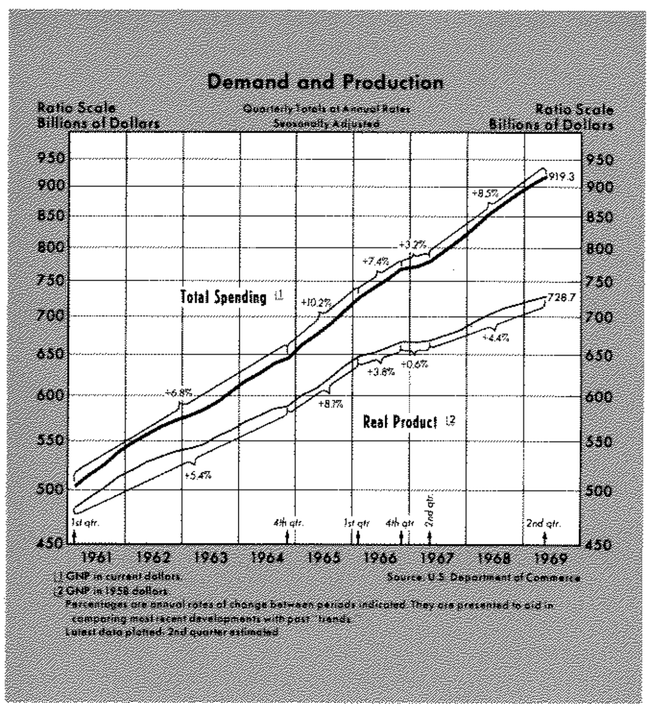
Credit Flows and Recent Interest Rate Trends

STRINGENT CREDIT CONDITIONS in 1969 similar to the late summer of 1966 have been haunting lenders and would-be borrowers. High interest rates, in the presence of intense resource use and a monetary policy which seeks to reduce the growth of total spending, have been forboding to those who desire to finance near-term purchases. Some fear that current monetary developments will culminate in a severe reduction in credit flows relative to what is believed necessary to maintain growth of production.



Current high interest rates have resulted primarily from the buildup of excessive total spending, loan demand and inflationary pressures in recent years. To some extent they also reflect recent monetary restraint, which, in the short-run, has tended to intensify upward rate movements. Undue severity of impact on production and employment can probably be minimized by avoiding the degree of restraint – nine months of zero growth in money – which occurred in 1966 and was followed by return to excessive monetary stimulus and two years of accelerating inflation. However, whether a more gradual approach to restraint can more effectively change expectations and cause less total disruption in financial markets, compared to a more pronounced restraint over a shorter period, may be debatable.

Interest Rates

Both long- and short-term interest rates generally moved upward from last fall to June. Rates reached

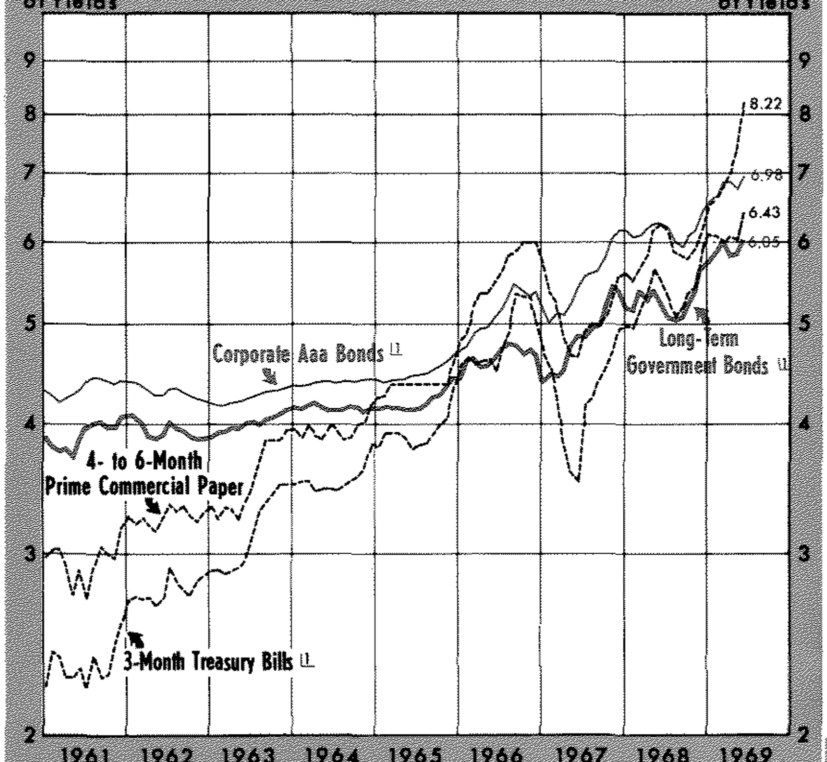
Table I

MARKET INTEREST RATES

(Weekly Averages of Quoted Annual Yields)

	Peak in Fall 1966	Peak in June 1969
3-month Treasury bills	5.55	6.65
4- to 6-month prime commercial paper	6.00	8.55
3- to 5-year Governments	5.83	6.77
Long-term Governments	4.87	6.09
State and local governments	4.04	5.60
Corporate Aaa Bonds	5.52	7.03

Yields on Selected Securities



Monthly averages of daily figures.
Latest data plotted: June

than the previous historic peak reached in late March this year.

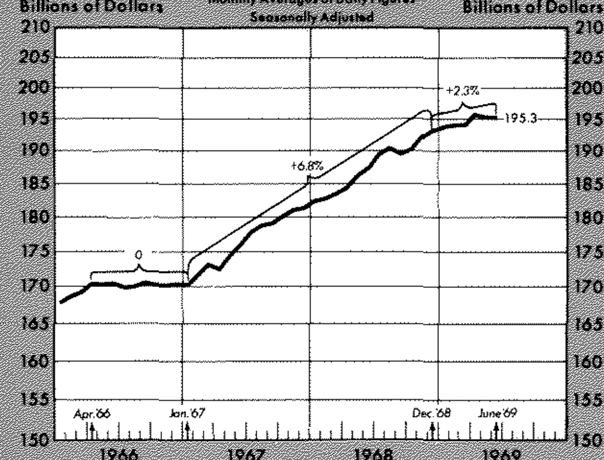
In the period of 1966 popularly referred to as the "credit crunch," most interest rates peaked between late August and October. The rates on most of these market instruments are now one or more percentage points higher than they were in the 1966 period.

Recent increases in interest rates have resulted from continued strong demand for loan funds at a time of restriction in the current supply, as reflected in slower growth of monetary aggregates such as the money stock. Such slower growth of monetary aggregates is an important step toward reducing the growth of total spending, demand for loan funds, and the inflationary pressures and expectations which have raised demands for credit and the level of nominal interest rates in the past three years. While the initial impact of monetary restraint is likely to raise interest rates, the later result of slower spending growth is likely to reduce credit

historically high levels in December, and then most of them continued upward. Yields on three-month Treasury bills, however, drifted lower on balance during the first five months of 1969 to less than 6 per cent, compared with 6.20 per cent in the last week of December and about 5 per cent last August. Recently the three-month Treasury bill rate has risen sharply, reaching 6.94 in early July. Other short-term rates, such as on commercial paper and secondary market certificates of deposit, rose more steadily from August through June. Yields on four- to six-month commercial paper rose from 5.88 per cent in late August to 6.38 per cent in late December, and to 8.50 per cent in late June.

Rates on long-term securities rose from last fall to late March and then eased somewhat during April and early May. Rates on long-term Government bonds rose substantially in late May, reaching 6.11 per cent in the week ending May 30, and subsequently remained in a narrow range through June and into early July. Yields on highest grade corporate bonds averaged 7.03 per cent in early July, slightly higher

Money Stock



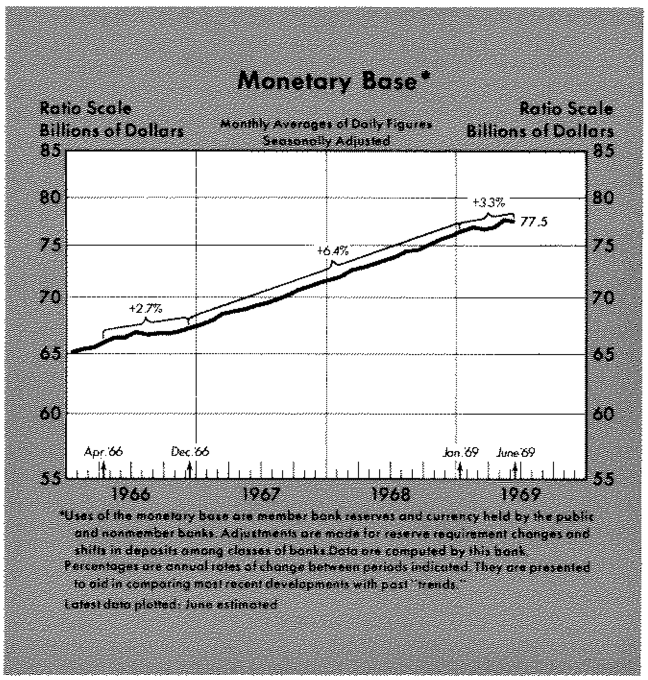
Percentages are annual rates of change between periods indicated. They are presented to aid in comparing most recent developments with past "trends."

Latest data plotted: June estimated

demands, the rate of price increases, and interest rates (the price of credit).

Monetary Aggregates

The money stock, consisting of currency held by the public and private demand deposits, has grown at a 2.3 per cent annual rate since last December, less than half the rate of the previous two years. The growth of the monetary base, which largely determines the trend growth of money, slowed to a 3.3 per cent rate from January to June, also less than half the growth rate in 1967 and 1968. The monetary base, in turn, is influenced strongly by the growth of Federal Reserve credit, which rose at a 5.1 per cent rate from January to June, slower than the 10 per cent rate of the previous twelve months.



Recent marked moderation of growth rates of time deposits and bank credit appear to have been interpreted by some as indicating a still greater degree of tightness. Since last December, large certificates of deposit at commercial banks have declined by $7.7 billion, and total time and savings deposits have declined at a 4.9 per cent rate. Disintermediation resulting from low Regulation Q ceilings relative to market interest rates has been the main factor affecting time deposits. Disintermediation also occurred in 1966, when from August to December large CD's declined about $2.7 billion and total time deposits rose at only a 2.3 per cent annual rate. In contrast, the trend growth of time deposits from 1957 to 1965 was 12 per cent per year.

As in 1966, banks recently have sought other sources of funds to meet both reserve requirements and the demand for loans. As one alternative they have liquidated investment holdings of Federal, state and local government securities. Since last December total bank credit has risen at a 3.6 per cent annual rate, while investments have declined at a 10.4 per cent rate and total loans have increased at a 11.2 per cent rate. Loans increased only slightly faster than this in the previous year. In addition to reducing security holdings in their asset portfolios, banks have borrowed Eurodollars, Federal funds, and from Federal Reserve Banks. During June, Federal funds and three-month Eurodollars traded at an average of 8.90 per cent and 11.0 per cent respectively. The basic rate on member bank borrowing through the Federal Reserve discount window has been 6 per cent since early April. A sharp increase in these borrowings during May and continuing in June was an important factor increasing Federal Reserve credit and the monetary base in these months.

Total Credit Flows

Higher interest rates and a banking system strained by disintermediation did not significantly reduce the total flow of credit in the economy in the first quarter. Total funds raised (less changes in cash raised and held by the Federal Government) amounted to $98.8 billion (annual rate) in that quarter, about the same as the fourth quarter of 1968.

Even though preliminary information does not indicate a decline in the total flow of credit in the first quarter, most demands for credit in that quarter could be met only at higher interest rates. In the second quarter pressures in financial markets, as measured by interest rates, intensified. Information on total credit flows in that quarter are not yet available.

In 1966, from the second to the third quarter – the period in which interest rates peaked – total funds raised declined by about $7.7 billion. There were larger declines in the preceding and subsequent quarters.

Channels of Credit Flows

Strains in credit markets are associated with changes in the paths of flows as well as with changes in total flows. The institutions or sectors of the economy holding funds before they are transferred to the unit which purchases goods and services can be considered the channel of flow. A part of the table entitled "Saving, Investment, and Financial Flows" in the Federal Reserve *Bulletin* describes this aspect of

Table II

DIRECT LENDING IN CREDIT MARKETS
(Billions of dollars)

	1966 I	1966 II	1966 III	1966 IV	1967 I	1967 II	1967 III	1967 IV	1968 I	1968 II	1968 III	1968 IV	1969[a] I
Total net of U.S. Govt. cash	87.3	76.4	68.7	48.7	74.9	59.1	91.2	102.2	108.6	99.8	93.7	98.3	98.8
Federal Reserve System	2.5	−0.1	6.6	4.2	2.9	−0.3	7.9	4.5	7.7	7.0	7.7	−3.2	*
Commercial banks, net	22.7	28.0	14.1	6.8	41.9	40.3	37.2	24.6	23.7	34.3	45.1	52.3	3.5
Nonbank finance, net	28.0	16.7	21.0	24.2	29.0	35.0	38.1	27.4	30.6	27.8	28.6	31.3	30.7
U.S. Government	11.1	10.0	7.8	2.8	6.1	0.8	5.0	8.0	12.2	9.0	6.2	5.1	8.6
Foreign	−1.3	1.2	−4.1	−1.6	3.3	3.6	.9	5.1	.4	−1.5	2.6	7.0	−3.5
Private domestic nonfin.	24.5	20.6	23.2	12.3	−8.1	−18.6	2.3	32.7	34.1	23.3	3.6	5.9	59.7
Households	14.0	15.3	11.0	1.9	−13.1	−18.1	−1.3	16.7	11.1	18.0	−10.8	−6.5	10.1
Business	5.7	1.4	3.4	2.5	1.2	−5.6	.2	5.9	11.4	5.8	6.5	6.1	25.7
State and local govts.	5.0	5.4	7.0	7.3	3.2	7.7	6.5	13.7	8.5	2.3	10.8	9.1	21.3
Less net security credit	.3	1.5	−1.9	−0.6	−.5	2.5	3.1	3.5	−3.0	2.7	2.9	2.8	−2.6

Source: Federal Reserve *Bulletin*
[a]Data is preliminary and based on incomplete information.
*Amount insignificant in terms of billions of dollars.

credit flows (See Table II). Sources of funds to spenders are the Federal Reserve System, commercial banks, nonbank financial institutions, the U.S. Government, foreign governments, state and local governments, and households and business firms.

Commercial banks traditionally perform a major role in channeling funds to spenders. In the first quarter of 1969, however, net funds advanced directly in credit markets by commercial banks was greatly reduced from $52.3 billion in the fourth quarter last year. Net funds advanced by nonbank financial institutions changed little from last year, holding at around $30 billion in the first quarter, according to preliminary figures. Households, businesses, and state and local governments advanced $59.7 billion directly in credit markets in that quarter, largely offsetting the decline in the flow from commercial banks.

In 1966 the channels of credit flows also shifted. From the second to the third quarter credit flows through banks declined from $28 billion to $14 billion. Flows through nonbank financial institutions increased from $16.7 billion to $21 billion, and flows through private domestic nonfinancial sectors increased from $20.6 billion to $23.2 billion.

Credit Flows

The Commerce Department expects business spending on plant and equipment to be $72.2 billion in 1969, or 12.5 per cent higher than in 1968. Some of the increase has been and will be financed by a runoff of corporate liquidity. During 1968 corporate liquidity was built up by an unusually large amount, a development which was facilitated by the rapid growth of the monetary base and money stock. However, much of the increase in business investment will have to be financed through money and capital markets.

Credit demands of the Federal Government have been substantially reduced. Due to the Revenue and Expenditure Control Act passed last year, the Federal budget is estimated to have had about a $1 billion surplus during the fiscal year ending June 30, 1969, compared with a deficit of $25.2 billion in the previous fiscal year. During the first half of calendar 1969 there was a net repayment of Federal debt amounting to about $12 billion, compared with net borrowing of $4.2 billion in the first half of 1968. If the surtax is continued at the 10 per cent rate in the second half of 1969, credit demands of the Federal Government are estimated to be about $6 billion compared with $11.1 billion in the second half of 1968. Credit demands of the Federal Government are typically larger in the second half of the year.

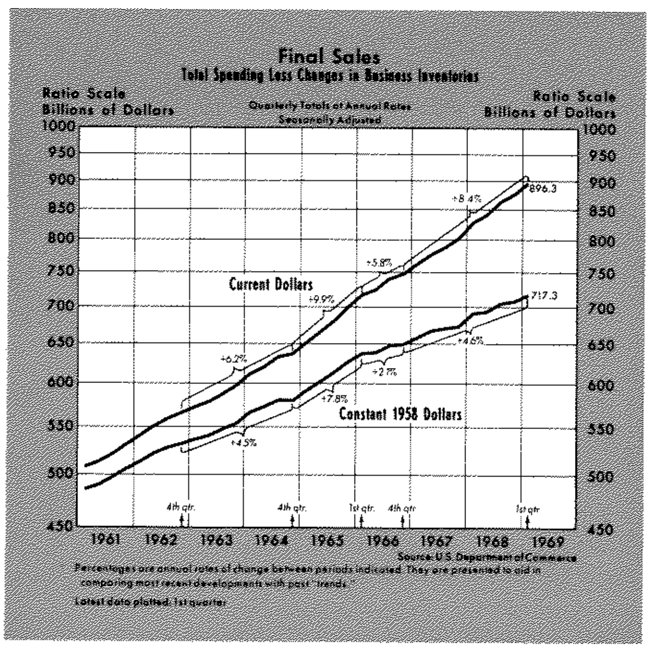
So far in 1969, state and local governments have apparently been the sectors most restricted in issuing new debt by high nominal interest rates. The Federal Reserve Board estimates that state and local governments offered $0.9 billion of bonds in the first quarter, less than the $1.2 billion in the first quarter of last year and down from $1.5 billion in the fourth quarter. In some cases legal limits on the interest rates which could be offered prevented state or local jurisdictions from issuing debt. There has also been greater voter reluctance to approve bond issues.

The net increase in mortgage debt in the first quarter of 1969 was $7.7 billion, compared with $7.5 billion in the fourth quarter of 1968, according to an estimate by the Federal Reserve Board. This includes a $5.4 billion net increase in residential (excluding farm) mortgages, compared with $5.2 billion in the fourth quarter. Much of this increase probably represents an increase in mortgages on existing structures. Private nonfarm housing starts declined from January to May.

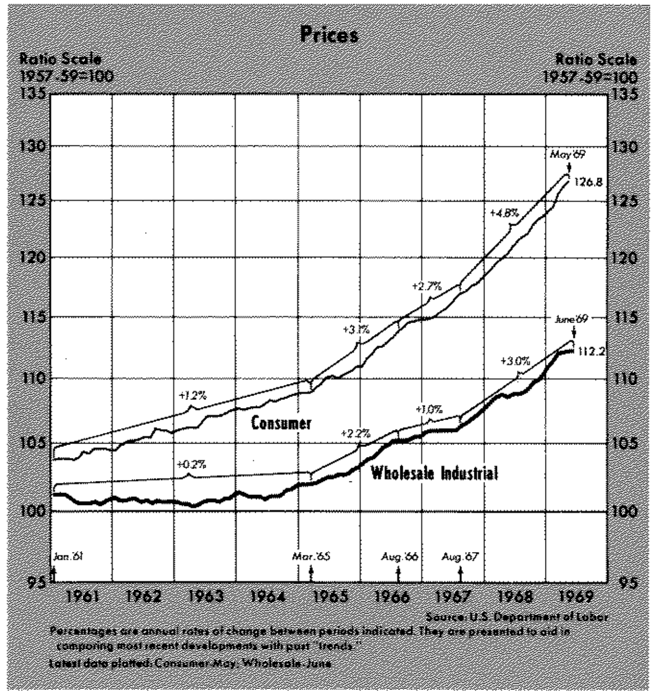
Other Economic Developments

Total spending in the economy rose at a 7.4 per cent annual rate in the first quarter, down from a 9.4 per cent rate last year. The moderation was largely due to slower growth of inventories. Final sales, which is total spending less changes in inventories, increased at a 9.2 per cent rate in the first quarter, the same as in 1968.

Real product increased at a 2.9 per cent annual rate in the first quarter, compared with a 5.4 per cent increase during 1968. Industrial production grew at a 5.9 per cent annual rate in the first five months of 1969, compared with a 4.1 per cent increase in the previous year.



Prices have increased even more rapidly in 1969 than in the past three inflationary years. During the first quarter, prices, as measured by the GNP deflator, increased at a 4.6 per cent annual rate, compared with a 3.5 per cent rate in the previous three years. Consumer prices rose at a 6 per cent rate in the first five months of 1969, compared with 4.7 per cent last year. Wholesale industrial prices increased at a 3.7 per cent rate from December to June, compared with 2.6 per cent in 1968. Due mostly to a large jump in May, wholesale prices of farm products and processed foods and feeds have risen at a 13.5 per cent rate since December, compared with 3.4 per cent in the previous year.



Summary

The interest rate increases of the first half of 1969 have been due in part to growing demand for loan funds and in part to less rapid monetary expansion. The increased demand for loan funds has possibly resulted in considerable measure from anticipations of continued inflation. Whether the restriction of monetary expansion has been great enough to adequately restrain total spending, and moderate price increases and interest rates, is not certain. However, experience suggests that if recent stabilization policies slow the growth of total spending and final sales, moderation in price increases and interest rates will follow.

Total flows of credit have not decreased, but have been growing less rapidly than last year. Regulations influencing the channels of credit flows have contributed greatly to strains in the money markets.[1] Regulation Q, for example, has forced the financial process into different and, most likely, less efficient channels. This development has created an uneasiness in the financial world because of the special and unnecessary restraint on commercial banks.

[1]See Clifton B. Luttrell, "Interest Rate Controls – Perspective, Purpose, and Problems," in the September 1968 issue of this *Review*.