Banking and Monetary Developments in the First Quarter of 1968

The growth of money and bank credit slowed further in the first quarter of 1968 as the movement toward credit restraint, which began in the closing months of 1967, intensified. Dangerous stresses in the international monetary system, resulting in large part from this country's continuing balance-of-payments deficit, plus growing inflationary pressures in the domestic economy necessitated the coordinated use during the first quarter of all the principal instruments of monetary policy. In mid-January, reserve requirements on demand deposits in excess of $5 million at member banks were increased by ½ percentage point, absorbing about $550 million of member bank reserves. Then, on March 14, following unprecedented speculative demand for gold abroad, the Board of Governors of the Federal Reserve System announced approval of an increase in the discount rate from 4½ per cent to 5 per cent, effective the next day, at nine Federal Reserve Banks.[1] The new 5 per cent discount rate was the highest in nearly four decades. (After the quarter closed, monetary restraint moved a step further in April with another increase in the discount rate to 5½ per cent.)[2] Moreover, open market operations were adjusted progressively during the quarter to restrain further the expansion of money and credit. As one measure of the increasing restraint brought to bear on bank reserve positions, daily average free reserves declined steeply during the quarter, dropping from an average of about $100 million in the first weeks of the year to an average of minus $310 million in March. At the same time, the effective rate on Federal funds increased sharply, rising from just over 4½ per cent in early January to roughly 5½ per cent in late March.

The System's move toward progressively tauter monetary conditions was reflected in slower rates of growth in most credit and liquidity indicators during the January-March period. The growth of total commercial bank credit fell to a seasonally adjusted annual rate of 6.8 per cent from 7.5 per cent in the fourth quarter of 1967, markedly below the growth in 1967 as a whole. The rate of increase in the money supply also slowed during the first three months of this year, as did the growth of commercial bank time deposits. At the same time, nonbank thrift institutions experienced relatively modest growth in their deposits and share capital.

The progressive tightening of money market conditions was also manifested in upward pressure on market interest rates. While yields on most short- and long-term Government and private debt issues declined during the first part of the quarter, they climbed thereafter as monetary restraint intensified and, for the most part, closed the quarter at higher levels than those prevailing three months earlier.

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[1] The Federal Reserve Banks of San Francisco and Philadelphia posted increases in their rates effective on March 15 and 18, respectively, while the Federal Reserve Bank of New York did not take similar action until March 21, effective the following day.

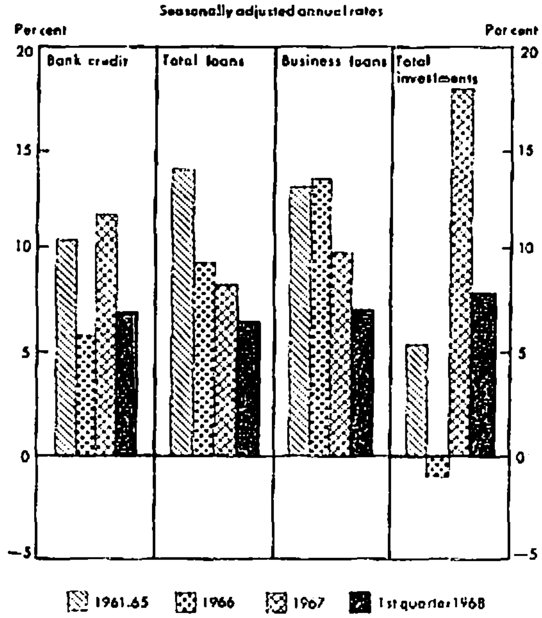
[2] For details, see page 95 of this *Review*.

Rates on short-term Treasury bills were relatively stable until mid-March, when they rose in response to the increase in Federal Reserve Bank discount rates. Yields on intermediate- and long-term Government issues matched, and in some cases surpassed, their 1967 peaks in mid-March and then declined slightly over the remainder of the month. Corporate and tax-exempt bond yields continued to climb throughout March, however, and tax-exempt yields reached the highest levels in thirty-five years.

BANK CREDIT

Although the rate of expansion of total commercial bank credit moderated on balance in the first quarter of 1968 (see Chart I), the pattern of growth within the period was highly uneven. In January and February bank credit increased at annual rates of 10.8 per cent and 13.8 per cent, respectively, while the final month of the period witnessed a small decline. This extreme unevenness largely reflected wide swings in holdings of United States Government and other securities and in loans for the financing of securities dealers.

Chart I
RATES OF CHANGE IN BANK CREDIT
AND COMPONENTS AT ALL COMMERCIAL BANKS
Seasonally adjusted annual rates



Note: Changes are computed from levels on the last Wednesday of the month before and at the end of each period.

Source: Board of Governors of the Federal Reserve System.

Bank holdings of Government securities rose sharply in February, when banks were accorded full Tax and Loan Account privileges in connection with the Treasury's sale during the month of $4 billion of new notes. However, a large proportion of these securities was then distributed to the nonbank public in March, and over the quarter as a whole bank holdings of Government securities increased only modestly. Even so, this slight gain did represent a substantial turnaround from the fourth quarter of 1967 when Government securities were liquidated. On the other hand, acquisitions during the first quarter of other securities—primarily tax-exempt issues—were at only half the pace recorded in the final three months of 1967. This slowdown about offset the greater relative strength in holdings of Government securities, and total investments rose in the first quarter at an annual rate of 7.9 per cent, only slightly faster than in the fourth quarter and markedly below the advance in 1967 as a whole. This modest advance undoubtedly reflected tighter monetary conditions and slower deposit inflows in the January-March period.

Total commercial bank loans increased at a seasonally adjusted annual rate of 6.4 per cent in the first quarter, somewhat below the 8.5 per cent advance in the fourth quarter of last year. Loans gained sharply in January, moderately in February, and then actually declined slightly in March. This pattern was influenced by sharp fluctuations in securities loans. In January, sales of Federal National Mortgage Association participation certificates and tax anticipation bills swelled dealer inventories, giving rise to substantial dealer borrowing at commercial banks. Securities loans advanced again in February, though more moderately than in January, as dealers borrowed at banks to finance purchases of the Treasury notes issued just after midmonth. The sharp drop in securities loans outstanding in March was attributable in large part to a reduction in dealer inventories, which was facilitated by the lack of any significant Treasury financing during the month, and was encouraged by the sharply higher rates charged by banks on call loans to securities dealers. Indeed, call loan rates were almost a full percentage point higher after mid-March than they had been during most of January.

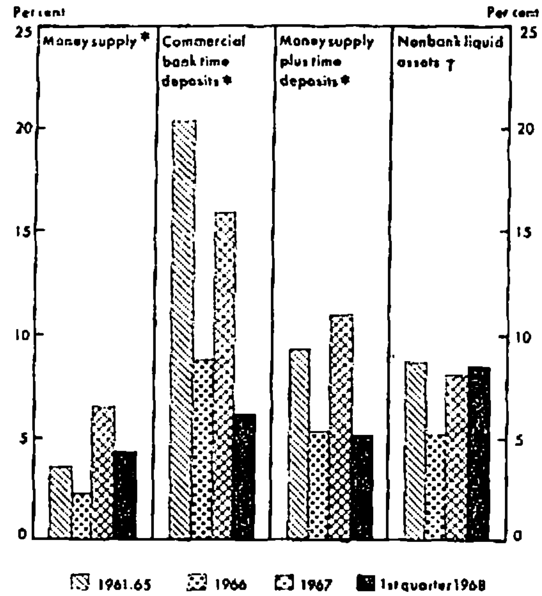
The demand for bank loans by business was relatively modest in the first quarter as a whole, although a more aggressive demand did emerge toward the end of the period. Commercial bank loans to business increased at a seasonally adjusted annual rate of 7 per cent in the January-March period, substantially slower than the 10 per cent rate of advance during the fourth quarter of 1967. Business loan demand strengthened in March, however, even though corporate income tax payments were roughly $2.5 billion less than they were on the same tax date in the previous three years. The March advance was broadly based, as business activity expanded rapidly in most sectors of the economy. A strong surge in business loans after mid-March may have reflected in part increased expectations that commercial bank prime rates would rise following the discount rate increase.

Construction activity remained strong in the first quarter, and real estate loans held by banks expanded at an 11 per cent annual rate, continuing the relatively rapid growth that began in the second half of 1967. At the same time, extensions of consumer credit by commercial banks also advanced sharply, reflecting the record advance in consumer spending during this period. The 13.7 per cent annual rate of growth was twice the increase in the fourth quarter of 1967 and represented the largest quarterly gain in this loan category since the third quarter of 1965.

Chart II

RATES OF CHANGE IN LIQUIDITY INDICATORS

Seasonally adjusted annual rates



* Computed from daily average levels during the week prior to and at the end of each period.

† Computed from levels at the beginning and end of each period.

Source: Board of Governors of the Federal Reserve System.

MONEY SUPPLY AND DEPOSITS

The rate of expansion of the daily average money supply —privately held demand deposits plus currency outside banks—continued to moderate in the first quarter, when the annual rate of growth fell to 4.2 per cent from 5.1 per cent in the final quarter of 1967. The money supply rebounded in January, after growing very slowly in December, but then remained virtually unchanged in February as Treasury deposits in commercial banks swelled and private deposits declined. (This inverse relationship between Treasury and private deposits often holds over short periods of time.) In March, when Treasury deposits declined, the money supply expanded once again.

The growth of daily average time deposits at commercial banks fell sharply in the first quarter to an annual rate of 6.1 per cent, after an 11 per cent rise in the fourth quarter of last year. In January commercial banks actually lost time deposits, but inflows recovered in February and March. The relatively slow growth in time deposits over the quarter was attributable in large part to the weak performance of large-denomination certificates of time deposit (C/D's representing deposits of $100,000 or more). At weekly reporting banks, outstanding C/D's advanced by $224 million during the first quarter, about half of the previous quarter's increase and far below the $3.6 billion gain in the first quarter of 1967. Increases in January and February were smaller than in the same months of the previous year, and in March large C/D's fell sharply, declining by $500 million during the tax week alone. The relatively slow growth of C/D's in the first quarter resulted largely from a $644 million net loss by large New York City banks. Indeed, reporting banks outside New York City recorded a net gain of $868 million over the quarter. However, large outflows were also experienced by these banks in March, indicating the widespread difficulty in rolling over maturing certificates. Although rates most often posted on certificates of 180-day maturity or longer were at the 5½ per cent Regulation Q ceiling throughout the quarter, and rates on shorter maturities were at the ceiling before the end of the period, yields on alternative forms of investment were becoming more attractive than the maximum allowable C/D rate.[3]

The ratio of loans to deposits at all commercial banks increased slightly over the quarter as a whole, from an average of 62.7 per cent in December 1967 to 63.1 per cent in March. The ratio rose a full percentage point in March, however, after declining in January and edging up only slightly in February. The loan-deposit ratio at large New York City banks, where C/D losses were substantial,

[3] On April 18, the Board of Governors of the Federal Reserve System announced increases in Regulation Q ceiling rates for most maturities of large denomination C/D's. For details, see page 97 of this *Review*.

increased rather sharply during the quarter. Moreover, these banks borrowed quite heavily from their foreign branches during the January-March period, permitting loans to expand relative to deposits.

BROAD LIQUIDITY TRENDS

Liquid assets held by the nonbank public increased at a seasonally adjusted annual rate of 8.6 per cent during the first quarter (see Chart II), somewhat slower than the 9.3 per cent growth rate in the final quarter of 1967. The expansion of deposits and share accounts at commercial banks, mutual savings banks, and savings and loan associations failed to keep pace with the growth of other liquid assets. Deposits held by the nonbank public at thrift institutions advanced at a seasonally adjusted annual rate of 6.6 per cent from December through March, slightly faster than in last year's fourth quarter but considerably slower than the 9.1 per cent growth over 1967 as a whole. Both mutual savings banks and savings and loan associations experienced reduced growth in January, following year-end interest and dividend crediting, but their growth rates picked up in February and March.

The public continued in the first quarter to acquire large amounts of Government securities maturing within one year, after having purchased $2.3 billion in the final quarter of 1967. Indeed, holdings of these liquid assets increased by $5.6 billion in the January-March period, a larger gain than in the entire second half of the previous year. Fully 40 per cent of the gain in total liquid assets in the January-March period was accounted for by the increase in short-term Government securities. Undoubtedly, the high and rising yields on securities market investments relative to deposit rates offered by commercial banks and thrift institutions exerted an important influence on this development.

The relative liquidity of the nonbank public, as measured by the ratio of total liquid assets to gross national product, remained virtually unchanged in the first quarter. This ratio was 79.4 per cent, slightly below the 79.6 per cent of the previous quarter but equal to the average for the year 1967.