Recent Banking and Monetary Developments

Commercial banks, which had experienced strong liquidity pressures in the summer months of 1966, found conditions significantly easier in the final quarter of the year. The Federal Reserve System acted during the period to relieve pressures in the money markets so that bank credit growth might resume. As short-term interest rates fell, the ability of commercial banks to attract and retain time deposit funds gradually improved, and by December the expansion of total bank credit and deposits began to pick up markedly. The net reserve position of member banks in the aggregate eased during the quarter, as borrowings at the Federal Reserve Banks declined appreciably and excess reserves remained roughly unchanged.

During the first three quarters of 1966, pressures on banks had progressively increased, reflecting both intensifying loan demand and diminishing reserve availability. Banks responded to this development in several ways: they liquidated large amounts of securities, raised the prime rate to their business borrowers, increased other lending rates, tightened compensating balance requirements, and sought to scale down loan requests. At the same time, many banks attempted to raise funds by competing more aggressively for both large- and small-denomination certificates of deposit (C/D's), some borrowed heavily in the Euro-dollar market, and some increased their borrowings at the Federal Reserve Banks. In the fourth quarter, however, the combination of firmer control over lending at commercial banks and a slowing in some sectors of the economy operated to reduce substantially the growth of business loans, thereby alleviating one of the key sources of pressure on bank portfolio and reserve positions. Indeed, business loans grew less rapidly in the fourth quarter of 1966 than in any quarter since early 1961.

Less pressure on reserve positions and the moderation in business loans made it possible for banks in November and December to increase their holdings of United States Government securities sufficiently to offset heavy October liquidations. Also, holdings of other securities held steady in the fourth quarter, following a small net reduction on a seasonally adjusted basis in the preceding three months. The expansion of total loans remained at the reduced pace of the third quarter of the year.

The money supply declined slightly further in the fourth quarter, and total time and savings deposits at commercial banks rose by only a small fraction of their gain earlier in the year. There was a widespread improvement in time deposit growth in December, but for the quarter as a whole smaller denomination "consumer-type" time deposits issued by banks advanced noticeably more slowly than in the preceding nine months, and large C/D's and passbook savings again declined.

BANK CREDIT AND LIQUIDITY

Despite a strong December gain, total loans and investments of commercial banks[1] expanded during the final three months of the year at a modest 2.6 per cent seasonally adjusted annual rate (see Chart I). The decline in seasonally adjusted total bank credit that showed up in the statistics for September continued into the early part of the fourth quarter. However, the changed pattern of corporate tax payments and tax borrowing—a development not accounted for in the seasonal adjustment factors—may have contributed to this abrupt decline. For the year as a whole, total bank credit grew 5.9 per cent —much more in line with real economic activity than the 10.2 per cent gain of 1965 (see Chart II).

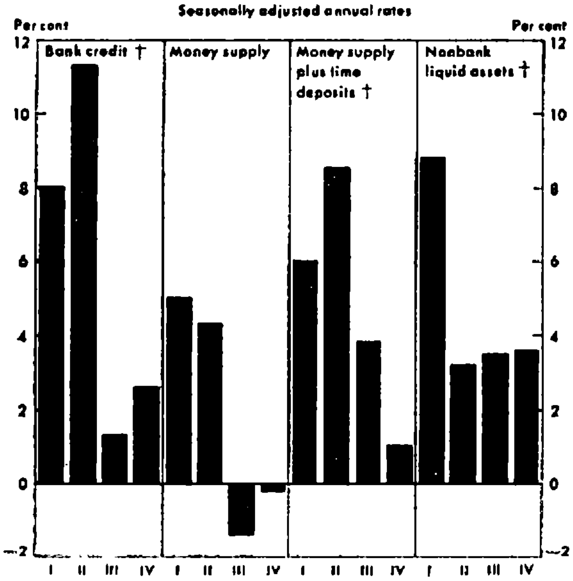
Total loans less securities loans at all commercial banks grew at a 3.0 per cent seasonally adjusted annual rate during the fourth quarter, bringing the rate for the entire year to 10.0 per cent, one-third below the 1965 pace. Loans to brokers and dealers for purchasing and carrying securities, however, expanded strongly in the fourth quarter—especially in December—as nonbank United

[1] The data for bank credit and relevant components have been adjusted to eliminate the effects of the exclusion of loans related to hypothecated deposits and the reclassification of participation certificates, both beginning June 15, 1966.

Chart I

QUARTERLY RATES OF CHANGE IN CREDIT AND LIQUIDITY INDICATORS DURING 1966*

Seasonally adjusted annual rates



*End of quarter to end of quarter.

† Data include adjustments to eliminate the exclusion of hypothecated deposits and related loans beginning June 15, 1966.

Source: Board of Governors of the Federal Reserve System.

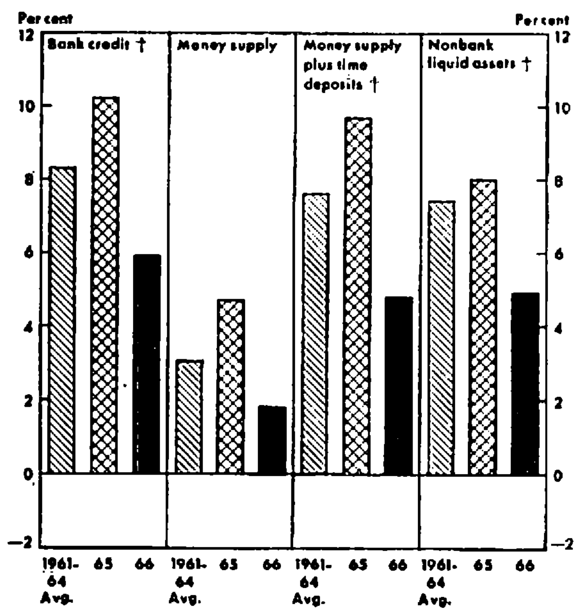
Commercial banks in December expanded their holdings of United States Government securities by $1.4 billion (seasonally adjusted), in an apparent attempt to rebuild their liquidity positions. For the quarter as a whole, however, holdings of Governments at all commercial banks were unchanged on a seasonally adjusted basis, with the November and December increases offsetting the heavy October liquidation. Holdings of other securities by commercial banks remained steady during the fourth quarter, on a seasonally adjusted basis. For the year as a whole, other securities—which mainly consist of tax-exempt obligations of state and local governments and issues of United States Government agencies—were higher by $2.5 billion, the smallest increase since 1960. Holdings of Government securities declined by the same amount in 1966 as in 1965—$3.4 billion.

The loan-deposit ratio of commercial banks in the aggregate remained virtually unchanged at 65.5 per cent during the fourth quarter. At New York City weekly reporting banks, however, where negotiable C/D's declined over the quarter, the loan-deposit ratio moved up 2.0 percentage points to an average of 79.6 per cent in December. Outside States Government securities dealers took advantage of lower financing costs to rebuild their depleted inventories in anticipation of higher market prices in the new year.

The fourth-quarter weakness in bank lending was especially apparent in the performance of business loans. The 4.6 per cent annual rate of increase of these loans was less than one half of the third-quarter pace, and was far below the exceptional 20.2 per cent first-half rate. The further slowing of business loans in the fourth quarter extended the downward trend that first began to show up after midyear, following especially heavy business tax borrowing in the second quarter. The continued high cost and limited availability of bank loans may have resulted in greater reliance by businesses on alternative sources of funds during the fourth quarter. Overborrowing earlier in the year, reflecting fears of a future shortage of loanable funds, also could have been a factor in the slowdown of business loan expansion later in the year. Reduced business loan growth in the second half of the year brought the expansion for the entire year to 14.3 per cent, down from the exceptionally strong 18.5 per cent expansion of 1965.

Chart II

YEAR-TO-YEAR PERCENTAGE CHANGES IN CREDIT AND LIQUIDITY INDICATORS*



*End of year to end of year.

† Data include adjustments to eliminate the exclusion of hypothecated deposits and related loans beginning June 15, 1966.

Source: Board of Governors of the Federal Reserve System.

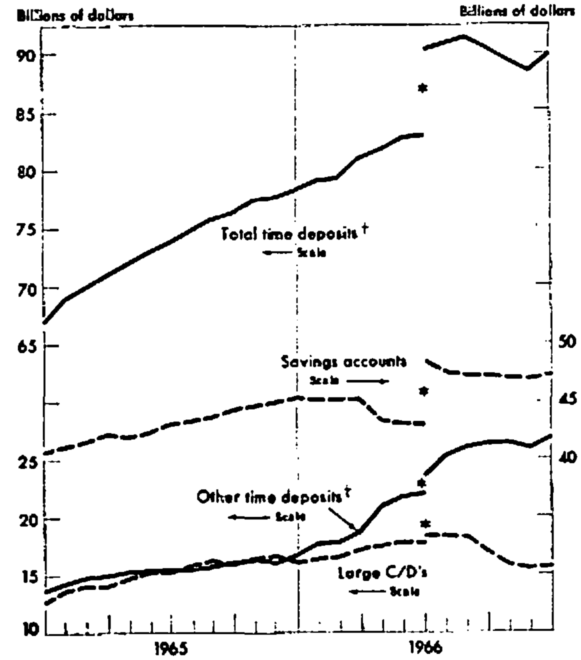
New York City, the ratio at weekly reporting banks declined fractionally to 69.1 per cent.

Member bank reserve positions were under decreasing pressure in the closing months of 1966. During the fourth quarter, nonborrowed reserves fell slightly on a seasonally adjusted basis, but required reserves were reduced somewhat more. As reserve availability improved during the quarter, banks were able to reduce their borrowings at Federal Reserve Banks, from a daily average of $766 million in September to $557 million in December. Net borrowed reserves dropped sharply from a daily average of $431 million in October to $161 million in December.

Chart III

TIME DEPOSITS

WEEKLY REPORTING LARGE COMMERCIAL BANKS



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

* Change in series due to a revised coverage of banks.

† Data include adjustments to eliminate the exclusion of hypothecated deposits beginning June 15, 1966. "Other time deposits" equals total time deposits, less savings accounts and large C/D's.

Source: Board of Governors of the Federal Reserve System.

MONEY SUPPLY, BANK DEPOSITS, AND LIQUID ASSETS

The slowdown in bank credit growth in the second half of 1966 was accompanied by a slowing of the growth of the total of money supply plus commercial bank time deposits (see Chart I). This series grew at a seasonally adjusted annual rate of only 1.0 per cent in the fourth quarter,[2] well below the already modest pace of the third quarter. For the entire year, the money supply plus time deposits expanded by 4.9 per cent, approximately one half that of 1965. The money supply—privately held demand deposits plus currency outside banks—declined at an annual rate of 0.2 per cent in the fourth quarter, following a 1.4 per cent per annum rate of decline in the third quarter. In both quarters, the decline reflected a drop in privately held demand deposits; currency in circulation outside banks continued to rise. The growth of the money supply for the entire year, at 1.9 per cent, was less than half the 1965 rate, and well below that of the 1961-64 period (see Chart II).

The attraction of high yields on competing forms of financial investment, reinforced to some extent by the reduced maximum permissible rate of 5 per cent on consumer-type time deposits put into effect on September 26, made it difficult for commercial banks to obtain and keep time deposits during the first two months of the quarter. Thus, despite some net gains in December, total time and savings deposits, on a seasonally adjusted daily average basis, rose only 2.3 per cent in the quarter, well below the 9.6 per cent pace of the previous quarter. For the year as a whole, these deposits expanded 8.3 per cent as compared with a 16.0 per cent rate in 1965.

One of the major reasons for the modest growth in time deposits during the fourth quarter was the continued runoff in large-denomination C/D's outstanding. These deposits fell by $1.3 billion at weekly reporting banks over the three months as a whole, about the same as in the third quarter (see Chart III). Faced with an interest rate ceiling of 5½ per cent on large C/D's, commercial banks in October and November continued to find it difficult to compete with higher yielding market instruments. However, in December, as rates on some competing money market investments declined, weekly reporting banks experienced a $180 million increase in large C/D's, the first such increase since May. By the end of January, the further expansion of these deposits had brought the level of outstanding C/D's back three fourths of the way to the peak of last August.

Another important reason for the diminished growth in total time deposits was the small fourth-quarter rise in

[2] The time deposit data have been adjusted to eliminate the effects of the exclusion of hypothecated deposits beginning June 15, 1966.

"other time deposits", which consists primarily of small-denomination savings certificates. After growing rapidly during the first three quarters of 1966, these deposits advanced at weekly reporting banks by only $148 million in the final three months. This development was associated with attractive deposit rates at other savings institutions, coupled with the September reduction to 5 per cent (from 5½ per cent) in the ceiling rate on commercial bank time deposits under $100,000.[3]

According to preliminary estimates, holdings of liquid assets by the nonbank public, seasonally adjusted, moved up in the fourth quarter, but at a relatively low 3.6 per cent annual rate, just slightly above the already reduced rates of the second and third quarters (see Chart I). Growth for the entire year, at 4.9 per cent, was far below the 8.0 per cent rate of last year. The major factor limiting the rise of liquid assets in the final three months of 1966 was a sharp decline in holdings of United States Government securities with maturities of one year or less. Apparently, declining yields on short-term Government issues since mid-September made these somewhat less attractive to nonbank investors. Deposit growth at savings and loan associations and mutual savings banks improved in the final quarter of the year, however, and the November and December deposit gains were quite strong.

Because gross national product advanced in the fourth quarter almost twice as fast as liquid assets, the ratio of the nonbank public's holdings of liquid assets to GNP dropped to 78.9 per cent, the eighth consecutive quarterly decline in this broad-gauge measure of liquidity.

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[3] See this *Review* (October 1966), page 221, footnote 2.