# Liquidity and Credit in the Second Quarter

Fears of a general liquidity crisis rose to a peak late in the second quarter after the Penn Central Company filed a petition for reorganization on Sunday, June 21. These worries were exaggerated, even though nonfinancial corporations, commercial banks, thrift institutions, and other financial organizations had become less liquid through the extended period of rapid economic expansion in the past decade and the restrictive monetary policy of 1969. Evidence of a decline in liquidity included some increase in business failures and collection delays and greater resort by major banks to nondeposit sources of funds. However, specific instances of acute liquidity problems were relatively few and in some cases symptomatic of deeper difficulties that bore little relation to the recent course of business activity or economic policy.

Nevertheless, concern during the second quarter over the possible widening of liquidity problems aggravated the uneasy atmosphere in the money and bond markets, which were already disturbed by continuing inflation, the erratic but generally downward movement of corporate stock prices, and developments in the Middle and Far East. These pressures were most evident in the commercial paper market where participants became apprehensive that some borrowers would be unable to refinance a large volume of existing debt, some of which was of very short maturity. The Federal Reserve System acted to facilitate refinancing of these debts by the banking system, by suspending Regulation Q ceilings on large short-term time deposits, and by using the discount window and open market operations to guard against liquidity pressures. These actions had a salutary effect on most financial markets, tensions subsided, and rates of interest were declining as the quarter drew to a close.[1]

[1] See "The Money and Bond Markets in July", this *Review*, pages 187-91.

## THE CREDIT MARKETS AND INTEREST RATES

Market rates of interest rose during much of the second quarter, as borrowers sought to refinance a large volume of existing short-term debt and to raise longer term funds. Not all the pressures were evident in rate movements, however, since investors also became more selective in their purchases of assets. The impact of monetary restraint had sharply curtailed the role of financial institutions as credit intermediaries, and direct lending in the nonfinancial sector had jumped from an average of 22 percent of total nonfinancial credit extended in 1968 to almost 50 percent in 1969 and the first quarter of 1970. This increase in direct lending meant that the public's holdings of corporate liabilities rose relative to their holdings of bank deposits. Lenders became less willing to part with liquidity, and market rates of interest climbed with only temporary interruptions as demand for funds remained strong.

These developments became particularly evident in the commercial paper market during June. The persistence of record-high interest rates throughout 1969 had prompted many corporations to postpone raising long-term funds through the sale of securities. As a result, a growing number of borrowers had turned to the issuance of shorter term obligations such as commercial paper (see Chart I). Commencing in October 1968, the volume of commercial paper outstanding rose uninterruptedly for nineteen months and large gains were posted in both dealer and directly placed commercial paper. Commercial paper in effect consists of short-term promissory notes that businesses sell at a discount to dealers or place directly with investors to raise cash. These notes are usually unsecured; however, issuers often obtain lines of credit at banks in order to assure purchasers that no matter what happens they will have access to funds to redeem the commercial paper sold by them.

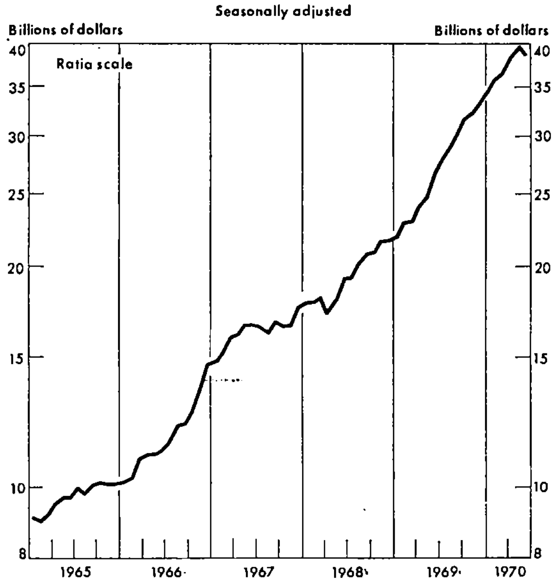
Typically, only large businesses with high credit ratings are able to acquire funds through such promissory notes. Directly placed commercial paper, which accounts for over 60 percent of the volume outstanding, is issued mainly by very large sales and personal finance companies and, more recently, by bank holding companies. Smaller financial intermediaries and nonfinancial businesses usually place their obligations through dealers who then sell the notes to corporations, banks, and others. The commercial paper market is often subject to heavy seasonal pressures around corporate tax dates, when both borrowers' and lenders' demands for cash increase. In addition, at quarterly statement dates, many corporations prefer to hold a relatively larger share of their liquid assets in Treasury bills and bank deposits, and thus a large volume of commercial paper generally matures shortly before the end of each quarter. Although the seasonally adjusted volume of commercial paper outstanding rose substantially in April and May of this year, pressures on the commercial paper market intensified as the June tax date approached and a heavy volume of paper was maturing, in accordance with the usual seasonal pattern.

These pressures were heightened shortly after the Penn Central Company, which had large commitments in the commercial paper market, filed a petition on June 21 for reorganization of its major operating subsidiary under the Federal Bankruptcy Act. Holders of obligations issued by other large corporations became somewhat apprehensive about the low level of corporate liquidity as well as about the ability of borrowers to refinance existing debt, given the tight banking position. The difficulties encountered by a number of brokerage firms, including some of the oldest and largest houses, and the fact that stock prices continued to fluctuate erratically added to the widespread uneasiness. The Federal Reserve, however, acted promptly to reassure the market that the strong demands for short-term funds would be met through the credit markets and the banking system. On June 23, the Board of Governors of the Federal Reserve System voted to suspend Regulation Q interest rate ceilings on 30- to 89-day large certificates of deposit (CD's), effective the following day. This action, which enhanced the ability of the banking system to attract funds, led to substantial improvement in the financial markets. The Board stressed that its action would not lead to an increase in total credit, but would constitute a transfer of borrowings from other financing avenues into the banking system. Shortly after the suspension became effective, purchases of large CD's from commercial banks expanded dramatically, rising by $1.1 billion at weekly reporting banks in the week ended on July 1. When the volume of commercial paper, not adjusted for seasonal variation, declined by more than $2 billion in the last week of June, weekly reporting bank lending to sales and personal finance companies and businesses increased by almost the same amount.

Chart I

COMMERCIAL PAPER OUTSTANDING*

Seasonally adjusted




*Includes bank-related commercial paper.

Other short-term financial markets generally functioned smoothly throughout the second quarter. Treasury bill rates rose somewhat in April and May but declined steadily in June, as demand from commercial banks and other investors pressed against a limited supply of issues. The Federal funds rate rose somewhat in April but then declined in late May and on balance fell in June. Over the quarter, the effective rate on Federal funds declined from an average of 8.10 in April to 7.60 percent in June.

Long-term interest rates remained under intensive upward pressures through much of the second quarter. Rate increases were particularly strong during May, when the Treasury conducted an exchange and new cash financing and when the American Telephone and Telegraph Company raised $1.6 billion through the sale of debentures with warrants to purchase the firm's common stock. In addition, concern about developments in the Middle and Far East and their implications for domestic and international affairs exacerbated the deteriorating atmosphere in the securities markets. The persistent downward trend in corporate stock prices heightened the tense atmosphere in other markets. Following a series of record one-day drops, prices of longer term Government securities improved near the end of May, fluctuated narrowly until mid-June, and were rising stongly as the quarter drew to a close.

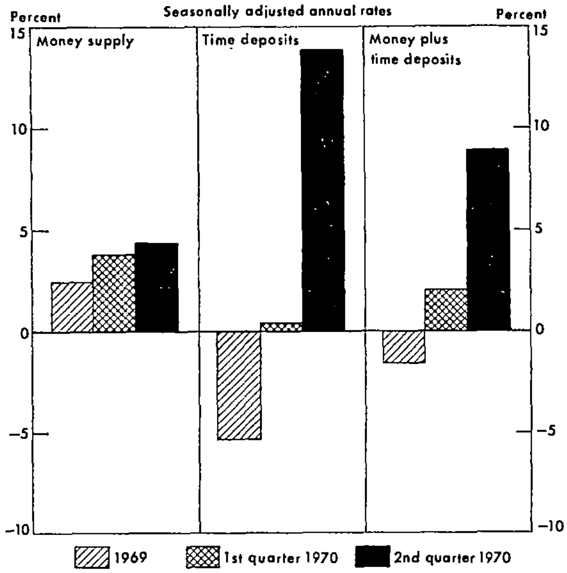
Prices of longer term corporate and municipal securities, however, did not experience major improvement until mid-June, when pressures on those markets subsided. Corporations, confronted with diminishing profit flows and a reduced availability of credit from financial intermediaries and the nonbank public, had steadily reduced their holdings of liquid assets as the gap between fixed investment spending and internally generated cash flows widened. The ratio of corporate liquid asset holdings of cash, bank deposits, and short-term United States Government securities to current liabilities reached an all-time low of 18 percent at the end of the first quarter of 1970. The low ratio of corporate holdings of liquid assets to liabilities did not necessarily indicate a serious liquidity problem, for this ratio had been declining steadily over the past twenty years. Given the tightness in the short-term credit markets and the banking system, it did suggest that demands for long-term funds would remain strong. However, the sluggish pace of economic activity and concern about the low level of corporate liquidity led business to cut back planned spending on plant and equipment. In addition, state and local governments limited their expenditures a bit. Around mid-June, the calendar of forthcoming publicly offered long-term financing began to taper off and this, combined with the successful flotation of a heavy volume of new issues, lessened the pressures on the corporate and municipal bond markets.

The upward movement in market interest rates during most of the second quarter did not lead to the heavy time deposit outflows and disintermediation of the banking system that it had during 1969 and early 1970, when the savings flows of the public had steadily shifted out of deposits as market rates rose and Regulation Q ceilings remained unchanged. An upward revision of interest rate ceilings in January and the partial suspension of Regulation Q ceilings in June helped reverse this trend.

Chart II

CHANGES IN MONEY SUPPLY AND TIME DEPOSITS AT ALL COMMERCIAL BANKS

Seasonally adjusted annual rates




Source: Board of Governors of the Federal Reserve System.

## MONEY SUPPLY AND TIME DEPOSITS

The daily average money supply, the most liquid of financial assets held by the public, expanded moderately during the second quarter. After increasing at a 3.8 percent seasonally adjusted annual rate in the first quarter, the public's holdings of demand deposits and currency grew at a 4.2 percent rate in the April-June period (see Chart II). The gain in the second quarter brought the rate of money supply expansion to exactly 4 percent in the first half of 1970. The modest growth of the money supply was accompanied by a substantially more rapid increase in the public's holdings of other depository assets. Thus, total time and savings deposits expanded at a seasonally adjusted annual rate of almost 14 percent in the second quarter, bringing growth for the first half of the year to just over 7 percent. This behavior represented a marked reversal from the 5.3 percent time deposit decline in 1969, when heavy deposit outflows persisted while banks were constrained to pay rates below those available on alternative investments. The gain in time deposits in the second quarter as a whole was distributed equally between large CD's and other time and savings deposits. Weekly reporting bank data, which are not adjusted for seasonal variation, show a strong increase in large CD's in April, followed by a tapering-off in May and a decline in June as market rates of interest rose. However, bank data will not reflect the effect of the suspension of Regulation Q ceilings on 30- to 89-day deposits until July. Monthly bank data for weekly reporting banks are as of the last Wednesday of each month and the suspension became effective on June 24, the last Wednesday in June.

Data on other time deposits—time and savings deposits less large CD's—show that weekly reporting banks steadily attracted passbook and time accounts, and this appears to reflect liquidity rebuilding in the household sector. Although the data are not adjusted for seasonal variation, the $1.2 billion gain in other time and savings deposits between the end of March and the end of June indicates substantial strength when compared with the $814 million decline and $148 million increase recorded during like periods in 1969 and 1968, respectively. These deposits had picked up, along with flows to thrift institutions, following the revision of Regulation Q ceilings in late January. An increase from $1,000 to $10,000 in the minimum denomination of newly issued Treasury bills, which became effective at the beginning of March, also helped stem disintermediation by the small saver.

As a result of the increased flow of deposits to banks, the broad money supply—demand deposits and currency plus time deposits, which serves as a measure of the nonbank public's highly liquid asset holdings—grew at a 9 percent annual rate of increase in the second quarter, a substantial advance over the approximately 2 percent gain registered in the first quarter.

## THRIFT INSTITUTIONS

Interest rate ceilings at thrift institutions had also been raised at the end of January, and deposit flows to mutual savings banks and savings and loan associations began to increase shortly thereafter. Deposit growth at thrift institutions accelerated further in the second quarter, and combined holdings expanded at an almost 7 percent seasonally adjusted annual rate, the largest quarterly gain since the third quarter of 1967 (see Chart III). Consumers also improved their liquidity position by borrowing relatively less, and the ratio of instalment debt to disposable income declined in April and May.

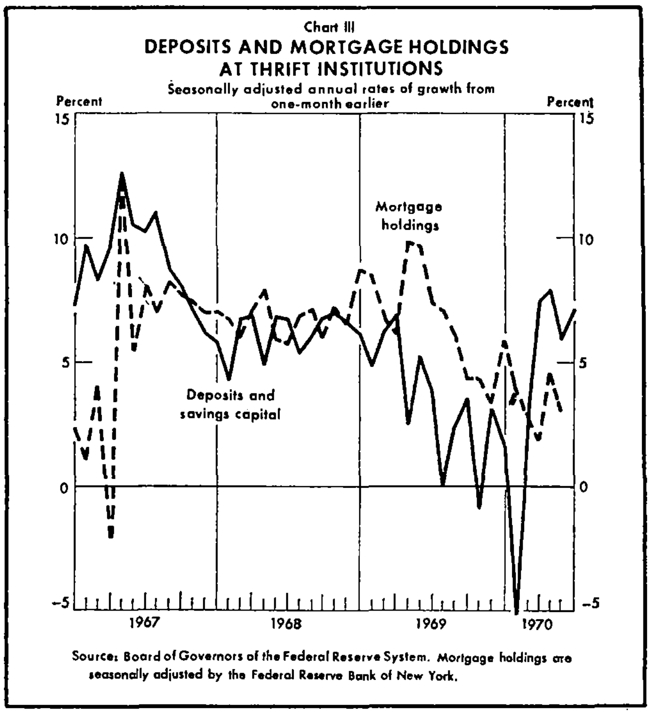



Chart III
DEPOSITS AND MORTGAGE HOLDINGS AT THRIFT INSTITUTIONS
Seasonally adjusted annual rates of growth from one-month earlier

Source: Board of Governors of the Federal Reserve System. Mortgage holdings are seasonally adjusted by the Federal Reserve Bank of New York.

These developments were associated with only moderate increases in mortgage lending. Deposit growth outpaced mortgage extensions over most of the March-June period as the thrift institutions rebuilt liquidity as well. In the second quarter, savings and loan associations were able to increase their cash holdings for the first time since the fourth quarter of 1968. Similarly, mutual savings banks used some of their increased deposit flows to diversify investments and build reserves. Although member associations increased their borrowing from the Federal Home Loan Banks in the first half of 1970, they did so at a slower pace than in 1969.

## BANK CREDIT

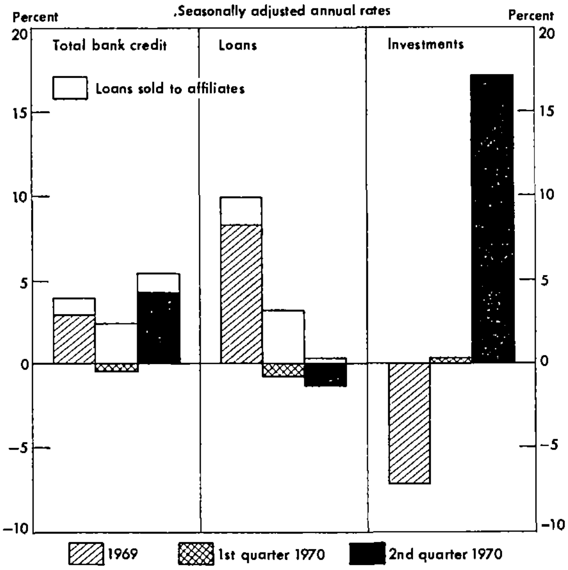
The growth of all commercial bank credit accelerated slightly in the second quarter and was accompanied by an improvement in bank liquidity. This development contrasted strongly with bank credit behavior in 1969 and early 1970. In that period, which was characterized by persistent deposit losses, the continued liquidation of investment holdings accompanied by the expansion of loan portfolios had led to a decline in bank liquidity, as measured by traditional standards. However, it is difficult to obtain an accurate gauge of bank liquidity since the increased use of nondeposit sources of funds mitigated any deterioration of liquidity by providing funds during a period of deposit outflows.

The decline in bank liquidity was nonetheless a problem for commercial banks. During most of 1969 and early 1970, banks had steadily liquidated their investment holdings in order to obtain loanable funds (see Chart IV). From the end of December 1969 to February 1970, bank investment in Government securities fell at a 24.3 percent annual rate, while holdings of other securities, principally state and local government obligations, remained virtually unchanged. By February 1970 the ratio of loans, other than overnight loans, to deposits plus Euro-dollar liabilities reached 78.0 percent at all weekly reporting banks, the highest level on record. A shift from Government securities into loans, such as had occurred during 1969 and early 1970, often implies a general decline in bank liquidity, since bank loans cannot be liquidated as easily as Government securities. However, ratios of

Chart IV

CHANGES IN BANK CREDIT AND ITS COMPONENTS AT ALL COMMERCIAL BANKS

Seasonally adjusted annual rates




Source: Board of Governors of the Federal Reserve System.

loans to deposits are not a fully accurate measure of bank liquidity positions, as they consider neither the quality of loan portfolios nor the cash flow arising from loan repayments. The ratio of short- and intermediate-term United States Government securities to deposits plus Euro-dollar liabilities at weekly reporting banks declined rather steadily from about 12 percent in October 1968 to 9 percent in February 1970. A decline in this measure of bank liquidity indicates that banks have relatively fewer readily marketable earnings assets. This measure has its own drawbacks, however, in that it does not include holdings of liquid investments, such as short-term securities, which increased in this period. While both measures overstate an erosion of bank liquidity, banks did have an interest in rebuilding their holdings of highly marketable assets.

The second quarter of 1970 saw a reversal of recent trends in the composition of total bank credit, as investment holdings rose markedly while total bank lending slackened. The growth of total loans, including loans sold to bank affiliates, slowed to a 0.3 percent seasonally adjusted annual rate of increase from a 3.3 percent rate of growth in the first quarter. Bank holdings of investments, on the other hand, grew at a rapid 17.2 percent annual rate, up from less than 0.5 percent growth in the first quarter. The second-quarter increase in bank investment portfolios was the strongest quarterly gain since the third quarter of 1968. Holdings of United States Government securities expanded at a 25.4 percent rate, while holdings of other securities, primarily obligations of state and local governments, grew at an 11.5 percent rate. Bank holdings of Governments, principally short-term Treasury bills, had fallen quite rapidly, while investments in other securities had risen slightly during the period of securities liquidation.

Most major categories of bank loans expanded at modest rates during the three-month period ended in June. The nonbank financial institutions, however, relied on the banking system to a somewhat greater extent. Loans to nonbank financial institutions rose substantially in May and June, and grew at a 19.2 percent seasonally adjusted annual rate for the quarter as a whole, following a 35 percent decline one-quarter earlier. The rate on prime commercial paper of four- to six-month maturity was well above the bank prime lending rate in May and June, and these institutions may have transferred some of their borrowing to banks from the commercial paper market. Business lending quickened slightly in the second quarter, and commercial and industrial loans, including business loans sold to affiliates, expanded at a 6.2 percent rate as opposed to 5.2 percent in the first quarter. The strongest advance, 12 percent, was recorded in May and in part reflected anticipatory borrowing by business in preparation for payment of corporate taxes in mid-June. The other major categories of bank loans grew at slower rates in the second quarter, compared with the first three months of the year. Consumer loans were unchanged in each month, and real estate lending grew at only 1.1 percent annual rate, down from 5.1 percent in the first quarter. These developments, in combination with the renewed inflow of deposits, led to an improvement in bank liquidity during the second quarter.