Banking and Monetary Developments in the Third Quarter of 1968

The growth of total bank credit and total deposit liabilities accelerated in the third quarter. Reserve pressures eased slightly during the period, banks' large-denomination certificates of deposit (C/D's) once again became competitive in the market for short-term funds, and overall credit demands in the economy remained strong. The Federal Reserve System in July moved through open market operations to accommodate tendencies toward less firm conditions in the money market, and then in the final two weeks of August each of the twelve Reserve Banks lowered its discount rate by ¼ percentage point to 5¼ per cent. This latter action was designed to bring the discount rate into better alignment with the reduced level of short-term rates that had already emerged, largely as a result of passage of the tax surcharge and the companion program of Federal spending restraint.

The decline of short-term interest rates gave banks renewed market competitiveness under the Regulation Q ceiling rates for large C/D's established last April. In this environment, banks were able to sell new large C/D's at declining interest rates to recoup deposit losses suffered earlier in the year, to replenish their depleted holdings of liquid investments, and to meet the strong credit demands of a still rapidly expanding economy. Indeed, the growth of large C/D's was the major factor in the stepped-up growth of banks' deposit liabilities to private holders during the third quarter, although consumer-type time deposits also grew substantially. Privately held demand deposits, on the other hand, expanded at a rate well under half the second-quarter pace. The sharp reduction in the growth rate of such deposits was reflected in a marked slowing of money supply growth, as the rise in currency in circulation outside banks—the other component of the money supply—also moderated.

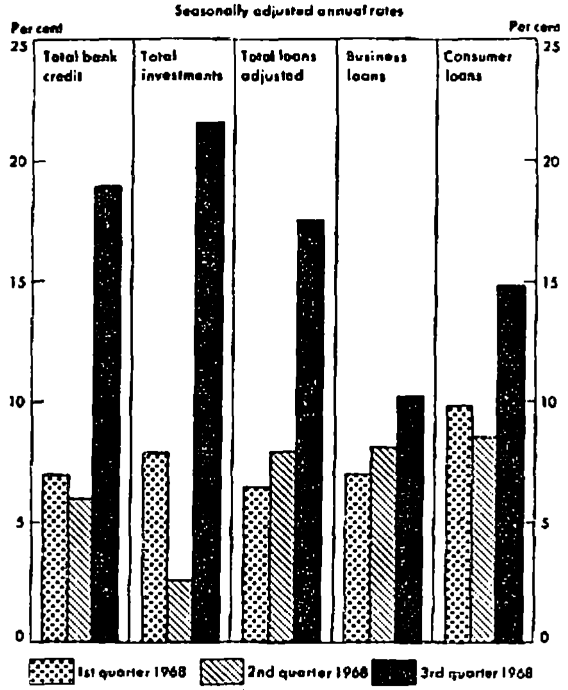
INTEREST RATE DEVELOPMENTS AND MEMBER BANK RESERVE POSITIONS

Short-term market rates of interest declined considerably in the third quarter, with the bulk of the downward adjustment taking place from mid-June to early August. Thereafter, many short- and intermediate-term rates drifted up again, but most closed the quarter at levels significantly below those which had prevailed at the opening of the period. The steep downward adjustment from mid-June to early August reflected passage of the fiscal restraint program and widespread belief that monetary policy would have to ease to prevent undue restraint on the economy. The subsequent upturn of rates was associated with a growing recognition in the markets that the economy was continuing to expand strongly and that monetary policy might therefore be unlikely to ease substantially. In mid-July the Federal Reserve System began conducting open market operations with a view toward accommodating the slightly easier money market conditions that had already developed. Then, beginning with an action on August 16 by the Federal Reserve Bank of Minneapolis, the discount rate was lowered by ¼ percentage point to 5¼ per cent in a technical move designed to align the rate with the reduced rates already prevailing on other money market instruments. Over the ensuing two weeks the other Reserve Banks followed suit.

The Federal Reserve Banks of Atlanta, San Francisco, St. Louis, and New York were the last to act, lowering their rate on August 30. Another major interest rate development was a reduction late in the quarter in the commercial bank prime rate. While a few smaller banks had lowered their prime rate around mid-September, the first action by a major money market bank was a ½ percentage point reduction (to 6 per cent) by a New York City bank on September 24. Over the next few days other major banks around the country also reduced their prime rate, but by ¼ percentage point to 6¼ per cent.

Member bank borrowings at the "discount window" declined in the third quarter, while the level of required reserves advanced sharply. Borrowings declined from an average level of about $700 million in the second quarter of the year to $535 million in the third quarter. Since excess reserves contracted only slightly, net borrowed reserves fell from the second-quarter level of $360 million to a third-quarter average of $210 million. With the lessening of reserve pressures and the discount rate cut, the Federal funds rate eased over the quarter from an average of 6.07 per cent in June to 5.78 per cent in September. September saw wide fluctuations in the Federal funds rate, however, as banks sought to adjust to the new reserve-accounting procedures.[1]

Chart I
CHANGES IN BANK CREDIT AND ITS COMPONENTS AT ALL COMMERCIAL BANKS
Seasonally adjusted annual rates



BANK CREDIT

The growth of total bank credit accelerated substantially in the third quarter of 1968 (see Chart I). Commercial bank holdings of loans and investments expanded over the quarter at a seasonally adjusted annual rate of 19 per cent, more than three times the rate of gain during the second quarter of the year. Close to two fifths of the $17.0 billion advance in total bank credit was accounted for by a step-up in acquisitions of investments. Banks were heavy purchasers of Treasury issues, including those offered in the July and August financings, and also acquired a sizable share of the large flow of new tax-exempt securities issues available throughout the period. Commercial banks increased their holdings of United States Government securities in the third quarter by $3½ billion, seasonally adjusted, in sharp contrast to a decline of $1 billion over the preceding nine months. Holdings of "other securities"—mainly tax-exempt obligations of states and municipalities—also moved up sharply in the July-September period, by $3 billion seasonally adjusted. In the second quarter, holdings of other securities had remained virtually unchanged when banks came under heavy pressure from losses of large C/D's.

Liquidity rebuilding, facilitated by renewed ability to attract funds through large-denomination C/D's, was undoubtedly a principal reason for the sharp gains in bank investments during the third quarter. But banks may also have been influenced by changing interest rate expectations in the financial community at large. As the third quarter opened, the fiscal restraint legislation—comprising the tax surcharge and a cutback in Federal spending—was just going into effect. Rates on most money market instruments were declining, and there was widespread discussion of prospects for further significant declines. A near-term

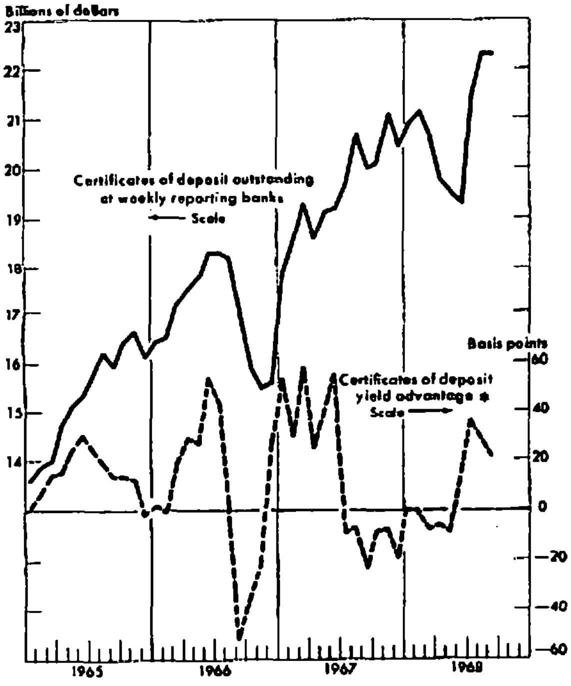
[1] Under the new procedures, which took effect in the statement week ended on September 18, member bank required reserves in a given week are based on average deposits two weeks earlier, rather than on current deposits, and the vault cash component of banks' reserves is also that amount held two weeks earlier. Moreover, banks now carry over from the previous statement week daily average reserve excesses or deficiencies of up to 2 per cent of their average required reserves. The new procedures require that all member banks settle their daily average reserve requirements on a weekly basis; previously, a two-week settlement period had applied to "country" banks.

slowdown in economic activity was widely expected, and this in turn was thought likely to result in a significant easing of monetary policy.

Against this background, not only banks, but also Government securities dealers, began to add aggressively to their inventories of Treasury obligations. Dealers attempted to cut back on their inventories after early August, as further interest rate declines failed to materialize, but their average holdings in September remained nearly $2 billion higher than in June. Reflecting the heavy financing requirements of their positions, borrowing at banks by United States Government securities dealers showed a sharp advance over the quarter, following a decline in the first half of the year. Loans to stock market brokers and dealers were also quite strong, no doubt in some measure because of the continuing high level of stock market trading. As a consequence of these heavy demands, total securities loans spurted in the third quarter by close to $4 billion, seasonally adjusted, following a decline in each of the previous three quarters.

Chart II

CERTIFICATES OF DEPOSIT OUTSTANDING AND YIELD ADVANTAGE



* Average of most often quoted new issue rate on 90- to 179-day certificates of deposit less average yield on six-month Treasury bills.

Source: Board of Governors of the Federal Reserve System.

Loans other than securities loans strengthened in the third quarter, advancing at a seasonally adjusted annual rate of 11½ per cent, compared with 9 per cent in the April-June period. Business loans expanded at a rate of just under 10½ per cent, or somewhat more rapidly than in the second quarter, although the rate of expansion moderated substantially as the quarter progressed. The August-September moderation in the growth rate of commercial bank business loans can be related in part to reduced demands stemming from the slowdown in the rate of business inventory accumulation and in part to increasing competition from the commercial paper market. Business inventories, as measured in the GNP accounts, increased in the third quarter by an estimated $7.7 billion (seasonally adjusted annual rate), down from a $10.8 billion rate of accumulation in the second quarter. At the same time, borrowing costs in the commercial paper market moved lower throughout the quarter. Before the ¼ percentage point reduction in the commercial bank prime loan rate in late September, commercial paper rates were about 75 basis points lower than the prime rate.

Bank lending to consumers accelerated sharply in the third quarter. Consumer loans outstanding at banks increased at a seasonally adjusted annual rate of 15 per cent, compared with 8½ per cent in the preceding three months. Total consumer indebtedness to banks and other lenders expanded sharply in each month of the quarter as consumers relied heavily on credit to increase their spending. Despite the income tax surcharge, which cut significantly into the rate of growth of disposable income, personal consumption expenditures accelerated sharply in the third quarter, with spending on both durables and nondurables showing impressive advances.[2] The strong credit demands stemming from the consumer sector also affected banks indirectly by giving rise, in the final two months of the quarter, to increased loan demand by nonbank financial institutions. The major borrowers in this category are sales and personal finance companies, and in the third quarter they not only stepped up their borrowing from commercial banks but also relied heavily on placing their own paper in the open market.

The third-quarter rate of growth of real estate loans was about unchanged from that of the second quarter. There was a marked strengthening in such loans in September, however, perhaps reflecting the sharp nationwide

[2] For a more detailed discussion of third-quarter income and product developments, see "The Business Situation", this *Review*, pages 226-29.

increase in housing starts as well as the increased attractiveness of such loans under the higher usury law ceilings established during the summer in several populous Eastern states.

Since almost two thirds of banks' large inflows of funds during the third quarter was placed in investments and in loans to brokers and dealers, their loan-deposit ratios[8] declined over the quarter. The ratio for all commercial banks in the aggregate fell from the very high June level of 65.4 per cent to 64.2 per cent at the end of September. As noted earlier, the major source of new funds for banks was a sharp increase in large C/D's made possible by declining rates on competing short-term instruments (see Chart II on page 237). The large New York City banks, however, did not build up their C/D's as rapidly as did the other banks, relying instead on large borrowings of Euro-dollars through their own foreign branches. As a result, these banks were able to increase their outstanding loans relative to their deposit liabilities. Thus, the loan-deposit ratio at large weekly reporting banks in New York climbed further in the third quarter, from an average of 80.0 per cent in June to 80.5 per cent in September. However, when their Euro-dollar balances are counted as deposits in the computation of the loan-deposit ratio, these New York City banks showed a decline of about the same magnitude as at all commercial banks.

MONEY SUPPLY AND TIME DEPOSITS

The money supply—privately held demand deposits plus currency in circulation outside banks—grew at a seasonally adjusted annual rate of 4½ per cent in the third quarter, down substantially from the 8½ per cent rate in the second quarter. For the latest quarter as a whole, the slowing in money stock growth probably reflected somewhat reduced needs for transactions balances as the pace of stock market activity moderated slightly, coupled with a flow of deposits from the private sector into the Treasury. Within the quarter there was considerable variation in month-to-month movements in the money stock. In July, a very rapid increase in privately held demand deposits pushed money supply growth to a rate of just under 13 per cent. The run-up in deposits reflected, on the one hand, the continuing high level of economic and financial activity, and sharp declines in Treasury deposits at commercial banks, on the other. However, money supply growth moderated substantially in August, to a rate of 5½ per cent per annum, and in September the money stock actually declined. The August-September slowdown centered in private demand deposits, as the large Treasury financing in August and the increased tax collections in September drew funds out of the private sector.

Time and savings deposits at commercial banks expanded in the third quarter at a very rapid seasonally adjusted annual rate of 18 per cent, in marked contrast to the sluggish 5 per cent growth rate recorded in the first half of the year. The time deposit strength was attributable to heavy inflows of funds in the form of large C/D's and consumer-type deposits. Throughout much of the second quarter, maximum offering rates on large C/D's had been limited by Regulation Q ceilings to levels generally lower than those on competing money market instruments. Toward the end of that quarter, however, short-term market rates began to decline and the competitive position of C/D's improved. In July, market rates dropped sharply and banks were able to move their offering rates below the Regulation Q ceilings and still attract a large volume of funds. At weekly reporting banks alone, the volume of large C/D's outstanding climbed in July by $2.2 billion, more than offsetting the second-quarter loss of $1.3 billion. In August and September, New York City banks turned to Euro-dollars as a source of funds, but banks outside New York City continued to issue C/D's in substantial amounts. Thus, by the end of the quarter, large C/D's outstanding at weekly reporting banks were $3 billion above the level at the end of June. The other major factor accounting for the third quarter's rapid time deposit growth was the surprising strength in consumer-type time deposits. While passbook savings accounts continued to show weakness, time certificates and open account time deposits grew at an increased pace. There are no data available on these deposits at all commercial banks, but weekly reporting bank figures—which are not adjusted for seasonal variation—show a third-quarter rise in consumer-type deposits of $1.8 billion, compared with a second-quarter gain of $0.8 billion.

THRIFT INSTITUTIONS

Flows of savings into thrift institutions slowed further in the third quarter of the year. The reduced inflows to thrift institutions occurred despite a substantial narrowing of spreads between rates at these institutions and yields on competing money market instruments, suggesting that the third quarter's large cutback in consumer saving out of disposable income may have had some effect in this

[8] The loan-deposit ratio is here defined as loans adjusted less loans to brokers and dealers, expressed as a percentage of total deposits less cash items in the process of collection.

area. Share capital at savings and loan associations increased at a seasonally adjusted rate of 5½ per cent, down only slightly from the second-quarter increase. On the other hand, the growth of deposits at mutual savings banks dropped in the third quarter to 6 per cent, a marked slowing from the second-quarter rate of 7½ per cent.

The thrift institutions cut back on their net acquisitions of mortgages during the third quarter, in line with their somewhat slowed deposit inflows. Savings and loan associations added to their mortgage portfolios at a 6½ per cent annual rate in the third quarter, down from just over 7 per cent in the second quarter, while mutual savings banks curtailed their new mortgage lending more strongly, from an annual rate of 6 per cent in the second quarter to 4½ per cent in the third. A large proportion of the savings banks' net inflows continued to be invested in corporate bonds. Apparently the substantial increases in residential mortgage rates, subsequent to the liberalization of usury law ceilings in several states where mutual savings banks are important lenders, came too late to affect third-quarter mortgage loan disbursements by the savings banks.