Recent Banking and Monetary Developments

The nation's banking system was subject to increased pressure during the third quarter of 1966. Reduced nation-wide reserve availability, coupled with mounting difficulties in competing for short-term funds, contributed to a noticeable slowing of the growth of bank deposit liabilities and bank credit. Loan demand remained strong, on balance, though there was some moderation following the very heavy borrowing associated in part with accelerated payments of business taxes in the spring and early summer months and in part with anticipations of tighter loan terms. Reflecting pressure from a wide spectrum of borrowers, banks reduced their holdings of all types of securities as a means of obtaining funds for loans. They also raised their prime lending rate from 5¾ per cent to 6 per cent in mid-August, the fourth time in a span of nine months that this rate had gone up. Throughout the third quarter, moreover, banks continued to bid aggressively for reserves in the Federal funds market, and many with branches in Europe were very active in seeking funds in the Euro-dollar market. In addition, some banks increased their resort to the "discount window" in order to satisfy their residual reserve needs.

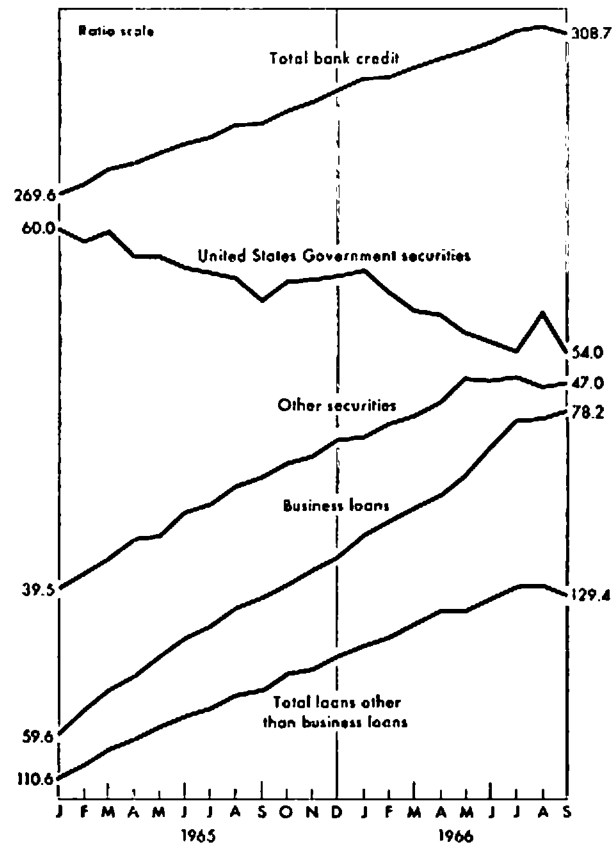
One major factor bearing on bank lending and investing policies during the third quarter of the year was the growing difficulty of attracting and keeping time deposit funds—especially those obtained through issuance of large negotiable time certificates of deposit. Since banks have been limited under Regulation Q to a 5½ per cent offering rate on these instruments, many money market investors were increasingly attracted to higher yielding short-term investments available elsewhere, and banks found the volume of their certificates of deposit (C/D's) actually shrinking. Moreover, banks exercised more loan restraint because they had already drawn heavily on their holdings of liquid investments and had permitted their loan-deposit ratios to rise steeply in the course of satisfying much of the heavy demand for funds in the first half of the year.

The slowing of total deposit growth at commercial banks, together with the reduced rate of growth this year of the public's claims on savings and loan associations and mutual savings banks, has contributed to a much slower rise of total liquid assets held by the nonbank public. Indeed, relative to economic activity, there was another decline in the nonbank public's liquidity during the third quarter of the year, as liquid assets grew at less than half the rate of gross national product (GNP). This trend in liquid assets has been in progress since late 1964, but it accelerated in the past quarter. The slowing of the growth of liquid assets in part reflects reduced intermediation of credit flows by depository and other liquidity-creating intermediaries. Over the past year, an increasingly large share of total credit growth has taken the form of direct purchases by the public of securities sold by borrowers in the open market, a substantial proportion of which is long-term nonliquid claims.

Chart I

RECENT DEVELOPMENTS IN BANK CREDIT AT ALL COMMERCIAL BANKS

Billions of dollars; seasonally adjusted



Source: Board of Governors of the Federal Reserve System.

BANK CREDIT AND BANK LIQUIDITY

Total loans and investments at all commercial banks moved higher, on balance, over the third quarter but at a 2.9 per cent seasonally adjusted annual rate, compared with an 8.2 per cent growth rate during the first six months of the year (see Chart I). The behavior of bank credit ordinarily tends to be highly erratic over very short time periods, which makes it extremely difficult to assess underlying trends. This has been especially true in the period since February, as the volume and spacing of business credit demands have been affected strongly in that period by the acceleration of corporate income tax payments, by the changed pattern of corporate remittances to the Treasury of withheld income taxes and social security contributions, and by borrowing in anticipation of further credit tightening. The changes in payment schedules contributed to an unusually rapid expansion in business loans during the second quarter when business tax payments rose sharply. Subsequently, business loan demand moderated as corporate tax payments returned to more normal levels in the third quarter. On balance, of course, business loan demand arising out of tax payments added to total borrowing in the first nine months of the year. Nonetheless, total bank credit for the nine-month period ended September expanded at an annual rate of only 6.5 per cent (seasonally adjusted), down from the 10.2 per cent increase during all of 1965 and the roughly 8.5 per cent annual rate of growth in the first four years of the current business expansion.

During the third quarter specifically, total bank loans outstanding increased at an annual rate of only 5.5 per cent, well below the 13.3 per cent rate of growth in the first six months of the year and the 14.7 per cent gain registered in all of 1965. A substantial part of the slower bank loan growth was attributable to actual net reductions in securities loans and in loans to nonbank financial institutions, with the combined decline in these two categories amounting to $2.5 billion. In part, the weakness in securities loans may have reflected the improved atmosphere in the corporate and state and local bond markets during the latter part of the quarter, which enabled dealers in these securities to lighten their inventories and hence to reduce their bank borrowings. But perhaps more important, bank lending rates continued to rise on both securities loans and loans to nonbank financial institutions, thus encouraging borrowers to economize on their credit needs or to seek funds elsewhere. For example, the rate charged securities dealers on new call loans by the major New York City banks rose from an already high 6⅛ per cent rate at the end of June to 6½ per cent at the end of September. Similarly, the further increase to 6 per cent in August in the prime loan rate at banks encouraged finance companies to divert a greater share of their borrowing into the commercial paper market.

The third-quarter advance in business loans also fell below the pace recorded in recent periods. These loans grew at a seasonally adjusted annual rate of 12.7 per cent, bringing the growth rate for the first nine months of 1966 to 17.3 per cent, which is about in line with all of 1965. As noted above, the underlying trend in business loan demand has been obscured by the special corporate payments to the Treasury. Nevertheless, it seems clear that the underlying business loan demand has remained strong, in view of the continued heavy spending by nonfinancial corporations on fixed investment and inventories. In order to bring the demand for loans in line with reduced availabilities of loanable funds, banks not only raised their prime rate once again but also firmed their loan terms in other respects. In addition, banks became more reluctant to enter into loan agreements with corporate borrowers other than their established customers. It was also in recognition of this strong demand that the Federal Reserve System suggested, on September 1, that "the national economic interest would be better served by a slower rate of expansion of bank loans to business within the context of moderate overall money and credit growth".[1]

On balance, bank holdings of United States Government securities continued to decline on a seasonally adjusted basis during the third quarter. Although banks took most of a $3.0 billion issue of tax anticipation bills in late August, they apparently had disposed of a large portion of these acquisitions by late September. The $0.5 billion net drop in the third quarter was only about one third the size of the liquidations in each of the first two quarters of the year (see Chart I). Bank holdings of other securities, on the other hand, declined slightly on a seasonally adjusted basis in the third quarter, after rising steadily since 1960. The much smaller reduction of United States Government securities in the third quarter than in other recent periods, and the decline in other securities, may indicate that many banks are now unwilling or unable to dispose of their remaining holdings of United States Governments, a large part of which may be needed as collateral for government deposits.

With the expansion of loans continuing to take place at the expense of investments, bank loan-deposit ratios increased further in the third quarter from their already high levels. The aggregate loan-deposit ratio at commercial banks moved up to 65.5 per cent at the end of September from 65.1 per cent in June. In New York City, where much of the strong business loan demand has been centered and where a sharp decline in deposits has occurred, the rise in loan-deposit ratios was even more pronounced. At weekly reporting New York City banks, the ratio rose by a substantial 3.5 percentage points from the end of June to the end of September, to a level of 77.3 per cent.

BANK DEPOSITS AND RESERVES

Total commercial bank deposits and related liquidity measures also expanded at a more moderate pace in the third quarter (see Chart II). Both private and United States Government demand deposits moved lower during the quarter, contrary to the inverse relationship that frequently exists between these two deposit components over short periods of time. With demand deposits falling, the money supply actually declined slightly. The growth rate for the first nine months of 1966 now stands at 2.6 per cent, in contrast to the 4.7 per cent gain for all of 1965.

Commercial bank time and savings deposits grew in the third quarter at a seasonally adjusted annual rate of 9.6 per cent, slightly below the reduced rate in the first half of the year and sharply lower than the 16.0 per cent advance in 1965. This slower growth, together with the net decline in the money supply, resulted in a third-quarter rise in the combined total of time deposits and the money supply of only 3.8 per cent (annual rate), bringing the nine-month growth rate to 6.2 per cent as compared with the 9.7 per cent increase in all of 1965.

The rate of growth of total bank time deposits continued to be restrained by declining passbook savings accounts. At weekly reporting banks, for instance, such deposits fell by $1.2 billion from June through September, following a $2.0 billion drop in the previous quarter. The decline in passbook savings accounts of $3.5 billion for the first nine months of 1966 compares with a $3.6 billion rise over the same period in 1965. To be sure, not all the recent drop in savings accounts resulted in an outflow of funds from commercial banks as a whole. Many of these deposits undoubtedly remained in the banking sys-

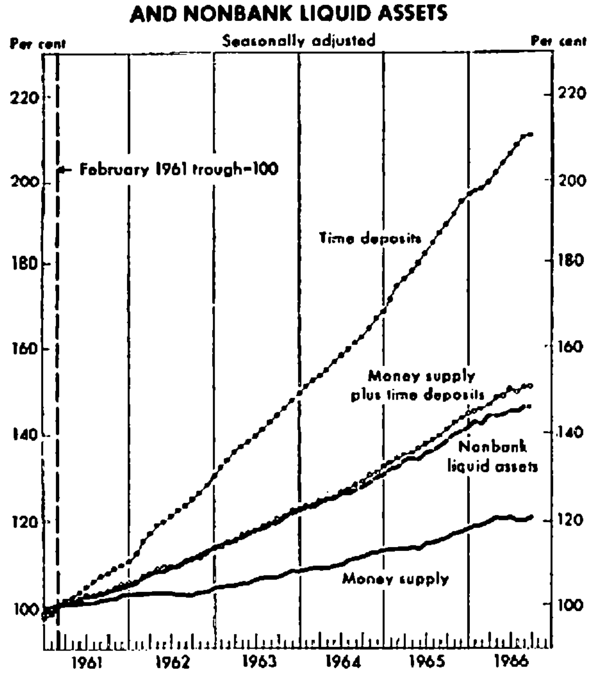
[1] See this *Review* (September 1966), page 209.

tem (and, in some cases, at the same bank) in the form of consumer-type time deposits, which banks have aggressively promoted throughout the year. Indeed, the category of "other" time deposits (which includes consumer-type time deposits but excludes C/D's in denominations of $100,000 or more) rose at reporting banks by $2.9 billion in the third quarter, a sizable gain approximately in line with the advance in the preceding quarter.

The developing bank competition this year for consumer savings—competition effected primarily through promotion of consumer time deposits—has in some instances resulted in shifts of funds from other savings institutions to banks. To help reduce such shifts, the Board of Governors of the Federal Reserve System took two steps during the quarter to lower the rate ceilings on certain types of bank time deposits that are offered primarily to small investors. Effective July 20, 1966, the Board, acting under the limited authority then available to it, set a maximum rate of 5 per cent that member banks may pay on new multiple-maturity deposits of ninety days or more, and a maximum rate of 4 per cent on such deposits with maturities of less than ninety days. Previously, the maximum rates for both these time deposit categories had been 5½ per cent. Then, with passage of new legislation increasing its powers to set maximum deposit rates, the Board, effective September 26, reduced to 5 per cent from 5½ per cent the maximum rate of interest that member banks may pay on any time deposit less than $100,000.[2]

Chart II

GROWTH OF MONEY SUPPLY, TIME DEPOSITS, AND NONBANK LIQUID ASSETS



Note: The money supply and time deposits are monthly averages of daily figures. Nonbank liquid assets are end-of-the-month observations.
Source: Board of Governors of the Federal Reserve System.

These moves to restrain excessive competition in the markets for consumer savings came at a time when banks were already experiencing a net outflow of C/D money obtained in denominations of $100,000 or more. The maximum rate banks may offer has remained at 5½ per cent. Although banks have moved their issuing rates to the allowable maximum, the higher yields available on competing money market instruments have proved increasingly attractive to corporations and other large investors. (This factor has also affected other thrift institutions as well, particularly while money market rates were especially high in September and early October.) At weekly reporting banks, large C/D's fell by $1.3 billion net in the third quarter as a whole, compared with a $600 million increase in the comparable period last year. At the same time, the average maturity of large C/D's outstanding declined, as banks generally were competitive only in the short maturities, even though they were paying the maximum permissible rate on all maturities during much of the quarter.

During the third quarter, the Board of Governors of the Federal Reserve System increased in two steps the reserve requirements against time deposits (other than savings deposits) in excess of $5 million at each member bank. The first increase went into effect July 14 for reserve city banks (July 21 for all other member banks), and raised the reserve requirements from 4 per cent to 5 per cent. Another increase, to 6 per cent, went into effect beginning September 8 for reserve city banks (September 15 for all other member banks). These measures were taken by the Board "to temper the aggressive competition for funds among commercial banks and other financial institutions, and at the same time to assure an orderly and moderate rate of growth in bank credit in order to restrain inflationary pressures".[3]

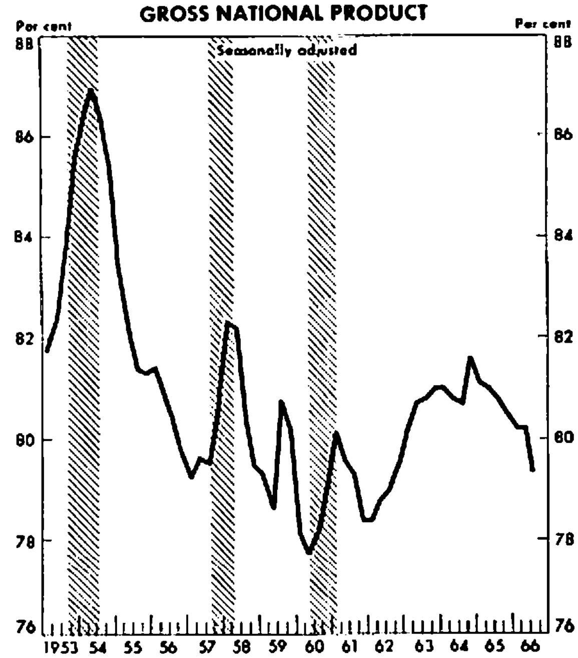
[2] This action was taken under the new authority signed into law on September 21, 1966, giving the several regulatory agencies of commercial banks and other depository institutions greater flexibility for establishing rate ceilings on the interest-bearing deposits of the regulated institutions. For a more complete description of these rate ceilings, see this *Review* (October 1966), page 221, footnote 2.

[3] See *Federal Reserve Bulletin* (September 1966), page 1338.

The growing pressures on the banking system were reflected in an increase of member bank borrowings at Federal Reserve Banks from a daily average of $674 million in June to $766 million in September. At the same time, net borrowed reserves (excess reserves less borrowings) increased from a daily average of $352 million in June to $374 million in September. On a seasonally adjusted basis, nonborrowed reserves declined in the third quarter by about 2.9 per cent (annual rate), as contrasted with gains of 3 per cent and 4.3 per cent annually in the first six months of 1966 and all of 1965, respectively.[4]

Chart III

NONBANK LIQUID ASSETS AS A PERCENTAGE OF GROSS NATIONAL PRODUCT



Note: Shaded areas represent recession periods, according to National Bureau of Economic Research chronology.

Sources: Board of Governors of the Federal Reserve System; United States Department of Commerce.

NONBANK LIQUID ASSETS

Total liquid assets owned by the nonbank public[5] rose at a reduced seasonally adjusted annual rate of only 3.0 per cent in the third quarter, notably below the 7.1 per cent annual growth during the first six months of the year and the 7.8 per cent increase for all of 1965. As already noted, there was a fairly marked decline in the rate of growth of commercial bank time and savings deposits and an actual drop in the private money supply. In addition, seasonally adjusted net savings flows to mutual savings banks during the third quarter remained at about the reduced rate of the first half of the year. Share accounts at savings and loan associations (seasonally adjusted) remained unchanged, on balance, although August and September were distinctly stronger than July. As noted, all depository institutions have been affected by the attractive yields obtainable on competing open market instruments.

In contrast to the moderate growth in total nonbank liquid assets, GNP advanced by 7½ per cent (seasonally adjusted annual rate) in the third quarter,[6] or two and one-half times as fast as the rate of expansion in liquid assets. As a result, the ratio of nonbank liquid assets to GNP fell 0.9 percentage point to 79.3 per cent (see Chart III). This ratio has been trending downward, beginning with the fourth quarter of 1964, and is currently at the lowest reading since mid-1962.

The continuing decline since early 1965 in this broad-gauge measure of liquidity is indicative of the developing financial tightness throughout the period. As market rates of interest have risen, financial savings have increasingly bypassed those financial intermediaries which issue deposits and other liquid claims, flowing instead into direct (unintermediated) investment in market securities. Because a large proportion of open market borrowing and lending transactions involve long-term, nonliquid claims, this diversion of savings into the securities markets and away from intermediaries has been associated with proportionally less liquidity creation for any given amount of total credit expansion.

[4] In the calculations of the rate of change for nonborrowed reserves, an adjustment has been made to eliminate the effects of the recent changes in reserve requirements on time deposits.

[5] Total liquid assets of the nonbank public 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 figures is used in this section for the growth rate computations and in deriving the ratio of liquid assets to GNP.

[6] For more information on third-quarter movements in GNP, see "The Business Situation" in this *Review* (November 1966), especially pages 241-42.