Banking and Monetary Developments in the Second Quarter

The nation's banking system was subjected to heavy pressure from continued monetary restraint in the second quarter of 1969. Although there was a moderate step up in the rate of growth of bank credit and the money supply, compared with the first three months of the year, a noticeable slowing in the rate of expansion of these aggregates developed as the quarter progressed. There was a deceleration in the growth of most major types of bank loans to rates well below those posted in the first quarter. On the other hand, while banks further reduced their holdings of all types of securities as a means of obtaining loanable funds, their total holdings of investments declined at a slower pace than in the first quarter. A major factor influencing bank lending and investment policies during the second quarter was the continued heavy losses of large certificates of deposit (CD's), in response to sharply rising market interest rates and unchanged Regulation Q ceilings on bank time deposit rates. Larger banks, in order to offset their heavy CD losses, made extensive use of the Euro-dollar market and also greatly expanded their efforts to develop other nondeposit sources of funds. With loanable funds becoming more difficult and costly to raise, and continued strong loan demand, commercial banks increased the prime rate on June 9 from 7½ percent to a record 8½ percent, the fifth increase in seven months.

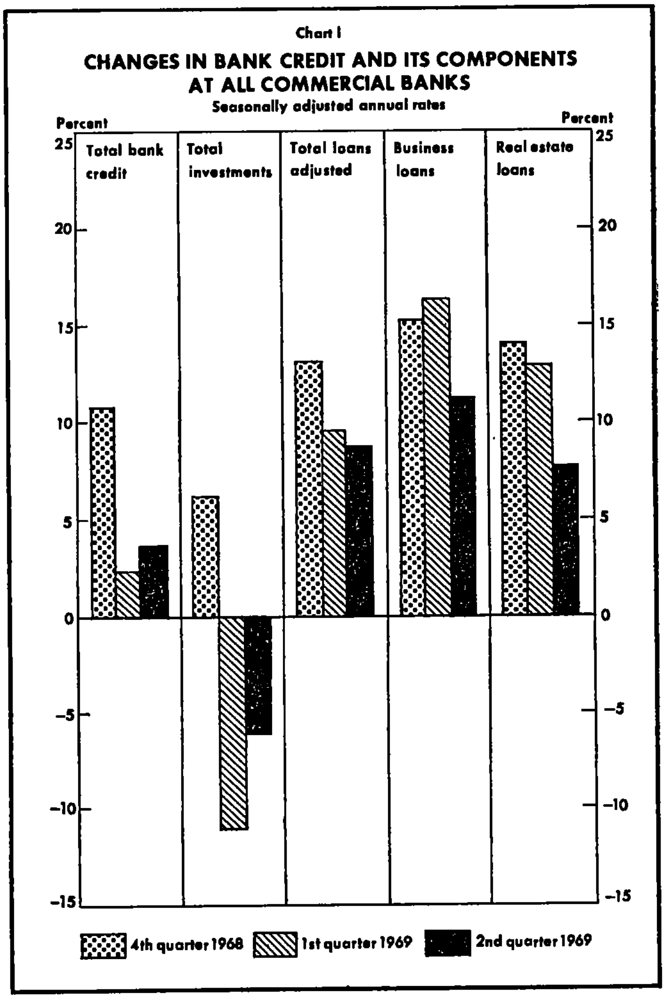
INTEREST RATE DEVELOPMENTS AND MEMBER BANK RESERVE POSITIONS

Market interest rates rose throughout the second quarter, as pressures on the money and bond markets intensified. The increase in rates was most pronounced during the last three weeks of June, in part because of pressures arising from the corporate tax and dividend payment dates in the middle of the month. The rate for three-month Treasury bills climbed 42 basis points over the quarter to an average of 6.43 percent in June. The rise in long-term rates, while substantial, was generally not so large; however, rates on high-grade tax-exempt securities issued by state and local governments rose 61 basis points, partly reflecting continued bank selling of these securities and, later in the period, investor concern about tax reform proposals that might restrict the tax-exempt status of these issues. While banks found it increasingly difficult to accommodate the strong loan demand, more borrowers turned to the commercial paper market. The increased pressure on this source of short-term funds was reflected in sharply higher interest rates. For example, the rate on prime four- to-six month commercial paper climbed from an average of 6.82 percent in March to 8.23 percent in June. Because of rising market interest rates, banks found it difficult to replace maturing large CD's even though they continued to offer the maximum rates established under Regulation Q, which range from 5½ percent on the shortest maturities to 6¼ percent on the longest.

At the beginning of the quarter, the Federal Reserve discount rate was increased to 6 percent from 5½ percent, and reserve requirements on member bank demand deposits were increased by approximately $650 million. With a relatively small increase in total reserve availability during a period when reserve drains ordinarily tend to be large, heavy pressure on member bank reserve positions developed. Net borrowed reserves increased from an average of $701 million in March to an average of $1.1 billion in June, and borrowings at the Federal Reserve Banks rose to $1.4 billion in both May and June from a March average of $918 million. These developments were associated with a sharp increase in the effective rate on Federal funds from an average of 6.8 percent in March to 8.9 percent in June.

BANK CREDIT

The growth of total commercial bank credit stepped up slightly to a seasonally adjusted annual rate of 3.7 percent during the second quarter (see Chart I). Bank credit expansion had decelerated sharply from a 10½ percent rate in the last quarter of 1968 to 2.3 percent during the first quarter of this year. Almost all the second-quarter increase in bank loans and investments occurred during April. As the quarter progressed, the pace of bank sales of loans—mainly to their own foreign branches and affiliated holding companies—stepped up, and partly for this reason total bank credit declined in June. These loan sales,



which reduce the level of loans appearing on a bank's balance sheet, lead to an understatement of the volume of credit originated through the banking system. Nonetheless, even after allowance for this possible distortion, bank credit growth during the first half of 1969 was still very much lower than in 1968.

Increased restraint on banks' loan portfolios began to develop in the April-June period. During the last quarter of 1968 and the first quarter of this year, banks made substantial increases in business, consumer, and real estate loans, which were financed in large part by sizable reductions in their holdings of Government securities and sharp declines in securities loans. In the second quarter, however, the seasonally adjusted \$3.6 billion growth of bank credit reflected a slower increase in total loans less securities loans, together with a more moderate rate of decline in total bank investments. Moreover, while banks continued to reduce their holdings of Government securities during the second quarter, they also found it necessary to reduce their holdings of other securities—primarily state and local government obligations—in order to accommodate borrowers.

Commercial bank holdings of United States Government securities declined \$1.5 billion on a seasonally adjusted basis during the second quarter. Virtually all the reduction occurred in May, and the total drop in holdings of Government securities in the second quarter was only about one third the size of the rundown in the first quarter of the year. However, bank holdings of other securities, principally tax-exempt notes and bonds issued by state and local governments, declined slightly on a seasonally adjusted basis in the second quarter after rising modestly in the first quarter. The reduced rate of decline of United States Government securities holdings in the second quarter, together with a turn to net liquidations of other securities, may indicate that banks were finding it difficult to reduce further their holdings of Government securities. A large proportion of these are pledged as collateral against Government demand deposits with banks.

Outstanding bank loans to securities dealers and nonbank financial institutions rose somewhat during the second quarter after declining in the first; however, the behavior of this component of bank credit ordinarily tends to be highly erratic over short time periods. Securities loans outstanding tend to vary with the levels of inventories held by securities dealers. In the first quarter, the heavy nonbank demand for Treasury obligations as well as a low level of Treasury borrowing encouraged dealers to reduce their inventories of Government securities, and inventories held by corporate and municipal bond dealers also fell. Thus, there was a substantial drop in securities loans over the first three months of the year. In the second quarter, although Treasury borrowing was not substantial, rising market rates and weak demands for securities led to small increases in dealers' inventories and, concomitantly, a moderate 4.5 percent increase in banks' securities loans. However, bank lending rates on securities loans were increased even before the prime rate went up, and securities loans declined substantially in June as borrowers economized on their credit.

In the face of rising market rates, nonbank financial institutions diverted a greater share of their borrowing to banks in April and May. However, after the prime rate increase in early June, borrowing by these institutions also fell rapidly. On balance, loans to nonbank financial institutions, which is a relatively small part of total bank credit, increased at a 13 percent rate in the second quarter.

Business loans grew at a seasonally adjusted annual rate of 11 percent during the second quarter, well below the 16½ percent rate of increase in the first three months of the year. The continued strength of spending on plant and equipment and the substantial increase in the rate of inventory accumulation contributed to heavy business demands for funds. In addition, the volume and timing of business credit demands were strongly affected by the corporate tax payments in April and June, and perhaps also by expectations of the higher cost and reduced availability of credit at banks. It is probable that many corporations borrowed two or three weeks before the corporate tax and dividend date on June 15, as they may have thought that the banking system would be hard pressed to provide funds when these payments were due. At the same time, the sale of business loans to foreign branches may have been a factor limiting the rise of business loan holdings in the second quarter.

The rapid expansion of bank real estate and consumer lending which began last fall slowed in the second quarter. Real estate loans increased at a 7½ percent annual rate, compared with a 13 percent gain in the first quarter. Moreover, the $0.3 billion June advance in these loans was the smallest monthly increase in a year. Consumer loans outstanding rose at a 7 percent seasonally adjusted annual rate, down from the 8 percent first-quarter increase. The second-quarter strength in consumer loans occurred mainly in April, and the rate of expansion also showed signs of moderating as the quarter progressed.

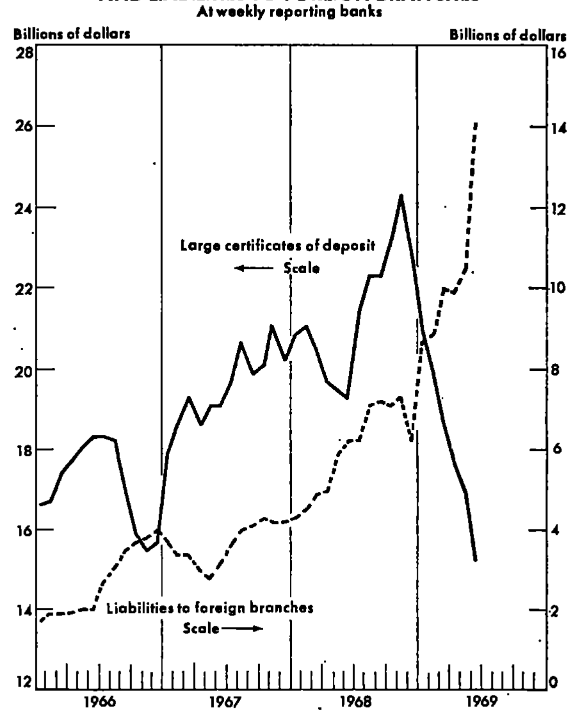
MONEY SUPPLY AND TIME DEPOSITS

The daily average money supply—privately held demand deposits plus currency in circulation outside banks—grew at a 2.5 percent seasonally adjusted annual rate over the second quarter, as presently measured. The second-quarter money supply gain was comprised of annual rate increases of 1½ percent in private demand deposits and 6½ percent in the currency component.

The modest rise reported for the money supply in the second quarter brought the increase for the first half of the year down to an annual rate of 2.2 percent, sharply below the 6½ percent rate of gain averaged during 1968. However, cash items in the process of collection, which are subtracted from gross private demand deposits in the computation of the money supply, continued to rise rapidly throughout the first half of 1969. Many of these cash items are apparently attributable to domestic banks' Euro-dollar transactions, and corrections of the money supply statistics to eliminate their effect would undoubtedly increase both the current level of the money supply and its rate of growth over the first six months of the year. Nonetheless, money supply growth for the year to date would still be significantly lower than in 1968.

Time and savings deposits at commercial banks declined at a 3½ percent annual rate in the second quarter, following a 6½ percent rate of decline in the first three months of the year. Banks found it increasingly difficult to retain maturing large CD's (see Chart II) or to issue new ones in the face of sharply rising market rates on alternative short-term investments. Losses of CD's at the weekly reporting banks, which in any month tend to vary with the amount reaching maturity, were rather severe in June. These banks were able to retain only 64 percent of maturing CD's in that month, when there were large cash needs associated with corporate tax and dividend payments. In the second quarter as a whole, CD losses were 28 percent of maturing deposits, or $3.5 billion, whereas they had been 26 percent of maturing deposits, or $4.0 billion, in the previous quarter. For the first time since the CD runoff began last December, the weekly

Chart II
LARGE CERTIFICATES OF DEPOSIT AND LIABILITIES TO FOREIGN BRANCHES*
At weekly reporting banks



* Outstanding on the last Wednesday of each month.
Source: Board of Governors of the Federal Reserve System.

reporting banks outside New York City sustained relatively greater losses in June than those in New York City.

The second-quarter rate of growth of total bank time deposits was also restrained by weakness in passbook savings accounts. At weekly reporting banks, for example, such deposits fell by $1.1 billion from March through June. Not all the decline in savings accounts need result in an outflow of funds from commercial banks as a whole; many of these deposits in the past have remained in the banking system in the form of higher yielding consumer-type time deposits. However, consumer-type time deposits —total private time deposits less those in denominations of $100,000 or more—increased only $184 million in the second quarter, compared with a first-quarter gain of $1.4 billion. These data are not adjusted for seasonal variation, but nevertheless the behavior of time and savings deposits at the weekly reporting banks seemed weak.

In an effort to offset time deposit losses, the larger commercial banks continued to turn to the Euro-dollar market as a source of funds and, through bank holding companies and other affiliates, to the commercial paper market. Large commercial banks increased their borrowings from their foreign branches by about $4.1 billion during the quarter even though Euro-dollar rates rose steadily, reaching an average in June of about 11 percent in the case of three-month maturities. Most of the increase in Euro-dollars liabilities—$3.6 billion—occurred in June when the CD runoff at banks was most severe. Funds raised outside the United States currently are subject neither to the reserve requirements specified in Regulation D nor to the interest rate ceilings established under Regulation Q. However, in response to the rapid rise in Euro-dollar liabilities in recent months, the Board of Governors of the Federal Reserve System on June 26 invited comments on a proposal to amend its regulations governing member bank reserve requirements and the foreign activities of member banks. The proposed amendments would subject borrowings by member banks from their foreign branches, as well as assets acquired by such branches from their parent banks, and credit extended by the branches to United States residents—above the amounts of such borrowings and assets in a base period—to a 10 percent reserve requirement. The proposed changes are described on page 140 of the July 1969 issue of this *Review*.

THRIFT INSTITUTIONS

The rate of growth of savings accounts at thrift institutions slowed substantially in the April-June period, falling to 3½ percent from the previous quarter's 6 percent gain. The continued widening of the spread between rates on deposits at the thrift institutions and rates on alternative money market instruments most likely retarded flows to these institutions. Share capital at savings and loan associations grew at a 3 percent annual rate, only one half the rate of increase attained in the previous two quarters. Deposits at mutual savings banks accumulated at an annual rate of 4¼ percent, compared with the 6¼ percent gain in the first quarter.

Despite the relative decline in savings inflows during the second quarter, there was no reduction in the rate of acquisition of mortgages by thrift institutions. During the April-June period, mutual savings banks added mortgages to their portfolios at a 5.2 percent seasonally adjusted annual rate, while outstanding mortgages held by savings and loan associations rose at an 8.9 percent annual rate. The savings and loan associations were able to finance net mortgage acquisitions in excess of savings inflows largely by a considerable increase in borrowing at the Federal Home Loan Banks.