Banking and Monetary Developments in the Second Quarter of 1967

Commercial bank deposits and credit increased substantially in the second quarter of 1967, although the growth of bank credit was considerably slower than in the first quarter. Member bank reserve positions eased further in the April-June period, and the Federal Reserve Bank discount rate was cut from 4½ per cent to 4 per cent in early April.

The second-quarter growth of the money supply—currency outside banks and private demand deposits—was the most rapid since the fourth quarter of 1965. In part, this sharp increase was the counterpart of a larger than seasonal reduction in United States Treasury balances at commercial banks and associated Treasury payments to the public. While business firms ran down their holdings of large-denomination negotiable certificates of deposit (C/D's) to make tax and other payments during the second quarter, savings deposits and "consumer-type" time deposits rose strongly. Total time and savings deposits at commercial banks increased again at about the very substantial first-quarter rate.

At the same time, deposit inflows into mutual savings banks and savings and loan associations accelerated, and these deposits reached record levels. While the nonbank public's holdings of short-term United States Government securities declined during the quarter because of heavy net redemptions of tax anticipation bills, the public's holdings of currency and deposits at banks and other depository institutions grew sufficiently to raise its total liquidity at a 6.9 per cent annual rate, a considerably faster rate of increase than in the first quarter. With overall economic activity rising at a more moderate pace than the public's liquidity, the ratio of nonbank liquid assets to gross national product (GNP) rose for the second consecutive quarter.

The slower rate of growth of bank credit in the second quarter was evident in both loans and investments. The decline in the rate of bank acquisitions of securities was especially sharp; large holdings of Treasury bills were sold or run off, offsetting much of the continued strong accumulation of state and municipal securities. Business loans grew at almost the same pace in the April-June period as in the previous three months. However, the growth of total loans slowed significantly in the second quarter, reflecting the sharp rundown in loans to Government securities dealers who reduced inventories in view of rising yields.

MONEY SUPPLY, BANK DEPOSITS, AND RESERVES

The money supply—currency outside banks and private demand deposits—rose quite rapidly in the second quarter. On a seasonally adjusted daily average basis the money supply increased $3.2 billion between March and June, an annual rate of 7.6 per cent compared with the 5.9 per cent rise of the first quarter (see Chart I). For the first six months of 1967 the growth of the money supply, at 6.8 per cent annually, was well in excess of the modest 1.9 per cent increase in 1966. The second-quarter strength in the money supply was, in part, a result of sharp declines in Treasury deposits at commercial banks, which are excluded from the money supply. In the short run, sizable declines in these deposits tend to be associated with increases in the money supply as Treasury expenditures are made and the proceeds deposited in private accounts.

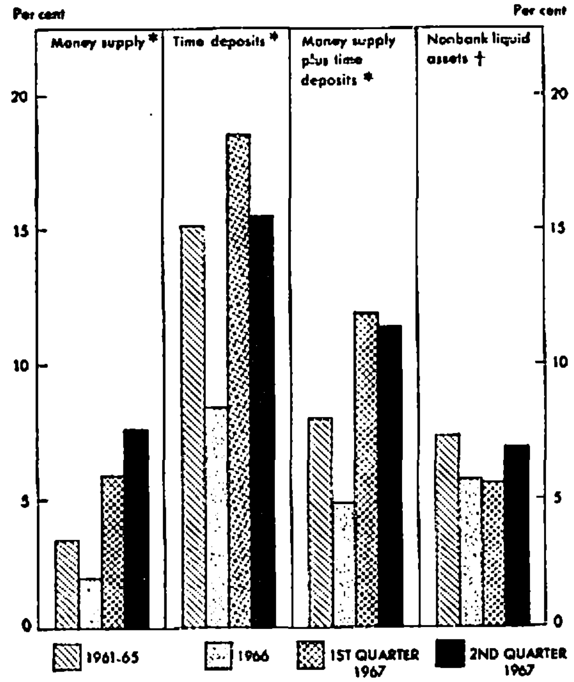
Time and savings deposits at commercial banks showed another substantial increase in the April-June period, although the 15.5 per cent annual rate of growth was a bit below the 18.5 per cent pace set in the first quarter. Over the first half of this year, time and savings deposits have grown at more than twice the 1966 rate. For a considerable period in 1966, the maximum interest rates allowable under Regulation Q effectively restrained the growth of these deposits.

At weekly reporting banks, the growth of total time and savings deposits was concentrated in passbook savings accounts and in small-denomination, consumer-type time deposits, which combined grew by more than $2.2 billion over the quarter. Passbook savings accounts rose $641 million in the April-June period, the first quarter in which these deposits have advanced since the third quarter of 1965. Although rates on consumer-type time deposits tended to remain relatively high over the second quarter, these deposits rose only $1.6 billion, compared with a rise of $2.8 billion in the previous quarter. The gains

Chart I

CHANGES IN LIQUIDITY INDICATORS

Seasonally adjusted annual rates



* Changes are computed from monthly averages of daily figures.

† Changes are computed from quarterly averages of end-of-month figures.

Source: Board of Governors of the Federal Reserve System.

in these deposits in the second quarter were more than sufficient, however, to offset the $146 million decline in large-denomination C/D's that occurred despite rising offering rates, over the latter part of the quarter, on C/D's with maturities of ninety days and longer. The rundown in outstanding large-denomination C/D's in part reflected sizable declines in business holdings of these instruments, as the heavy tax payments of mid-April and mid-June were made, offsetting increased holdings by other economic units during the quarter.

With the money supply growing more rapidly and time and savings deposits at commercial banks expanding slightly more slowly, the combined total of the money supply plus time deposits rose at almost the same rate in the second quarter as in the first, at seasonally adjusted annual rates of 11.4 per cent and 11.9 per cent, respectively.

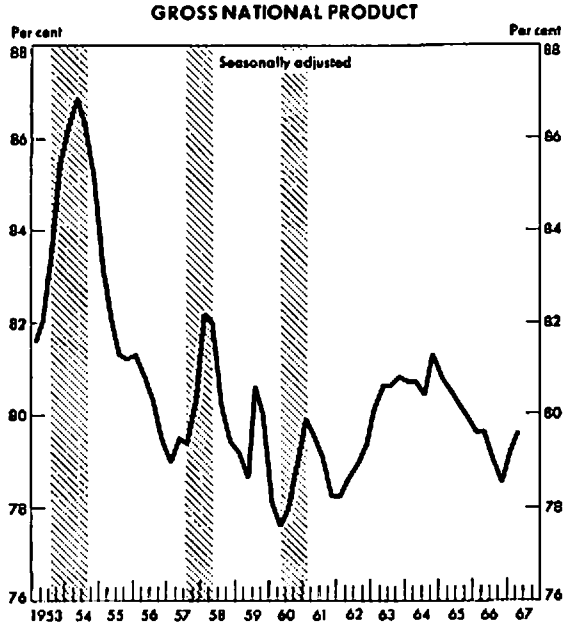
Net reserve availability continued to increase in the second quarter of 1967, although the growth of total member bank reserves slowed substantially. Total reserves rose at a seasonally adjusted annual rate of 2.6 per cent in the second quarter, following the very sharp 18.1 per cent gain of the first quarter (daily average basis). Nonborrowed reserves grew somewhat faster than total reserves, as borrowings by member banks from the Federal Reserve declined almost without interruption through the second quarter, from an average of $199 million in March to $123 million in June. Both excess reserves and free reserves—defined as the difference between excess reserves and member bank borrowings from the Federal Reserve—declined somewhat in April, but generally rose over the remainder of the quarter. At $420 million, excess reserves in June averaged slightly below the March level. However, average free reserves rose by $61 million from the March level to $297 million in June, the highest average since early 1963. Over the whole April-June period, free reserves averaged $247 million, compared with an average of $72 million during the first quarter.

NONBANK LIQUIDITY

The liquidity of the nonbank public rose more rapidly in the second quarter than at any time since the first quarter of 1966. Public holdings of liquid assets grew at a seasonally adjusted annual rate of 6.9 per cent in the second quarter, compared with the 5.6 per cent rise in the first three months of the year. Thus, the 6.3 per cent rate of expansion in the first half of 1967 exceeds that of all of 1966, when a major sector of the public—nonfinancial corporations—found their liquidity positions severely squeezed. Holdings of currency and demand deposits rose sharply during the second quarter as did personal-type savings, mainly commercial bank time and savings deposits and savings accounts at mutual savings banks and savings and loan associations. Interest rates on these deposits remained relatively high, while yields on some short-term market instruments, such as Treasury bills, declined during much of the quarter. The growth of deposits at nonbank thrift institutions over the period is among the strongest on record: deposits at mutual savings banks rose at a seasonally adjusted annual rate of more than 9.3 per cent in the second quarter after a 7.3 per cent gain in the first three months, and shares at savings and loan associations grew at better than a 10 per cent annual rate following an increase of less than 7 per cent earlier in the year. While a substantial part of these inflows has been devoted to rebuilding liquidity positions strained in 1966, mortgage lending by these institutions has also been accelerating.

The nonbank public's holdings of United States Government securities maturing within one year declined by

Chart II
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.

$5.7 billion in the second quarter, to the lowest level since the beginning of 1965, as a large volume of tax anticipation bills matured without replacement.

The sharp overall improvement in the public's liquidity position in the second quarter was accompanied by a moderate expansion of economic activity, with the result that the ratio of liquid assets held by the nonbank public to GNP rose from 79.1 per cent in the first quarter to 79.6 per cent (see Chart II). At this level, the nonbank liquid assets ratio is almost back to the 79.7 per cent of the first half of 1966 but is still below the average of the 1964-66 period.

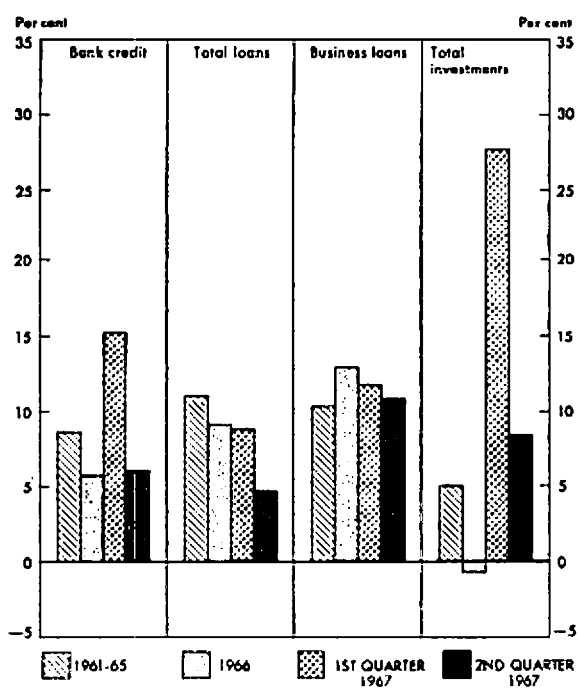
BANK CREDIT

Credit extended by commercial banks grew at a seasonally adjusted annual rate of 6.0 per cent in the second quarter of 1967, a sharp reduction from the 15.1 per cent rate of the first three months of the year (see Chart III). With a small increase in bank credit during the final quarter of 1966, the growth of bank credit over the nine months ended in June averaged 7.8 per cent, an annual rate slightly in excess of the pace of the first nine months of 1966. Both loans and investments at commercial banks grew at significantly reduced rates during the second quarter of 1967.

Total loan expansion at commercial banks fell to a 4.7 per cent seasonally adjusted annual rate in the April-June period, after increasing at an 8.9 per cent rate in the first quarter. This decline in the rate of growth was due primarily to a sharp reduction in securities loans, as expectations of rising interest rates and falling bond prices caused Government securities dealers to reduce inventories sharply. The growth of loans other than securities loans during the second quarter was only slightly lower than during the previous three months.

Business loans increased at a seasonally adjusted annual rate of 10.9 per cent during the second quarter, compared with gains of 11.8 per cent in the first quarter and 12.9 per cent over the year 1966. Business loan growth was subject to several opposing influences during the period. On the one hand, the growth was held down by the sharp decline in inventory accumulation along with

Chart III
CHANGES IN BANK CREDIT AND COMPONENTS AT ALL COMMERCIAL BANKS
Seasonally adjusted annual rates*



* Changes are computed from last-Wednesday-of-the-month figures.
Source: Board of Governors of the Federal Reserve System.

a strong drive by business firms to reduce their indebtedness to banks and reconstitute their lines of credit. A substantial proportion of the record amount of funds obtained by business firms in the capital market in the second quarter was apparently used to repay bank loans. In addition, nonfinancial businesses continued to substitute commercial paper for bank loans. The demand for business loans was bolstered, on the other hand, by the continued high level of fixed investment expenditures relative to internally generated funds and by the acceleration of corporate-profits tax payments in the second quarter. Bank loans to nonbank financial institutions were also affected by the tax speedup, as finance companies sought to replace commercial paper maturing around tax dates. Bank lending to nonbank financial institutions rose sharply in both April and June, and was up substantially on balance for the quarter. In contrast, there had been a moderate decline in loans to nonbank financial institutions over the first three months of the year, when yields on commercial paper were dropping faster than bank lending rates and when finance companies were finding ample funds in the commercial paper market. Other areas of bank lending showed diverse movements in the second quarter. Although the pace of residential construction continued to pick up, real estate loans rose somewhat more slowly than in the first quarter. Consumer loans continued to grow at their modest first-quarter pace. Agricultural loans, however, expanded sharply, on a seasonally adjusted basis.

Holdings of securities by commercial banks grew at a seasonally adjusted annual rate of 8.4 per cent in the second quarter, less than one third of the extremely rapid rise in the first three months of 1967. This reduced rate of growth of bank investments reflected a sharp rundown of short-term United States Government securities coupled with a continued strong rise in holdings of state and municipal securities.

The decline in bank holdings of Treasury securities in the second quarter reflected a number of special factors. Bank purchases of the bulk of the $2.7 billion issue of tax anticipation bills auctioned in mid-March brought bank holdings of Treasury issues to relatively high levels at the end of the first quarter and the beginning of the second quarter. The subsequent sale of a major part of these bills by the banks in April and the redemption on June 22 of a substantial amount of tax bills held to maturity by banks served to reduce sharply their holdings of Government securities by the end of the quarter. May was the only month of the quarter in which commercial banks as a whole added to their stock of Treasury securities. This rise resulted from commercial bank participation in the midmonth refunding of $22.1 billion of Treasury notes maturing in May, June, and August of 1967; banks picked up substantial amounts of Treasury notes with one- to five-year maturities in the refunding, partly at the expense of short-term issues. Over the full quarter, bank holdings of Treasury obligations fell at a seasonally adjusted rate of 9.0 per cent, after rising at a 25.8 per cent pace in the first quarter. In the first six months of the year, however, bank purchases of Government securities were strong on balance—up 8.1 per cent annually in comparison with the nearly 6 per cent declines of 1965 and 1966, when loan demands pressed heavily on available bank resources.

Commercial banks continued to purchase substantial amounts of securities other than United States Governments during the second quarter. Bank holdings of these securities—mainly tax-exempt state and municipal issues —rose at an annual rate of 27.5 per cent during the quarter, and have reached record levels on a seasonally adjusted basis in each of the last six months. However, the banks have generally been reluctant to take up substantial amounts of long-term tax-exempt securities.

Bank liquidity, as indicated by loan-deposit ratios, changed little during the second quarter. For all commercial banks as a group, the aggregate ratio moved up from 63.6 per cent in March to 64.8 per cent in June on a last-Wednesday-of-the-month basis. Most of this increase, however, stemmed from a sharp rise in loans (not adjusted for seasonal variation) in June. At weekly reporting New York City banks the loan-deposit ratio (monthly average of weekly figures) remained constant at 76.2 per cent over the quarter, while at banks outside New York City the ratio moved up 0.3 percentage point to 67.1 per cent in June. Because the money market banks tend to respond rapidly to changing monetary conditions, the ratio at New York City banks is now substantially below last year's high while the all-commercial-bank ratio is less than 1 percentage point below its high of 65.6 per cent in September 1966.