Financial Highlights: 1974

While 1973 was generally viewed as a year of renewed excitement and somewhat unusual developments in financial markets, by 1974 standards it was placid. Looking back over the past year at monetary and fiscal policy and developments in the money and capital markets, one is struck by the intensity of the economic and market pressures that interacted to mold 1974 into an unusual year when judged by historical patterns of market behavior. A few key developments stand out as singularly characteristic of 1974. Pressures in the farm and construction sectors persisted throughout the year, resulting in substantially increased Agency borrowing and restructured patterns of savings flows and mortgage rate behavior. Moreover, continued inflationary pressures along with soaring short-term market rates precipitated a shift in investor preference from long- to short-term securities. Prodded upward by monetary policy expectations, persistent inflation, and liquidity pressures, short-term rates exceeded 1973 highs, shifting the patterns of investment behavior as rate spreads adjusted to market forces.

Monetary Aggregates M_1, currency outside commercial banks plus private demand deposits, measured on an end-month-of-quarter basis, expanded at a seasonally adjusted annual rate of 5.5 percent in the first quarter of 1974. This increase represented a nearly 2 percent jump in growth over the same period a year earlier. Measured on a quarterly average basis, however, M_1 expansion slowed from its pace a year earlier, posting a 5.8 percent increase. Although the quarterly average method of reporting M_1 is more nearly comparable with the measurement of other economic aggregates, the end-month-of-quarter basis is a more sensitive indicator of short-run movements in the money stock. Table Ia shows quarterly M_1 and M_2 growth for 1973 and 1974, reported both ways for comparative purposes. For the remainder of this discussion, however, the end-month-of-quarter rates will be used.

As usual the monthly growth rates of M_1 showed wide fluctuation throughout the first 3 months of 1974. In January M_1 declined at an annual rate of 2.7 percent as a holiday-related accumulation of foreign bank deposits that had raised M_1 in December reversed itself. For February and March, M_1 showed sharp gains of 9.7 and 9.2 percent, respectively. The pronounced increases in the last two months of the quarter can be attributed to sizable income tax refunds and a net redemption of maturing Treasury debt that combined to shift the ownership of demand deposits from the public to the private sector. M_2, time deposits other than large CD's plus M_1, advanced at a 9.3 percent annual rate in the first quarter compared to 10.8 percent in the previous quarter. Rapidly rising bank time and savings deposits boosted M_2 growth throughout the quarter.

Measured on both a quarterly average and end-month-of-quarter basis, growth of the narrowly defined money stock (M_1) accelerated in the second quarter. High U. S. money balances held by foreign official institutions and foreign commercial banks accounted for much of the M_1 growth. In April, the expansion of M_1 slowed somewhat from a month earlier, posting a 6.1 percent annual rate of growth. Over one-third of this rise was accounted for by the growth of foreign official and foreign commercial bank demand balances. By May, when the growth of money balances had eased considerably, the narrow money supply expanded only 4.3 percent. This fig-

Table Ia

GROWTH RATE OF THE MONEY SUPPLY

(seasonally adjusted annual rates)

		M_1		M_2	
		M	Q	M	Q
1973	I	3.4	6.8	7.3	9.1
	II	11.3	7.3	10.6	8.6
	III	0.6	5.5	5.6	7.7
	IV	8.7	5.0	10.8	8.9
1974	I	5.5	5.8	9.3	9.6
	II	6.5	7.2	7.7	8.2
	III	1.6	3.6	4.6	6.2
	IV	4.0	3.3	6.8	6.4

M: Annual rates of growth calculated from average levels in the final months of the quarters.

Q: Annual rates calculated from average levels in all three months of the quarters.

Source: Board of Governors, Federal Reserve System.

ure jumped to 9.1 percent in June with transfers of funds to the oil-exporting countries distorting the money stock figures temporarily, as demand balances bulged briefly before funds were passed on to foreign recipients. Over the second quarter, M_2 grew at a fairly rapid 7.7 percent annual rate, substantially off the pace a year earlier and slightly slower than the first quarter growth. The time and savings component of the broad money supply grew at nearly 8.6 percent over the period. While this growth was slower than in the first quarter, it was still noticeably rapid given the high level of market rates.

In part because of increased upward pressure on money market rates in the preceding months, monetary aggregate growth slowed noticeably in the third quarter. Growth of the narrow money stock decelerated sharply over the period, showing only a 1.6 percent annual rate advance from July to September. The slowdown resulted, in part, from a delayed response to sharp increases in interest rates that occurred during the first half of the year. It also partly reflected a System attempt to cool the fairly rapid monetary aggregate expansion that characterized the first half of 1974. The 1.6 percent third quarter growth of M_1 was down significantly from the 6 percent rate of expansion experienced in the first half of the year; and for the first nine months of 1974, M_1 averaged a 4.5 percent annual rate of growth, contrasting rates of expansion of 8.5 and 6.0 percent in 1972 and 1973, respectively. The broad money stock also experienced slower expansion in the third quarter, posting a 4.6 annual growth rate.

Growth of the aggregates picked up gradually in the fourth quarter from the depressed level of the previous quarter. M_1 grew in October at a 3.8 percent annual rate. The decline in interest rates that began in early October did not exert full influence on M_1 until November when the aggregate expanded at a 6.0 percent annual rate. Influenced by a sharp rise in commercial bank time deposits other than large CD's, M_2 growth spurted at an 8.3 percent annual rate through October; and in November, M_2 expanded at a 9.3 percent annual rate, the highest since June.

The expansion of the aggregates that characterized the first two months of the fourth quarter waned in December as M_1 growth slowed to a 2.1 percent annual rate. Most of the growth was in the currency component with demand deposit balances little changed, a condition true of most of the period since mid-year. M_1 expansion over the second half averaged 2.8 percent, and for the year M_1 posted a 4.5 percent annual rate of growth, off 1½ percentage points from a year earlier. The slowed growth of M_1 and commercial bank time deposits other than large CD's combined to limit M_2 expansion in December to 2.5 percent, reducing M_2 growth for 1974 to 7.1 percent, down from 8.6 percent in 1973.

Table Ib

MONETARY AGGREGATE GROWTH RATES

(seasonally adjusted annual rates)

		M_1	M_2	ABCP
1974	January	−2.7	6.9	12.3
	February	9.7	11.1	2.9
	March	9.2	9.7	9.2
	April	6.1	8.0	29.6
	May	4.3	4.3	16.9
	June	9.1	10.5	13.6
	July	2.1	5.4	9.2
	August	1.3	5.2	6.4
	September	1.3	3.2	3.9
	October	3.8	8.3	−0.2
	November	6.0	9.3	6.1
	December	2.1	2.5	7.6

Source: Board of Governors, Federal Reserve System.

Another variable that should be mentioned in conjunction with any discussion of monetary aggregates is the adjusted bank credit proxy (ABCP). A complicated network of interacting relationships exists between M_1, M_2, and ABCP. As the total of all member bank deposits subject to reserve requirements plus nondeposit sources of funds such as Eurodollar borrowings and the proceeds of commercial paper issued by bank holding companies or other affiliates, ABCP is a sensitive measure of the volatility of bank liabilities. The total volume of negotiable and non-negotiable CD's outstanding, while only partially included in M_2 figures, are totally included in ABCP and have had a significant impact on money and credit markets over the past few years.

The growth of large CD's accelerated sharply in the first quarter of 1974, growing at a seasonally adjusted annual rate of 31.2 percent after declining 23 percent in the previous quarter. The pattern of growth reflects, in part, the lowering of the marginal reserve requirement on CD's from 11 to 8 percent in December 1973, thus making CD's a less expensive source of bank funds. With short-term rates generally falling during the first quarter, banks could lower their rates and still attract sufficient funds. Toward the end of the quarter, however, as banks began to market CD's aggressively to help meet the burgeoning demand for credit, rates rose dramatically. The rapid expansion of CD volume triggered

an expansion of adjusted bank credit proxy. Showing substantial acceleration over the previous quarter, ABCP advanced at a seasonally adjusted annual rate of 8.1 percent in the January-March period. All components of the proxy, with the exception of Government deposits, showed gains.

Attempting to continue to satisfy the expanding loan demand, banks competed aggressively for CD's throughout the second quarter, to the extent that the volume of CD's outstanding grew at an astonishing 92 percent annual rate over the period. This enormous surge combined with the other ABCP components to account for the 20.0 percent annual rate of credit proxy growth between April and June.

The growth of CD's slowed sharply in the third quarter from the explosive expansion of the previous period. High interest rates and a moderation of the demand for loans precipitated the decline in volume. Even with the sharp third quarter decline in CD volume, on a seasonally adjusted basis, the dollar volume of CD's outstanding rose more in the first nine months of 1974 than in any preceding entire year. Toward the close of the quarter, the 3 percent marginal reserve requirement on CD's with a maturity of more than 4 months was removed in an effort to encourage banks to lengthen the maturity of their liabilities.

The decline in the growth of CD volume, along with slowed demand deposit growth, caused the rate of growth of ABCP to decelerate to a 6.5 percent seasonally adjusted annual rate in the third quarter. Following on the heels of 8.1 and 20.0 percent ABCP growth rates in the first and second quarters, respectively, this deceleration represented a significant turnaround in credit market behavior.

The adjusted bank credit proxy expanded at a 4.5 percent annual rate over the fourth quarter. October figures were slightly distorted due to the failure of Franklin National Bank, which caused a brief inconsistency in the series. For November and December, the credit proxy expanded 6.1 and 7.6 percent, respectively, resulting in a second half growth rate of 5.5 percent. Compared to the first half's rapid acceleration of 14.1 percent, the second half figures represent a significant slowdown. A decline in the rate of growth of demand deposits and CD's precipitated the decelerated credit proxy growth.

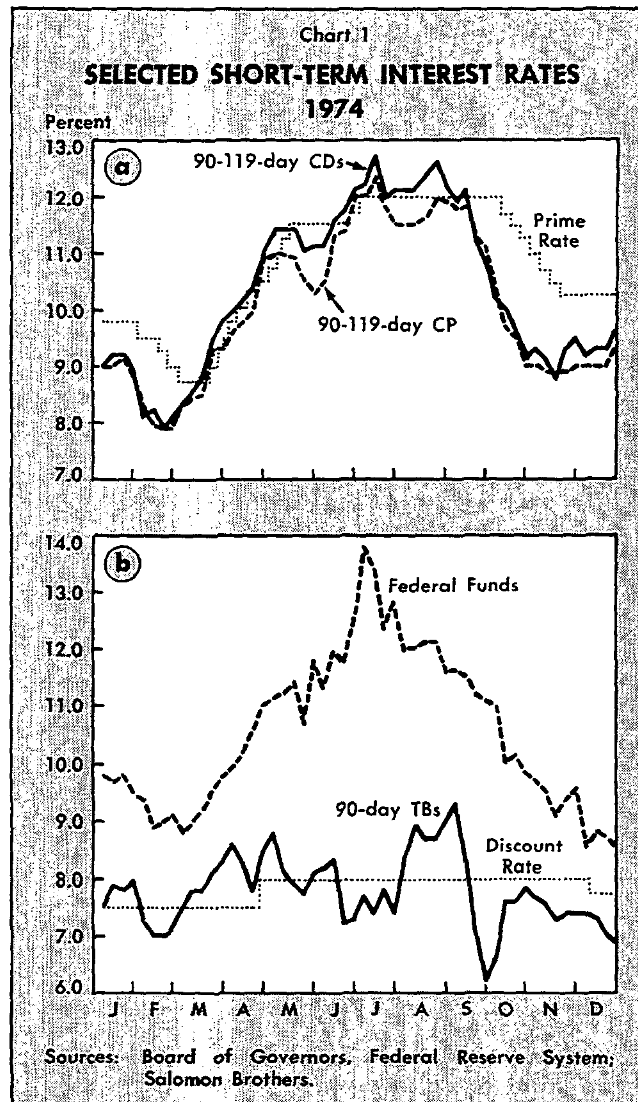
Bank Credit and the Money Market In the market for short-term funds, a combination of circumstances developed that produced an alignment of lenders and borrowers somewhat different from established historical patterns. Traditionally, certain businesses have concentrated their short-term borrowing at commercial banks, while others have preferred to rely on the commercial paper market. Although some shifting between these two sources of funds has occurred in the past, the quantity and extent of such shifts were unusually large on several occasions during 1974 in order for businesses to take advantage of changing interest rate spreads.

Following four consecutive months of sluggish growth, total loans and investments of commercial banks expanded rapidly in the first quarter of 1974, at a seasonally adjusted annual rate of 17.3 percent. The composition of bank credit shifted as the quarter progressed. Prior to a sharp jump in business loans in March, bank credit growth was buoyed by substantial seasonally adjusted increases in bank holdings of U. S. Treasury securities. The exceptional late-quarter surge in business loans, however, provided the major thrust to the rapid expansion of bank credit. Much of the surge in business loans was due, in part, to the need to finance large inventories at higher prices and also to finance some inventory accumulation in anticipation of rising material prices, raw material shortages, and gloomier inflationary expectations. Not all components of bank loans advanced over the first quarter. For example, the growth of both real estate loans and consumer loans continued to slide. The weakness of these latter two loan categories reflected the declines in the consumer durables and residential construction markets that accounted for much of the first quarter decline in real GNP.

As measured by the sum of bank commercial and industrial loans and nonfinancial commercial paper, total short-term business borrowing surged from January to March at an average annual rate of 22 percent. The requirements for financing inventories and accounts receivables played a major role in the exceptional business credit expansion. Another factor that put upward pressure on short-term credit demands late in the quarter was the increased postponements and cancellations of planned bond issues in the face of rising long-term rates. By late March, as increases in the prime rate lagged behind commercial paper rate gains (Chart 1A), the weight of business credit demand shifted out of the paper market toward commercial banks. This surge in short-term credit demands worked to push rates on short-term instruments toward 1973 peak levels. During the first quarter most short-term rates moved in a U-shaped pattern, declining 1¼ percentage points in the first half of the period, then rising in the latter half, with little net change over the period.

From early April through June, commercial banks continued to extend huge amounts of credit, as business loan demand showed continued strength. The volume of business loans outstanding advanced at a 23 percent annual rate over the quarter, with total bank credit expanding only 11.8 percent. Unsettled conditions in the commercial paper market, combined with a favorable spread between the commercial paper rate and the prime rate in late April and early May and again at the end of June, pushed the demand for business loans to record levels, as borrowers withdrew from money and capital markets. Market reaction to the financial difficulties of two large banks —one foreign and one domestic—and a large public utility company aggravated the shift of investor interest toward only the highest quality securities. Borrowers with less than a prime rating found themselves unable to market new commercial paper or to roll over existing debt. The new emphasis on quality instruments worked to increase the already heavy demand for business loans, precipitating sharp increases in the prime rate during the quarter. Commercial banks raised their prime lending rates in ten ¼ percentage point steps to a record level of 11.75 percent by late June. A key factor contributing to the prime rate increases was the need for banks to raise offering rates on CD's to obtain funds to cover their burgeoning loan demands. Rates on most other private short-term debt instruments also surged sharply upward and by the end of the quarter most short-term rates stood at record levels. Firm monetary policy, continued intense inflationary expectations, and the historically high level of business loan demand combined to push rates up further. The news of isolated instances of liquidity problems also aroused tensions throughout the short-term market. For the period, the Federal funds rate rose over 2½ percentage points to close the quarter at nearly 12 percent (Chart 1B), while the 3-month commercial paper rate jumped 2¾ percentage points and ended June at 25 basis points above the prime rate.

Conditions in the money market quieted somewhat in the third quarter. Bank credit expansion eased considerably, expanding at only a 5.6 percent annual rate compared to an 11.8 percent advance the previous quarter. Banks sold off heavy amounts of U. S. Treasury securities during the quarter, while their other investment holdings remained relatively stable. The major factor influencing the slowed growth of bank credit was a sharp fall in business loan demand. On a seasonally adjusted basis, the volume of business loans rose less than 1 percent in September, following a 21 percent gain in July and August. For the quarter as a whole, business loans grew at a seasonally adjusted annual rate of 14.2 percent, which, though high by historical standards, was 10 percentage points off the growth rate for the first six months of the year. A shift of borrowers out of the bank credit market into the commercial paper market, as paper rates fell below the 12 percent prime rate, nurtured the slowed business loan growth. Most private short-term rates rose sharply at the beginning of the third quarter as concern over inflation, firm monetary policy, and the continued strong demand for funds permeated short-term credit markets. In September, however, several developments effected a dramatic turnaround in rates. First, the Federal funds rate began to decline, indicating to market participants that an easing of monetary policy was in progress. Second, a reduction in the marginal reserve requirement on large CD's of more than four months matur-



ity was interpreted by the market as another sign of an easing in policy. Third, the excessively strong business loan demand eased as the spread between the paper rate and the prime rate returned to a more traditional alignment.

Reflecting the continuing decline in short-term market rates, the lagged response of bank prime rates, and generally stringent bank lending policies, total loans and investments at commercial banks were unchanged in October and expanded at only a 4 percent annual rate in November. The growth of business loans continued to decline through November, as many prime borrowers shifted their interest to the short-term securities markets to take advantage of the favorable spread between short rates and the prime rate. Business loans grew at about a 6 percent rate over the September-November period, well below the 14 percent third quarter expansion.

U. S. Government and Agency Markets In addition to the impact of corporate and municipal borrowers on long-term credit markets, the U. S. Treasury also had a substantial influence on market behavior during 1974. The financial needs of the Treasury in any given period are dictated by the excess of current Federal expenditures over current Federal revenues. Also, the Treasury must refund or retire those previously-issued securities that reach maturity during the period.

Early in 1974, the deficit for the fiscal year ending in July was forecast to be in the $4 to $6 billion range, with spending of about $273 billion and revenues in the neighborhood of $268 billion. By May, however, the budget deficit prediction was down to between $3 and $4 billion with spending reduced to just over $269 billion and receipts at $266 billion as budget cuts accompanied the fight against inflation. The final Federal budget deficit for fiscal 1974 was $3.5 billion, substantially below the $14.4 billion deficit a year earlier.

Late in January the Treasury announced plans for its first refunding operation of the year. This refunding would provide funds for retiring the $4.5 billion publicly held notes and bonds maturing February 15 by auctioning 3 issues to the public: (1) $2.25 billion 3¼-year notes at 6⅞ percent, (2) $1.5 billion 7-year notes at 7 percent and, (3) up to $300 million of 19½-year bonds at 7½ percent. The total package represented a pay down of $0.5 billion, thus arousing a positive market sentiment. Although interest in the refunding package was initially mixed, by the time of the auctions all the issues attracted good interest and were sold at prices above par.

After auctioning $1.5 billion of tax anticipation bills (TABs) on February 26, the Treasury next came to market with a $4 billion new cash borrowing in late March, consisting of $2.5 billion of 85-day tax anticipation bills and $1.5 billion 2-year 8 percent notes. The financing was well received, at least partly reflecting commercial banks' ability to pay for the bills by crediting Treasury Tax and Loan Accounts.

As the second quarter opened in April a cautious atmosphere prevailed in the Treasury market, partially due to relatively firm conditions in the money market, the announcement of a sizable Agency offering, and the close proximity of the May Treasury refunding. Terms of the refunding were designed to refinance $5.6 billion of publicly held securities maturing May 15. $4.1 billion would be retired by auctioning three issues to the public. $2 billion of 25½-month notes and $1.75 billion of 4½-year notes would carry a coupon rate of 8¾ percent, while $300 million of 25-year bonds would be placed at 8½ percent. The Treasury would use available cash balances to cover the remaining maturing issues. The terms of the refunding aroused substantial interest, especially from the small investor in view of the $1,000 minimum denomination. In addition, the Treasury announced plans to increase its weekly bill auction by $200 million each week for five weeks beginning mid-May.

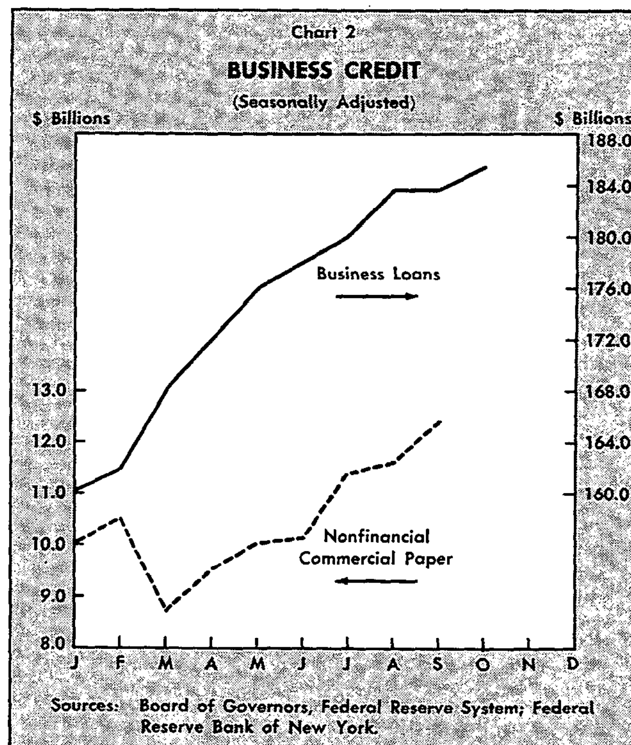
Toward the end of the second quarter the Government securities market benefited from the growing concern of market participants over liquidity problems that had recently come to light. Many participants were eager to shift part of their portfolios into the "safer" Treasury securities; thus, an $800 million strip auction of bills to raise cash in late May was well received by both large and small investors. For most of the remainder of the second quarter the Treasury market was shielded from the inflationary worries plaguing other sectors of the securities markets. Investors, including foreign official institutions from oil producing countries, showed a strong preference for Treasury obligations, especially bills. By the last half of June, 3-month bill rates averaged a record 4 percentage points below rates on CD's or commercial paper of the same maturity, considerably above the normal 1 percentage point spread (Chart 1). A substantial part of the demand for bills came from foreign central banks, but continued interest from individuals who found yields on bills more attractive than those on alternative investments also contributed to the strong demand.

The high level of short-term rates, bulging business loan demand, and deteriorating conditions in the

capital markets caused apprehension in the long-term Treasury market at the start of the third quarter. Yields on Treasury issues soared in August as new bill offerings bulged and gloomy price statistics were reported. As the Treasury approached the August refunding, the announced terms attracted intense interest from the small investor. The offering was structured to refund $4.3 billion of publicly held notes and to provide $100 million to cover part of the Treasury's short-term cash needs. At the same time the Treasury increased the regular weekly bill auction of 3- and 6-month issues by $200 million to $4.7 billion. Terms of the refunding included $2.25 billion of 9 percent 33-month notes, $1.75 billion of 9 percent 6-year notes, and $400 million of 8½ percent bonds maturing in 1999. Interest in the two note issues, particularly from the small investor, was unprecedented. Noncompetitive allotments for the two issues accounted for 55 percent of the total volume. Both the 9 percent rate and the availability of $1,000 minimum denominations attracted the small investor. Not since November 1970 when the Treasury started using the auction technique for note issues had the noncompetitive subscription been so large. Demand for the final $400 million of bonds was dampened by a rapid rise in wholesale price figures and the issue was sold at a price below par to yield 8.63 percent. As additional bills came to market later in August, dealer inventories bulged and bill rates soared until early September. As the month progressed, the continued strength of noncompetitive tenders at the weekly bill auctions combined with easing in the money market and continued strong demand for bills by foreign official institutions and other investors with a preference for high quality issues to drive rates on auctioned bills well below those on outstanding issues of comparable maturity. By the end of September rates on 3-month bills had dropped to the lowest level since May 1973 (Chart 1B). Yields on Treasury coupon securities also fell at the close of the third quarter in response to the sharp declines in the short end of the market.

After a small upswing in short-term bill rates in October, rates on most Treasury issues moved irregularly downward over the fourth quarter. Even though issue supplies were abundant throughout the quarter, market expectations of a broad decline in interest rates buoyed investor sentiment, and demand was generally strong. Declines in both the Federal funds and discount rates reinforced this belief.

Heavy financing activity dominated the Government securities market during the fourth quarter.



The Treasury raised $1 billion in new cash at the regular weekly bill auctions in October. In addition the Treasury undertook a $2.5 billion cash refinancing program, auctioning $1.5 billion of 7½-month bills and $1 billion of 4½-year notes at 7.93 and 7.89 percent, respectively. Late in October the terms of the quarterly refunding were announced with three issues making up the package. Treasury plans included refunding $4.3 billion publicly held notes and bonds maturing November 15 and raising $550 million cash by auctioning $2.5 billion of 3-year notes, $1.75 billion of 7-year notes, and $600 million of 8½ percent 25-year bonds. The 3-year notes were restricted to a $5,000 minimum denomination in an effort to reduce pressure on thrift institutions. Strong market interest in all three issues resulted in yields of 7.85, 7.82, and 8.21 percent, respectively.

In addition to the refunding package and the extra $200 million of bills auctioned weekly, the Treasury came to market with bills on three occasions in November. $2.25 billion of April 1975 tax anticipation bills were priced to yield 7.43 percent; $1 billion worth of additions to outstanding short-term bill series were offered November 21; and $1.25 billion of June 1975 tax anticipation bills were auctioned at 7.52 percent. Banks were not permitted to credit their Treasury Tax and Loan Accounts as payment for purchases in either of the TAB auctions.

The market for Government securities was highlighted by two separate occurrences in December that reflected the "encouraged" market tone. (1) The Treasury did not raise new cash at the third weekly bill auction for the first time in 10 weeks, and (2) in the regular monthly auction the average issue rate dropped to 6.63 percent, the lowest level since March. The Treasury came to market with two note financings at the close of the quarter, a $2.3 billion 2-year note issue and a $1.25 billion 7⅞ percent issue maturing in May 1979. Proceeds of the two auctions were to redeem $1.9 billion of debt maturing at year-end and to raise $1.65 billion of new cash.

A factor that must be dealt with in any discussion of the Government securities market, especially in a year such as 1974, is the market for Federal Agency securities. Although active in the past, the Agency market blossomed during 1974 as pressures in a wide variety of market sectors, particularly the farming and construction markets, caused increased demand for Agency funds to be used in support operations. As investors became nervous over the liquidity problems that came to light around mid-year, Agency issues began to look even more attractive because of their high quality status. The market for Agencies benefited from and reacted to many of the same pressures and stimuli that affected the Government market throughout the year. A good tone or moderate investor resistance in either market permeated the other, so the prevailing pressures will not be reiterated in this discussion. It is helpful, however, in understanding the impact of Agency financings to look at some specific issues that came to market.

The Agency market in the first quarter was dominated by farm and mortgage related issues. There were offerings by three major farm credit agencies during January and February. Federal Land Banks came to market with $300 million of 5-year bonds at 7.10 percent, $360 million 30-month bonds at 7.05 percent, and $389 million 5½-year 7.15 percent bonds. The Banks for Cooperatives and Federal Intermediate Credit banks marketed bond issues of $556 million and $753 million, respectively, in January and came back to the market in March with $251 million and $608 million bond issues. Around mid-quarter, a $600 million Federal home loan bank issue was offered and met with enthusiastic investor response. The offering represented a net pay down of $650 million of debt, reflecting reduced dependence of S&L's on Federal home loan banks as a source of advance funds as the growth of savings deposits resumed and mortgage demand slackened.

Throughout the second quarter, the major farm credit agencies marketed over $2 billion worth of bonds with varying maturities, as strong support for the farming sector continued. Although investor reaction was somewhat mixed around mid-quarter, most issues sold out well. On the housing front, support operations picked up over the quarter as evidence of withdrawals from thrift institutions mounted. Federal home loan banks came to market with a total of $3.5 billion of bonds in two separate issues. Of this total, $2.5 billion was new capital, and both issues met enthusiastic investor response. The Federal National Mortgage Association (FNMA) also marketed a large package totaling $1.5 billion and consisting of three separate debenture offerings. $750 million of this was to raise new cash as the mortgage market tightened.

At the start of the third quarter, in late July, the Federal Financing Bank held its first auction, selling $1.5 billion of 8-month bills at 8.05 percent. Bearing all the characteristics of Treasury bills, the bills were auctioned with full tax and loan account privileges. By coordinating the borrowing activities of several Federal agencies, the Financing Bank hoped to reduce financing costs. The proceeds of this first offering repaid $1.4 billion of advances from the Treasury and covered some current advances to the agencies.

In addition to this marketing, farm credit and housing related agencies continued their high level of offerings throughout the third quarter. In July Federal Land Banks, Federal home loan banks, Banks for Cooperatives, and Federal Intermediate Credit Banks came to market with $3.6 billion worth of bonds with varying maturities, mostly intermediate-term. During August a whopping $4.6 billion housing and farm credit related debt was marketed. Expectations of future heavy financings coupled with already large dealer inventories and the surge in Treasury yields weakened the Agency market somewhat during August. Prices of Agency securities moved up at the close of the third quarter with new issues generally well received. Housing and farm credit agencies continued their heavy volume of offerings, with the Federal home loan banks raising $1.7 billion of new capital.

The Agency market was characterized by strong investor interest and declining yields during the fourth quarter. Both housing and farm credit agencies continued to come to market with large offerings, some of which were to raise new cash. On November 26, the Federal National Mortgage Association sold $1.2 billion of debentures in a three-part pack-

age, raising $500 million new cash. Yields ranged from 7.50 percent on the debentures maturing September 1976 to 7.95 percent on the 9¾-year debentures. The Federal home loan banks marketed three offerings over the quarter: (1) $1.5 billion of bonds varying in maturity from 2 to 7 years and yielding an average 8.63 percent; (2) $500 million of 2¼-year 8.05 percent bonds and $500 million of 5-year 8.15 percent bonds, representing a net redemption of $216 million; and (3) $500 million of 5-year bonds for new cash at a yield of 7.5 percent.

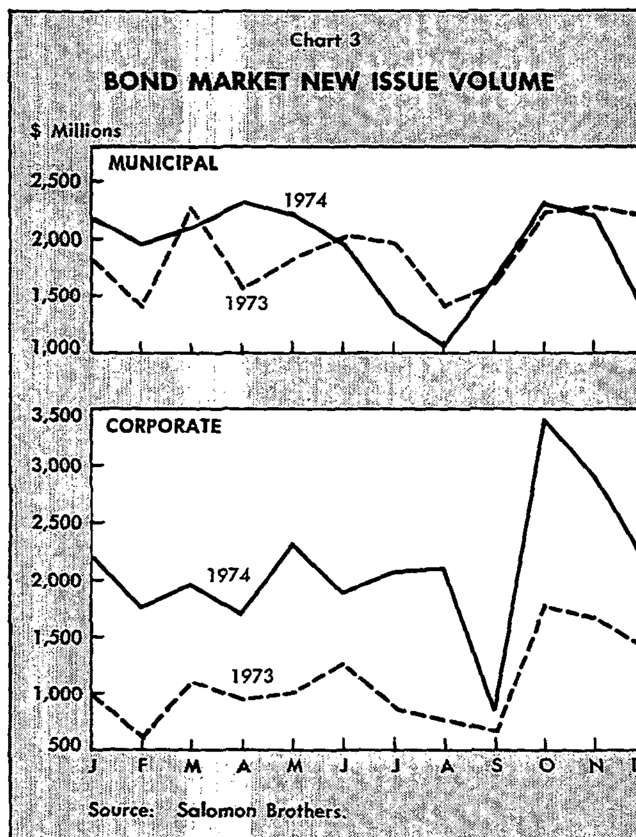
The farm credit agencies came to market in each month of the quarter with a total of $4.2 billion consisting of several issues of varying maturities. The offerings raised about $580 million of new cash, were generally well received, and carried steadily lower yields as the quarter progressed.

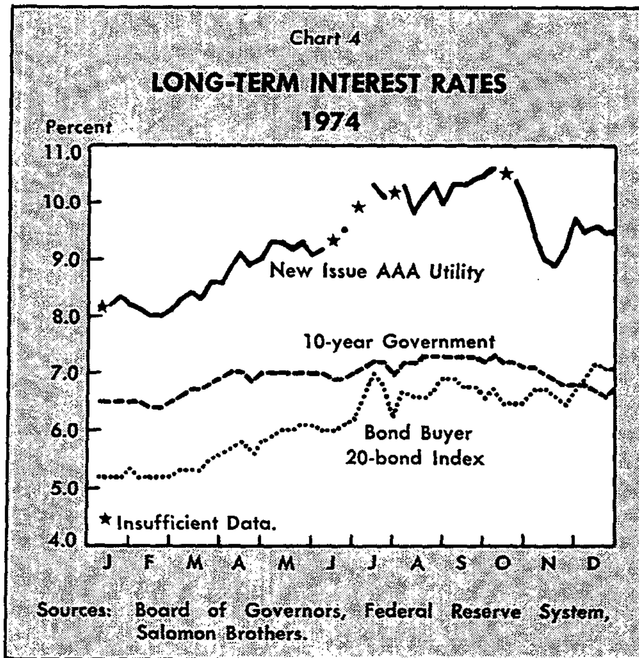
Corporate and Municipal Securities The volume of securities offered by corporations during 1974 far exceeded the 1973 level (Chart 3). The average monthly volume of new corporate debt securities issued during 1974 was $2,111 million; for all of 1973, new issue volume averaged $1,075 million per month. On the other hand, the average monthly voltime in the tax-exempt sector was only slightly more expansive at $1,879 million than in 1973 when the average monthly offering was $1,865 million.

Yields on long-term bonds increased on balance over the first quarter of 1974. By the end of March, yields in the corporate sector were at their highest level in more than 3 years. Seeking to finance capital outlays and improve liquidity ratios, corporations placed heavy demands on the capital market during the first quarter, issuing $5.9 billion in debt. Offerings would have been even higher if some scheduled issues had not been canceled as interest rates rose in late February and March. State and local governments were also heavy borrowers in the first quarter, although the $6.2 billion of municipal bonds offered was down somewhat from the large fourth quarter 1973 volume. Rates on municipals did not rise as noticeably as corporate rates. As sharp price rises pushed individuals into higher tax brackets, tax-exempt issues became more popular thereby holding rates down.

Capital market new issue volume remained high into the second quarter. Yields were up 70 to 90 basis points, with the sharpest gains experienced in June. After showing continued strong investor demand in the early part of the quarter, the long-term market firmed around mid-May. A large public utility's liquidity problems, combined with rising short-term rates, caused many investors to resist all but the most creditworthy issues, greatly increasing spreads between yields on high and low quality bonds. Rates on lower quality debt rose to unacceptable levels and issues were postponed or canceled. Corporations turned increasingly to banks for funds as conditions in the market deteriorated at the close of the second quarter. In addition, new stock issues dropped to the lowest seasonally adjusted quarterly volume since 1968, with stock prices falling to their lowest point in 3 years. In contrast, the volume of tax-exempt issues remained high throughout most of the quarter with good investor reception in spite of higher interest rates. A record-sized New York City bond issue artifically inflated municipal bond volume figures for the second quarter, but even without this issue, volume remained near a record high level. Late in the quarter some cutbacks in offerings were announced as the available rate terms exceeded statutory ceilings.

Corporate bond volume dropped only slightly over the third quarter. The new issue volume that was lost through postponement of utility issues was offset by 10 floating-rate note offerings. A newcomer to the capital market, these notes offered a fixed return for a specific period after which the rate was equal





to the 3-month Treasury bill rate plus a premium. The notes offered good call protection along with periodic redemption opportunities at par after a set period of time.

Throughout all of the quarter, long-term market participants showed preferred interest in high-quality, intermediate-term credit issues. Volume in the tax-exempt market dropped off sharply through September as a large number of issues were postponed because rate ceilings precluded acceptance of any bids. Yields in both sectors of the capital markets rose, on balance, over the quarter. Buffeted by the ill winds of inflation and investor pessimism, the equity market skidded through the third quarter as uncertainty over the future course of the economy continued to pervade investor outlooks. Stock prices fell nearly 25 percent over the quarter with the volume of margin credit outstanding moving down to the lowest point since 1971.

In the fourth quarter tax-exempt yields rose on net while corporate yields fell (Chart 4). The Bond Buyer 20-bond index reached a record 7.15 percent for the week of December 13 before declining slightly by year-end. A lack of demand for tax exempts by institutional investors and a net decline in tax exempts at weekly reporting banks during the quarter were two factors that contributed to the yield disparities. Both corporate and municipal bond markets suffered from a congestion of new offerings throughout the fourth quarter. Corporate volume rose to an astounding $8.5 billion while tax-exempt new issue volume was up only slightly over the previous quarter at $5.9 billion. Investor interest was fairly steady over the quarter, with selectively better response to the high quality issues.

Equity markets improved gradually and irregularly from the start of the fourth quarter through mid-November. The downward slide in the Dow Jones index that began the third week in November ended with the index closing December 6 at 577.50, its lowest level in 12 years. A steady improvement in the index followed and by year-end it was above 600 at 602.16. The cost of equity funds remained relatively high, however, so no dramatic upsurge in stock issuance occurred.

Thrift Institutions and the Mortgage Market

Over the first quarter, thrift institution deposits continued to grow at a moderate pace. Deposits at savings and loan associations and mutual savings banks grew at a seasonally adjusted annual rate of 8.7 percent between December and March, essentially the same rate of gain as in the previous 3-month period. Higher yielding certificate deposits accounted for all the deposit gains as passbook account balances remained substantially below early 1973 peaks. Early in the quarter, during January and February, thrifts were able to decrease their debt and increase their liquid asset holdings, thus halting a year-long downswing in mortgage commitments outstanding. As market rates began to rise sharply in March, net inflows of savings slackened and borrowing from the Federal home loan banks picked up. The higher interest rates on market instruments attracted individual savers, as indicated by the expansion in the number of noncompetitive tenders at the weekly Treasury bill auctions. The volume of such tenders rose to its highest level since 1970.

Net mortgage debt formation remained near the reduced rate of the previous quarter when measured

Table II

MORTGAGE INTEREST RATES*

	1973	1974		1973	1974
January	7.68	8.52	July	7.87	8.96
February	7.70	8.62	August	7.94	9.09
March	7.68	8.64	September	8.17	9.19
April	7.71	8.67	October	8.31	9.17
May	7.71	8.74	November	8.39	9.32
June	7.79	8.85	December	8.49	—

* FHLBB series for effective rate on purchase of newly built homes.

Source: Board of Governors, Federal Reserve System.

on a seasonally adjusted annual basis. The increase in mortgage holdings in most of the first quarter reflected a run-off of some of the heavy mortgage commitments made during the first half of 1973 when housing demand was quite strong. The relative strength of deposit flows at thrift institutions early in the quarter helped to cushion mortgage rates from the impact of sharply rising market rates. In recognition of the eventual rise in mortgage rates, however, ceiling rates on FHA and VA mortgages were raised ¼ percentage point to 8½ percent in April.

Reflecting the continued rise in interest rates on most market instruments, deposit growth at nonbank thrift institutions slowed sharply during the second quarter. Total deposits at savings and loan associations and mutual savings banks grew at a seasonally adjusted annual rate of 4.2 percent from April to June. Mutual savings banks bore most of the burden of slowed deposit expansion, experiencing only a 1 percent deposit expansion over the quarter and a net deposit outflow during May. Under pressures of disintermediation, savings and loans covered their mortgage commitments by borrowing from the Federal home loan banks, reducing their liquid asset holdings, and tapping established credit lines at commercial banks.

Net mortgage debt formation at thrift institutions, however, rose substantially over the second quarter at a seasonally adjusted annual rate of 9.9 percent, reflecting the eased money market conditions and strong deposit flows of the first quarter. The rise in mortgage debt formation was also spurred by direct and indirect financing from Federally sponsored credit agencies. The advance in mortgage lending was accompanied by rising interest rates. The average effective rate on conventional mortgages, as reported by the Federal Home Loan Bank Board, climbed to a record 8.85 percent by the end of the second quarter. To align FHA and VA mortgages with the prevailing market, ceiling rates on such mortgages were raised in two steps from 8½ percent in April to 9 percent in early July.

Following the trend established in the second quarter, thrift institution deposit growth decelerated further in the third quarter. Slowing to a seasonally adjusted annual rate of 2.6 percent, deposit growth was down 1½ percentage points from the rate of deposit expansion in the second quarter. Such factors as the keen interest in the Treasury's August refunding, the initially well-received new floating-rate securities, purchases of money market mutual funds, a decline in personal savings, and the continued high level of market interest rates combined to aggravate declining deposit flows. Mutual savings bank deposits grew more slowly than deposits of S&L's. For the 9-month period ending in September, MSB deposits expanded at a seasonally adjusted annual rate of 2.2 percent, while S&L deposits grew at a 6.4 percent rate. Although below the growth experienced in the final half of 1973, thrift institution deposits showed more rapid growth through the first three quarters of 1974 than during the periods of slow deposit growth in 1966 and 1969. Moreover, the base of deposits is currently more than double that in either 1966 or 1969. The third quarter level of deposits at savings and loans stood at nearly $240 billion compared to $110 billion in 1966 and $134 billion in 1969. Another factor to be considered, however, is that the level of mortgage commitments at S&L's ranged around $12 billion through the first 9 months of 1974, against only $2 billion in 1966 and $4 billion in 1969. Even with the substantial deceleration in the growth of mortgage holdings over the third quarter, it still exceeded the growth of deposits over the same period. To finance the lending thrifts borrowed heavily from Federal home loan banks.

Table III

FEDERAL NATIONAL MORTGAGE ASSOCIATION TOTAL MORTGAGE ACTIVITY

($ millions)

		Mortgage Volume			Mortgage Volume
1966		4,396	1974	April	25,263
1969		10,950		May	25,917
1971		17,791		June	26,559
1972		19,791		July	27,304
1973		24,175		August	28,022
				September	28,641
1974	January	24,424		October	29,139
	February	24,529		November	—
	March	24,875		December	—

Source: Board of Governors, Federal Reserve System.

Interest rates well below late summer and early fall highs precipitated increased savings inflows at thrift institutions throughout the fourth quarter. Preliminary data indicate that total thrift institution deposits closed the year at $341.1 billion on a seasonally adjusted basis, with the fourth quarter posting the sharpest rate of expansion. The tone of the mortgage market improved as the fourth quarter progressed; however, net mortgage debt formation continued to slacken throughout the quarter with no apparent upswing in commitments evident.

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