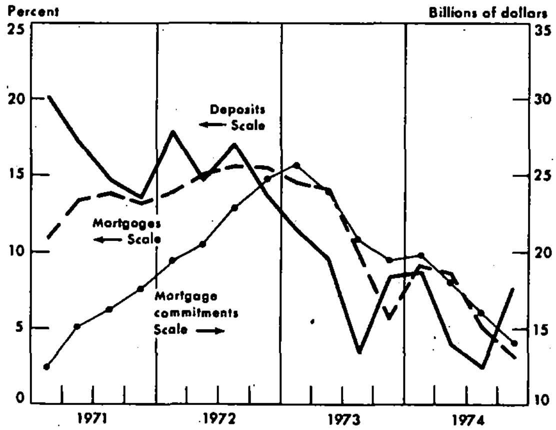
THRIFT INSTITUTIONS AND THE MORTGAGE MARKET

Thrift institution deposit growth accelerated during the fourth quarter, responding in part to the decline in short-term market interest rates that began toward the close of the preceding three-month interval. Total deposit growth took place at a 7.7 percent seasonally adjusted annual rate in the fourth quarter, significantly above the 2.5 percent rate of advance experienced in the third quarter (see Chart III). Despite this improvement, deposit growth for the year as a whole was at a slow 5.8 percent pace, down from 8.4 percent in the preceding year. The sluggishness of thrift institution deposit growth in 1974 stemmed largely from the adverse impact of relatively high interest rates that were available on competing money and credit market instruments during a considerable part of the year. Mutual savings bank deposit growth slowed to 3 percent in 1974, while savings and loan association deposit growth decelerated to 7 percent. The respective growth rates for the deposits of these institutions in the preceding year were 5.2 percent and 9.8 percent.

Although deposit growth accelerated in the fourth quarter, the rate of advance of mortgage holdings continued to decelerate. This deceleration reflected the sharp decline in mortgage commitments that began in mid-1973 and continued in 1974. For the year through November, the latest month for which data are available, mortgage holdings grew at a seasonally adjusted annual rate of 7 percent, after having grown about 11½ percent in 1973. Commitments for new home mortgages declined again during the fourth quarter, as thrift institutions continued to

Chart III

DEPOSITS AND MORTGAGES AT THRIFT INSTITUTIONS AND OUTSTANDING MORTGAGE COMMITMENTS



Note: Growth in thrift institution deposits and mortgage loans are expressed at seasonally adjusted annual rates. Mortgage commitments are the sum of the seasonally adjusted levels of mortgage commitments at all savings and loan associations and at mutual savings banks in New York State. Mortgages for the fourth quarter are based on data available through November.

Sources: Federal Home Loan Bank Board, National Association of Mutual Savings Banks, and Savings Bank Association of New York State.

manage their portfolios cautiously.

Secondary market mortgage yields fell sharply during the quarter. The easing of money market conditions reduced the pressure on mortgage originators to dispose of mortgages in their portfolios. Reflecting this development, the average yield on four-month commitments on insured mortgages at the last Federal National Mortgage Association auction in December was 9.47 percent, 109 basis points lower than the average yield at the final auction in September. These yields continued to decline in January. In the primary market the FHLB Board series on effective rates on new-home conventional mortgages rose 12 basis points over the quarter to 9.31 percent, as borrowers took down mortgages for which they had obtained commitments when credit market conditions were still firming. The volume of FHLB advances outstanding rose by about $1 billion during the quarter. Some of this borrowing from the FHLBs was offset by a reduction in thrift institution borrowing from other sources.

BANK CREDIT AND THE CAPITAL MARKETS

Seasonally adjusted total bank credit, including loans sold to affiliates, changed little in the fourth quarter from its average level over the previous three months (see Chart IV). In general, total bank credit has been exceptionally weak since August. The volume of total loans, for example, which dropped sharply in December, was virtually flat from August to November after advancing at an annual rate of about 18 percent during the first eight months of the year. Similarly, total investments declined almost consistently over the August-December period following sizable advances earlier in the year.

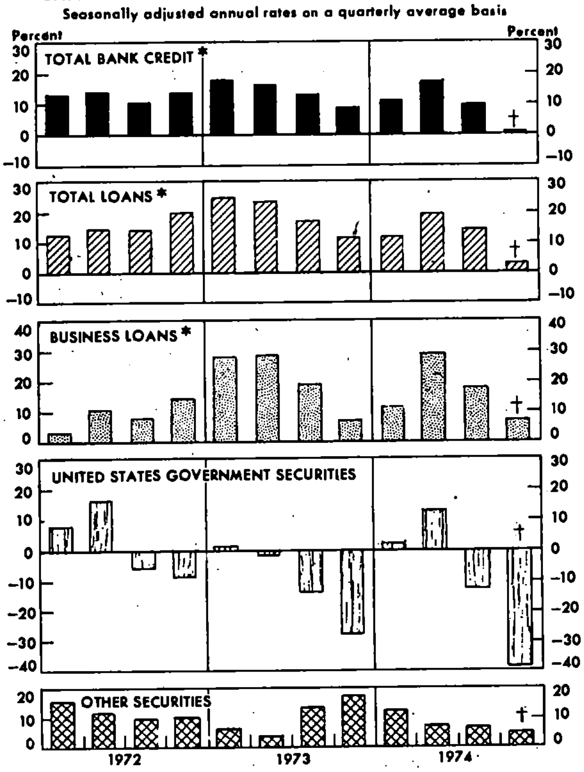
Business loans at all commercial banks grew at a 7½ percent rate in the fourth quarter, down substantially from the 20 percent average growth rate in the first three quarters of the year. Most of the recent slowdown occurred in December when business loans dropped off sharply. A slackening in the demand for business loans is not surprising in view of the sharp contraction in economic activity. Also, there seem to be indications that some of the regional banks may have been reluctant to make additional loans because of concern over bank liquidity and adequacy of capital. In contrast, major New York City banks experienced heavy loan demand as the year drew to a close, though declines in the early weeks of 1975 were much larger than seasonal. The different loan pattern exhibited at New York City banks relative to the rest of the country was due partly to heavy borrowing at major banks by some utility firms that were encountering problems in borrowing in the long-term debt markets. Moreover, New York City banks apparently attracted, particularly in December, borrowings from some firms which were experiencing difficulties in issuing commercial paper.

In the capital markets, yields fell on balance over the fourth quarter in both the Government securities and corporate sectors. The declines were generally less than those experienced in short-term rates, as new issue activity in the long-term debt markets over the period was exceptionally heavy and long-run inflationary expectations remained firmly embedded in yields. In the Government securities sector, rates on coupon-bearing issues dropped almost steadily throughout the quarter though concern about the potential size of the Treasury cash needs was evident. On three- to five-year issues, for example, rates fell about 1 percentage point from the end of September to

Chart IV

CHANGES IN BANK CREDIT AND ITS COMPONENTS

Seasonally adjusted annual rates on a quarterly average basis



* Adjusted for loans sold to affiliates.

† Adjusted to reflect the sale of Franklin National Bank's $1.5 billion of loans and investments to the Federal Deposit Insurance Corporation.

Source: Board of Governors of the Federal Reserve System.

the end of December. Over the same period, yields on long-term Government securities dropped about ½ percentage point. Corporate bond yields declined considerably through mid-November and then retraced part of their downward movement for the remainder of the quarter. Yields experienced upward pressure, as the forward calendar of new offerings for January built up to near-record levels while new issue activity in December remained unseasonably heavy. Investors continued to show concern for the quality of many public utility offerings over the quarter, and the spread between yields on these and yields on other corporate securities remained unusually wide.

In contrast to most other interest rates, yields on municipal bonds moved upward over much of the fourth quarter. As measured by The Bond Buyer's twenty-bond index, yields reached a record high of 7.15 percent in mid-December before receding to 7.08 percent at the year-end, a net gain of 46 basis points over the quarter. The rise in yields on municipal bonds seemed to reflect the absence of demand from commercial banks and fire and casualty insurance companies, which are traditionally heavy purchasers of these securities. A major contributing factor, however, was the budget difficulties affecting state and local governments.