Banking and Monetary Developments in the Fourth Quarter

The fourth quarter of 1969 rounded out a full year of sustained monetary stringency. While bank credit growth in the quarter recovered somewhat from a near halt in the previous quarter, the growth of all monetary aggregates remained severely restricted. Member bank reserve positions were under considerable pressure, and the continuation of monetary restraint and strong credit demands resulted in new short- and long-term interest rate highs. The rise of market rates in the face of unchanged deposit ceilings continued to affect time and savings deposits adversely. The Board of Governors of the Federal Reserve System took a number of regulatory steps, however, to reduce the attractiveness of nondeposit sources of funds.

INTEREST RATE DEVELOPMENTS AND MEMBER BANK RESERVE POSITIONS

The strong upward movement in short-term interest rates, which characterized the first three quarters of the year, continued on balance over the final months of 1969. Although most money market rates fell in October under the impact of peace rumors and expectations of reduced inflationary pressure, they climbed again in both November and December. Over the final quarter, the discount on three-month Treasury bills rose by 73 basis points to an average of 7.81 percent in December for a new high and rates on commercial paper and bankers' acceptances also showed sizable increases. Yields on intermediate- and long-term Treasury issues rose markedly over the quarter as well. A heavy volume of Federal agency and corporate new issues in November and considerable selling for tax purposes in December contributed to the substantial rate increases, as did the $8.3 billion new cash offerings by the Treasury. The average yield on United States Government securities maturing in three to five years jumped 40 basis points to an average of 7.98 percent in December, and yields on long-term Government bonds rose to record levels shortly before the end of the year. Rates also moved up strongly in the corporate bond market: the average rate on new issues of high-quality corporate bonds rose by about 81 basis points over the quarter to an average of 8.83 percent in December.

These interest rate increases resulted from strong credit demands during a time of severe monetary restraint. Member bank reserve positions continued under pressure in the October-December period, and net borrowed reserves remained high. Net borrowed reserves, which are not adjusted for seasonal variation, represent the amount by which member bank borrowings at the Federal Reserve Banks exceed member bank excess reserves. The level of these reserves was close to $1 billion in both October and November, but was allowed to move somewhat lower in December to accommodate the heavy increase in financial transactions typical of the month. The effective rate on Federal funds declined substantially in October along with most other money market rates, but it moved up again in each of the last two months of the year, averaging 8.97 percent in December.

Required reserves of member banks increased $400 million in the week ended on October 22 because of the August 13 amendments to Federal Reserve Regulations D and M. The amendment to Regulation M established a 10 percent reserve requirement on net borrowings by member banks from their foreign branches to the extent that such borrowings exceed the daily average amounts outstanding in the four weeks ended on May 28, 1969. This marginal reserve requirement also applies to most assets which are acquired by foreign branches from their United States head-office banks. The amendment to Regulation D established an equivalent 10 percent reserve requirement on member bank direct borrowings from foreign banks.

BANK CREDIT

Bank credit growth in the October-December period recovered a little from the very low level to which it had fallen in the third quarter. The fourth-quarter increase, including an adjustment for loans sold, was at a 2.3 percent seasonally adjusted annual rate, compared with a third-quarter rate of 0.8 percent. Since expansion of bank credit had been somewhat higher earlier in 1969, the last two quarters brought the rate for the year as a whole down to 3.3 percent from the 11.0 percent gain posted in the previous year (see Chart I). Certain loans sold by the banks have been included in the figures for 1969 in order to obtain a more accurate measure of the volume of credit originating in the banking system. Loans were sold by the banks over the year primarily to their branches and affiliates in order to gain access to an additional source of funds during a period of heavy deposit losses. Although these loans no longer appear on the banks' balance sheets, their sale financed a part of the total credit extended by the banking system in 1969. In dollar terms, the annual gain in bank credit as it appears on the balance sheets of the banks totaled $9.1 billion, while loans sold by the banks amounted to an additional $3.9 billion of credit during the year. The resulting $13 billion is not only far below the $39 billion recorded in the previous year, but is also smaller than the increase in any year since 1960. In 1966, when monetary restraint sharply reduced bank credit growth in the second half of the year, the advance in bank credit totaled $17.5 billion.

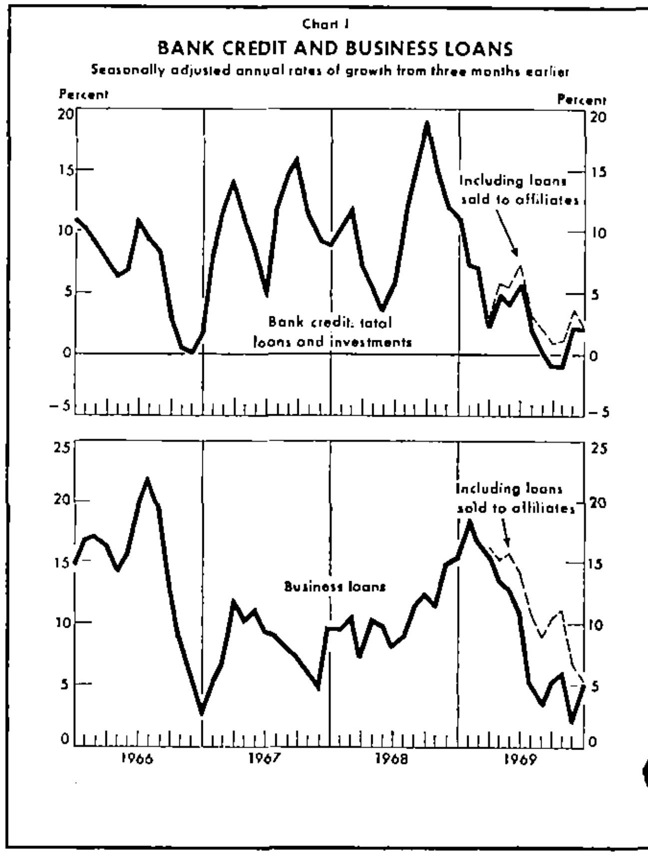


Chart I
BANK CREDIT AND BUSINESS LOANS
Seasonally adjusted annual rates of growth from three months earlier

The rise in fourth-quarter 1969 bank credit consisted of a moderate increase in total loans partially offset by a contraction in total investments. This pattern, characteristic of periods of monetary restraint, had also been evident in each of the previous quarters of 1969, as banks reduced their holdings of investments in order to accommodate loan activity. Over the fourth quarter, total investments held by the banks fell at a seasonally adjusted annual rate of 9.3 percent, about equal to their decline during the third. The reduction in bank investment holdings was particularly sharp in December and may have been associated with provisions of the Tax Reform Act of 1969, signed into law at the end of December. Under the new legislation, banks may have found it advantageous to sell certain securities before the year-end.

All the fourth-quarter contraction in bank investments was in holdings of United States Government securities which had been built up before 1969. Holdings of Treasury bills at all weekly reporting banks had more than doubled during the second half of 1968, and holdings of short-term Treasury notes and bonds had also risen during that period. Liquidation of these investments over the first nine months of 1969 reduced their level considerably and, with the further reduction during the fourth quarter, seasonally adjusted bank holdings of United States Government securities fell to $51.8 billion at the end of December—the lowest level since the beginning of the series in 1948. The previous low point had occurred under similar circumstances during the second half of 1966. Bank holdings of other securities—primarily state and municipal obligations—were unchanged on balance in the fourth quarter, but over 1969 holdings of these securities dropped by $0.8 billion for their first annual decline in ten years.

The growth of the loan component of bank credit during the fourth quarter consisted partly of a sharp increase in the volume of securities loans—credit extended to stockbrokers and securities dealers. After having shown a net decline in the third quarter, securities loans rose over the last three months of the year at a 32.6 percent seasonally adjusted annual rate. Much of this increase is associated with the fact that securities dealers were financing a higher level of inventories after rebuilding depleted inventory positions toward the end of October. Securities loans frequently show relatively large short-term fluctuations as dealer inventory positions vary. If these loans are excluded from the data, total loans including those sold grew in the fourth quarter at a seasonally adjusted annual rate of 6.6 percent.

An increase in business loans accounted for the largest part of the absolute increase in loans less securities loans over the fourth quarter. The outstanding volume of loans extended to business appearing on banks' balance sheets increased by $1.3 billion on a seasonally adjusted basis. A substantial amount of business loans does not appear on the banks' books because these loans have been sold to affiliates and branches. The growth of business loans including those sold proceeded at a seasonally adjusted annual rate of 5.3 percent over the fourth quarter, a notable deceleration from the 10.5 percent rate of growth over the preceding three-month period (see Chart I). Indeed, throughout 1969 such business loans have shown successively smaller rates of growth in each quarter. Since business loan demand has continued to be heavy, the markedly slower growth of such loans over the last three months of the year would seem to reflect increasing restrictions on the supply of these loans as the period of monetary restraint lengthens.

Credit extended to nonbank financial institutions increased during the final quarter of the year at a 22.4 percent seasonally adjusted annual rate of growth, after having declined on balance over the previous three months. Loans to finance companies accounted for the bulk of the gain in this category, as a large volume of their commercial paper ran off at the year-end. The finance companies may have turned to the banking system as a temporary source of funds instead of issuing new paper at a time when financial markets faced heavy seasonal demands for liquidity.

The seasonally adjusted volume of real estate loans outstanding grew at a 5.8 percent annual rate over the final quarter of the year. This represents a somewhat more rapid gain than that of the preceding three-month period, but the rate of advance continued well below that seen in the first half of the year. Loans to consumers also expanded at a slightly more rapid pace relative to the preceding quarter, growing at an annual rate of 5.9 percent. On balance over the second half of the year, however, a deceleration in this category is evident as well.

MONEY SUPPLY AND TIME DEPOSITS

Over the final quarter of 1969 the narrowly defined money supply—currency held by the public plus demand deposits adjusted—continued to reflect the impact of a policy of restraint. On a seasonally adjusted basis, this aggregate grew at a rate of only about 1½ percent in the fourth quarter, slightly above its zero rate of growth over the preceding three-month period. These increases brought the rate of growth of the money supply over all of 1969 to 2.5 percent, a sharp contrast with rates of growth of approximately 7 percent in each of the two preceding years. The fourth-quarter rise resulted from moderate currency growth throughout the period and an unusual late-December bulge in demand deposits. The bulge was partly associated with the clearing of Euro-dollar transactions during the holidays, as European banks were closed from Christmas Day through the following Sunday, while United States banks were open on December 26. A similar aberration occurred in April 1969 over the Good Friday and Easter weekend.

The total volume of time and savings deposits at all commercial banks in the fourth quarter was essentially unchanged on a seasonally adjusted basis, compared with the previous quarter's 13 percent decline. Weekly reporting bank data, which are not adjusted for seasonal variation, suggest that an increase in the volume of both large certificates of deposit (CD's)—those in denominations of $100,000 or more—and other time and saving deposits at the New York City banks partially accounts for this performance. Other time and savings deposits at New York City banks rose $0.4 billion and CD's $0.7 billion over the fourth quarter, while banks outside New York City lost $0.6 billion in other time and savings deposits and $1.6 billion in CD's. This development reversed the trend of heavy time deposit and CD losses at banks in New York City (see Chart II).

This turnaround may be linked to Federal Reserve Board regulatory changes that may have led some foreign official depositors to shift funds from the Euro-dollar market to New York City banks, where the bulk of foreign official time deposits and CD's in this country have traditionally been held. A November amendment to Regulation Q broadened the number of foreign official institutions qualifying for exemption from the interest ceilings. The August amendments to Regulations D and M subjected United States banks' Euro-dollar borrowing over a base amount to a 10 percent reserve requirement. Time deposits and CD's are subjected to a 6 percent reserve requirement, and United States banks may have found it advantageous to borrow additional funds directly from foreign official institutions rather than indirectly through their foreign branches.

Despite this fourth-quarter reversal at New York City banks, the CD runoff has been prolonged and severe. The differential between the maximum interest rates payable on large CD's and yields available on alternative investments began to widen in November 1968. From the end of that month until the end of December 1969, CD's at all weekly reporting banks declined $13.4 billion, reducing the total volume of CD's outstanding to $10.9

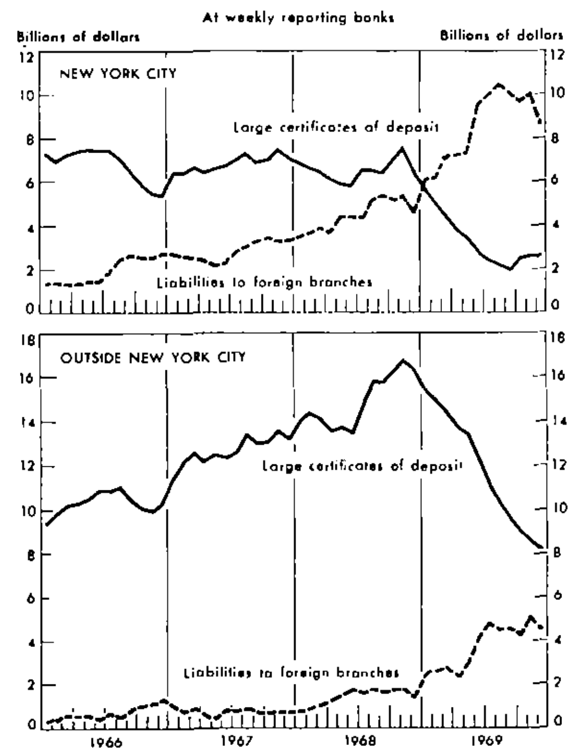
billion—their lowest level since April 1964 when such deposits were being built up. The CD runoff of 1969 was thus much larger than that of 1966, when the fall in CD's during the second half totaled $2.6 billion. During the last half of 1966 the most frequently quoted rate on 30- to 89-day CD's was slightly above the Treasury bill rate on a monthly average basis, and was at most about 40 basis points below the rate on three- to six-month commercial paper. By mid-1969 the spread between CD's and the three-month Treasury bill rate was about 100 basis points, and by the year-end had reached about 250 basis points; the spread between the CD and commercial paper rates was even greater. While disintermediation has been a severe problem during the past year, recently announced changes in Regulation Q may help stem the outflow of time deposits from commercial banks in the future. (For details, see box on page 39.)

In a related action, the Board announced at the same time its proposal to apply a 10 percent reserve requirement on funds obtained by member banks through the issuance of commercial paper or similar obligations by bank holding companies or affiliates. Banks have used the sale of commercial paper by their affiliates to obtain funds from a nondeposit source during a period of deposit contraction. The proceeds of these sales have been channeled back to banks primarily through the purchase of loans from the banks' portfolios by the affiliates. The Board's dual moves on the revision of interest rate ceilings and the proposal regarding funds obtained from the sale of commercial paper were undertaken within the framework of continued monetary restraint. The Board stated that the simultaneous measures were based on considerations which included a rebalancing of the Board's regulatory structure in the light of recently expanded authority in this field, a readjustment of the structure of maximum interest rates payable on commercial bank deposits to bring it more in line with yields on market securities, and a desire to encourage long-term savings in reinforcement of anti-inflationary measures.

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

The volume of bank-related commercial paper has grown substantially in recent months. Over the fourth quarter, such obligations increased by $1.7 billion, bringing the total volume outstanding to $4.2 billion at the year-end. The bulk of the fourth-quarter increase in commercial paper issued by bank affiliates occurred during the first month of the period, with somewhat smaller increases in November and December. The deceleration occurred subsequent to the announcement on October 29 by the Board that it was considering amending Regulation Q to include funds obtained from the sale of commercial paper by a bank's parent company or collateral affiliates, and that similar obligations by bank subsidiaries were already subject to Regulation Q ceilings and Regulation D reserve requirements. The application of this latter ruling was subsequently extended until February 26. The Board has since withheld action in applying interest rate ceilings to commercial paper issued by parent companies or affiliates, while it is considering amending its rules to apply reserve requirements to such obligations.

THRIFT INSTITUTIONS

Deposit growth at thrift institutions continued to be adversely affected during the quarter, as depositors were attracted by the increasingly higher yields available in alternative investments. Following the crediting of third-quarter interest payments, combined deposits at savings and loan associations and mutual savings banks experienced an actual contraction in October, the first monthly decline in this aggregate on a seasonally adjusted basis since July 1966. Over the period as a whole, deposits at both institutions increased at a seasonally adjusted annual rate of just over 1 percent.

In order to mitigate somewhat the potential deposit losses facing savings and loan associations, particularly at the year-end when a heavy volume of savings certificates was scheduled to mature, the Federal Home Loan Bank Board on December 15 authorized the payment of up to 6 percent on "special housing certificates of deposit". The rate applied only to deposits of $10,000 or more which existed as of December 15, 1969, and the new certificates were offered in maturities of from two to five years. An additional move to stem disintermediation was made by the Home Loan Bank Board at the time of the Federal Reserve Board's revision of interest ceilings under Regulation Q. The measure revised upward the maximum rate payable by savings and loan associations throughout the deposit-maturity structure. A similar measure was also carried out by the Federal Deposit Insurance Corporation with regard to mutual savings banks. (For details, see box on page 39.)

Although mortgage lending at thrift institutions slowed in the October-December period, the deceleration was not so severe as recent deposit experience would suggest. Mortgage holdings at savings and loan associations and mutual savings banks grew at a 4.3 percent seasonally adjusted annual rate in the fourth quarter, compared with 5.5 percent in the third. Even with this moderate slowing, it is of note that during 1969 mortgage lending was better maintained than in the 1966 period of monetary stringency. At that time, mortgage lending by mutual savings banks and savings and loan associations slowed to about 2 percent from the end of June to the end of October, when deposit growth was weakest. The major factor contributing to the improved condition in 1969 was an increase in borrowing by savings and loan associations from the Federal Home Loan Banks. In 1969, deposits at the savings and loan associations grew by approximately $4.5 billion—not greatly above the $3.6 billion increase in 1966; but during 1969 Federal Home Loan Bank advances to these associations of about $4 billion almost matched the gain in deposits, whereas in 1966 advances rose by only about $1 billion.