Recent Banking and Monetary Developments

In the second quarter, banks faced continued heavy loan demands and increasing reserve pressures as their sources of funds became more costly and less certain. With nationwide reserve availability shrinking, trading in Federal funds took place at premiums as high as 1 to 1⅛ percentage points above the discount rate. At the same time, rising money market rates made it increasingly difficult for banks to compete for short-term funds in the form of negotiable certificates of deposit (C/D's). Consequently, they were forced to raise offering terms, and rates paid on these deposits reportedly hit the 5½ per cent Regulation Q ceiling for maturities as short as thirty days; the same ceiling was quite commonly paid on longer maturities. With money market conditions tightening, banks more frequently found themselves forced to turn to the "discount window" and average member bank borrowings from the Federal Reserve increased. Bank liquidity positions also tightened further during the quarter, as loans were added and investments liquidated so that loan-deposit ratios continued their seemingly unending climb. Credit demand and reserve supply pressures culminated in a rise on June 29 and June 30 in the prime lending rate of most commercial banks from 5½ per cent to 5¾ per cent.

Despite higher rates paid on C/D's and other time deposits, total savings flows into commercial bank interest-bearing accounts continued to fall behind those of recent years. The available evidence seems to suggest that, while consumer-type time deposits and other related deposits grew substantially over the second quarter, roughly two thirds of this gain was offset by a sharp decline in passbook savings accounts. The rate of advance in seasonally adjusted private demand deposits, on the other hand, bettered the substantial first-quarter gain and contributed to a second-quarter money supply growth rate that fell just short of the fast pace set in the year 1965.

Primarily reflecting a sharply reduced flow of liquid savings into time deposits and savings and loan shares, total liquid assets held by the nonbank public grew at a slower rate in the second quarter of this year than in the preceding quarter. But, as a result of a corresponding slowdown in gross national product, the ratio of total liquid assets to GNP remained about unchanged from the first quarter to the second quarter.

BANK CREDIT

Total loans and investments at all commercial banks grew at an 8.3 per cent seasonally adjusted annual rate in the second quarter of this year. This advance is roughly in line with the 8.0 per cent first-quarter gain in bank credit, and remains somewhat below the 10.2 per cent expansion in all of last year. Total loans by banks increased at an annual rate of 12.7 per cent, a bit slower than the 13.8 per cent first-quarter pace and even further behind the 14.7 per cent gain experienced over 1965 as a whole. There was, on the other hand, a smaller second-quarter decline in bank investment holdings than over the first three months of the year.

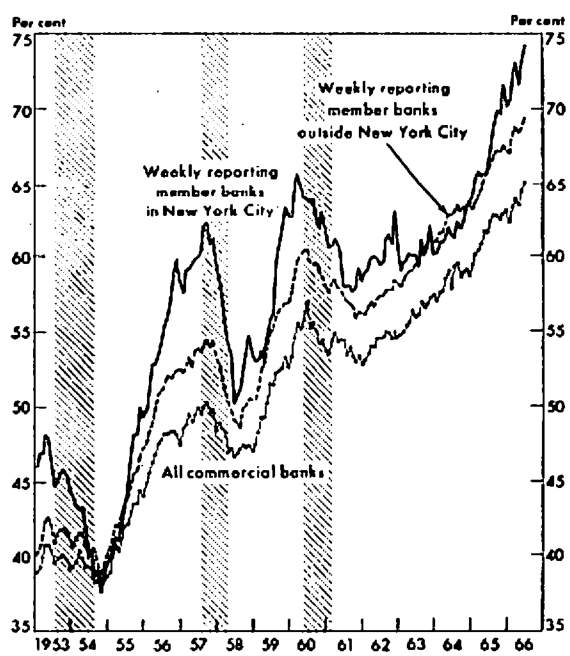
The second-quarter advance in business loans by banks matched the sharp rise in the preceding quarter and was attributable in part to cash needs stemming from stepped-up corporate tax payments. This was evidenced by particularly heavy business loan demands around the June tax date and in the latter part of June, when a new collection schedule for personal income and social security taxes withheld by large employers went into effect. Business loan demand has apparently also been inflated by the continuing tendency of investment expenditures to outpace internally generated funds. In response to business demands, banks continued to tighten loan terms—as evidenced by the late-June increase in the prime rate referred to above—and rates charged on other types of loans followed a similar pattern. Rates posted by the major New York City banks on call loans to Government securities dealers rose, for example, by 1 to 1⅛ percentage points over the second quarter to 6⅛ per cent at the end of June. Around mid-June some large city banks also raised the rate of interest discounted in advance on most types of consumer instalment loans by ½ of 1 percentage point.

Loans by commercial banks to nonbank financial intermediaries also rose sharply in the second quarter, reflecting in part heavy tax-related finance company borrowing. There was, on the other hand, a marked second-quarter slowdown in consumer loan growth, explainable in large part by a corresponding decline in automobile purchases. The growth of real estate loans also moderated over the second quarter, falling to barely more than half the 1965 rate of advance.

Banks followed up a substantial first-quarter reduction in their holdings of United States Government securities with another sizable $1.5 billion rundown (seasonally adjusted) in the succeeding three months. This decline was nearly offset, however, by a $1.4 billion increase in bank holdings of other securities, apparently prompted in large part by the fact that rates on these obligations became increasingly attractive over the quarter. Available data suggest that bank participation in a heavy volume of new Government agency issues probably accounted for a substantial portion of this rise.

Chart I

BANK LOAN-DEPOSIT RATIOS



Note: Loan-deposit ratio equals loans (adjusted), less loans to brokers and dealers, as a percentage of total deposits (less cash items in process of collection). Shaded areas represent recession periods, according to National Bureau of Economic Research chronology.

Source: Board of Governors of the Federal Reserve System.

The second-quarter increase in loans brought further pressure to bear on bank liquidity positions. The loan-deposit ratio for all commercial banks climbed to 65.2 per cent by the end of June, from 63.9 per cent at the end of March (see Chart I). During this same period, the loan-deposit ratio at all weekly reporting banks rose by a full percentage point to 70.8 per cent. An even more striking increase was registered by the loan-deposit ratio for New York City reporting banks—from 72.4 per cent at the end of March to 74.4 per cent by the end of June. Indeed, lending by these large money market banks has resulted in a rise of no less than 4.5 percentage points in their aggregate loan-deposit ratio over the first half of the year. In view of current money market conditions, the steady rise in loan-deposit ratios to the highest levels in decades would seem to call for an increased measure of restraint on the part of banks in accommodating loan demand.

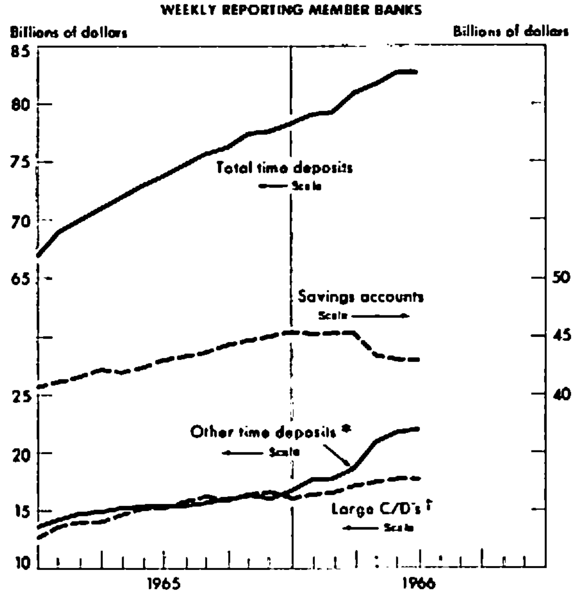
BANK DEPOSITS AND RESERVES

The daily average money supply grew at a 4.5 per cent seasonally adjusted annual rate during the second quarter of this year, closely in line with the 4.3 per cent pace of the first three months of the year and only slightly below the rapid 4.8 per cent advance in all of 1965. Relatively sharp swings in the money supply from month to month again reflected the relatively close inverse relationship between private demand deposits and United States Government deposits, which have shown unusually large month-to-month changes.

Commercial bank time deposits continued to expand in the second quarter at a diminished rate relative to last year's pace. Over the first six months of this year, daily average time deposits have grown at a 9.8 per cent seasonally adjusted annual rate, as against the 16.1 per cent advance in 1965. Largely as a result of this slowdown, the money supply and time deposits combined rose at a 6.9 per cent annual rate over the first half of this year, somewhat below the 9.8 per cent gain throughout last year. Data for weekly reporting member banks indicate that the slower time deposit growth continues to be largely attributable to a marked contraction in passbook savings accounts (see Chart II). Indeed, funds in these accounts have declined by some $2.1 billion over the second quarter alone, in marked contrast to the $805 million increase over the comparable period last year.

The flow of new funds into C/D's also diminished during the second quarter. At weekly reporting banks, C/D's rose by $530 million, only a little over one third of the $1.4 billion increase during the comparable period in 1965,

Chart II
TIME DEPOSITS
WEEKLY REPORTING MEMBER BANKS



* Other time deposits equal total time deposits, less savings accounts and large C/D's.

† Large C/D's are defined as negotiable certificates of deposit in denominations of $100,000 or more.

Source: Board of Governors of the Federal Reserve System.

as the banks faced increasing difficulties in competing against other short-term investment outlets. By the end of the second quarter, rates paid on most maturities of C/D's were, as already noted, at the maximum permissible rate of 5½ per cent. At the same time, the rates on finance company paper and other competing money market instruments have become increasingly attractive to corporate treasurers. Over the second quarter alone the rate on ninety-day finance company paper rose by some 37 basis points to 5½ per cent, and more recently has moved to 5⅝ per cent.

A sharp second-quarter rise of some $3.3 billion in "other" time deposits (total time deposits less savings accounts and C/D's in denominations of $100,000 or more) at weekly reporting banks has run counter to the reduced overall flow of funds into bank interest-bearing accounts. Of special interest within this residual category has been the recent sharp rise in consumer-type time deposits. The Federal Reserve System's recently published survey of member bank time and savings deposits has found, for example, that between December 1965 and May 1966 consumer-type time deposits (savings certificates and bonds plus nonnegotiable and small denomination C/D's) increased by some $5.3 billion, or by 40 per cent. Widespread increases in rates paid on these time deposits over this same period were apparently the primary factor in this sharp increase. The System survey disclosed, for instance, that between December and May over half of the member banks soliciting consumer-type time deposits raised their rates on each type of instrument offered. This survey also revealed that the larger banks that were most successful in attracting funds into these instruments were also those having the sharpest declines in their passbook savings accounts. Such a finding suggests that some of the funds destined for consumer-type time deposits would otherwise have been lodged in savings accounts; thus, in numerous cases, banks may have been competing to some extent with themselves for these funds.

Member banks relied somewhat more heavily on the discount window to meet reserve needs arising out of the overall expansion in their demand and time deposit liabilities during the second quarter. Borrowings from the Federal Reserve increased from an average level of $626 million in April to a $674 million average in June. At the same time member bank net borrowed reserve positions (excess reserves less borrowings) deepened from an average of $268 million in April to a $360 million June average. On a seasonally adjusted basis, member bank nonborrowed reserves grew at a 3.2 per cent annual rate in the second quarter of this year, more rapidly than the depressed first-quarter pace of 1.6 per cent but considerably below the 4.2 per cent gain over 1965 as a whole.

NONBANK LIQUID ASSETS

Liquid assets[1] held by the nonbank public rose at a 5.7 per cent seasonally adjusted annual rate in the second quarter, appreciably slower than the 8.4 per cent gain in the first quarter and less than the 7.8 per cent increase for the full year 1965. Within this total there has been, in addition to the decline in the growth rate of commercial bank time deposits, a marked drop both in the rate of expansion of mutual savings bank deposits and in savings and loan share growth. This general weakness in the interest-bearing deposit and share components of total liquid assets ap-

[1] Total liquid assets are defined to include demand deposits and time deposits (adjusted) at all commercial banks and currency outside banks—all measured on a last-Wednesday-of-the-month basis—as well as deposits at mutual savings banks, savings and loan shares, postal savings deposits, United States Government savings bonds, and the nonbank public's holdings of United States Government securities maturing within one year—all measured on an end-of-the-month basis. A quarterly average of monthly liquid assets figures is used in this section for the growth rate computations and in deriving the ratio of liquid assets to GNP.

parently continued to reflect the increasingly attractive yields on state and municipal bonds and other competing open market instruments.

The ratio of total liquid assets to GNP was 80.2 per cent during the second quarter of this year, which is about in line with the previous quarter but somewhat below last year's second-quarter figure of 81.0 per cent. The relative stability in the ratio from the first quarter to the second quarter of the year—despite the marked second-quarter slowdown in total liquid assets growth—was attributable to a similar decline in the rate of growth of GNP.[2]

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[2] For more information on movements in GNP, see "The Business Situation" in this *Review*, especially pages 171-73.