Banking and Monetary Developments in the Fourth Quarter of 1970

The rechanneling of credit flows through the banking system that had begun at midyear continued to be a dominant feature of banking developments in the fourth quarter of 1970. While inflows of funds through time deposits were substantial, loan demand was weak, prompting a succession of three ¼ percentage point reductions in the prime lending rate. The weakness of business loans in particular may have been intensified by the ten-week strike at the General Motors Corporation. This same factor also contributed to a reduction in the public's demand for cash balances, which in turn resulted in a slowing in the rate of growth of the money supply. Reflecting the ample availability but slackened demand for funds, short-term interest rates declined sharply over the quarter.

As a result of the sharp run-up in time deposits and the slack loan demand, commercial banks added to their securities holdings at a rapid pace. Consequently, the liquidity position of the banking system improved further, as the loan-deposit ratio declined and the liquid asset ratio increased. In a related development, the banks continued to reduce their dependence on nondeposit sources of funds by further decreasing their borrowings in the Euro-dollar and commercial paper markets.

SOURCES OF FUNDS TO THE BANKING SYSTEM

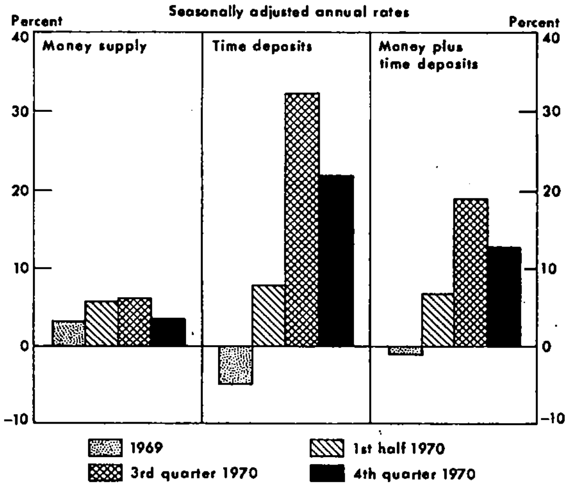
During the fourth quarter of 1970, the rate of growth of the money supply—privately held demand deposits and currency—was a modest 3.4 percent (see Chart I) as the slackness in the economy, reinforced by the effects of the strike against General Motors, restrained the transactions demand for money. Money supply expansion was particularly slow in October and November, when the seasonally adjusted annual rates of gain were 1.1 percent and 2.8 percent, respectively. Growth of the money stock rebounded in December to a rate of 6.2 percent. However, for the quarter as a whole, the rate of expansion of this monetary aggregate was appreciably below the 6 percent rate of growth achieved over the first nine months of 1970. The relatively slower growth of the money supply in the fourth quarter reflected the sluggish performance of the demand deposit component, which grew at only a 2.7 percent annual rate in the final three months of the year, while currency outside banks increased at a 5.8 percent annual rate.

In contrast to demand deposits, total time and savings deposits at all commercial banks advanced at a very rapid 21.8 percent seasonally adjusted annual rate during the fourth quarter. This brought the growth rate of total commercial bank time deposits to almost 28 percent over the second half of the year. By way of contrast, during the last six months of 1969, time deposits contracted at a 6.6 percent rate. Weekly reporting bank data, which are not adjusted for seasonal variation, indicate that time and savings deposits other than large negotiable certificates of deposit (CD's) rose by about $1.7 billion in the October-December period. The major gains were in large CD's, which rose $3.8 billion in the fourth quarter to $26.1 billion, or $1.8 billion above the late-1968 peak (see Chart II). From late June, when Regulation Q interest rate ceilings on time deposits of $100,000 or more

Chart I

CHANGES IN MONEY SUPPLY AND TIME DEPOSITS AT ALL COMMERCIAL BANKS

Seasonally adjusted annual rates

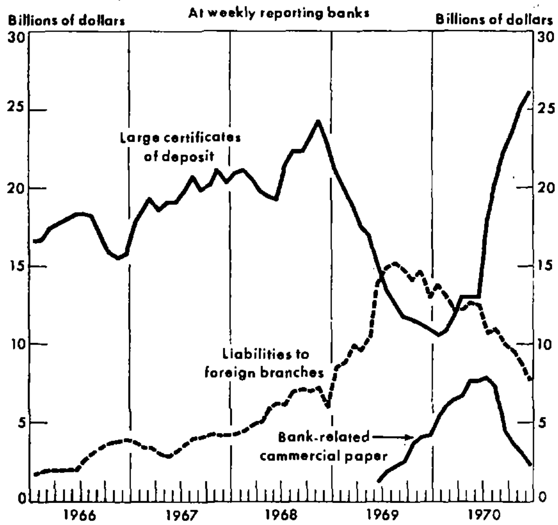


Source: Board of Governors of the Federal Reserve System.

Chart II

LARGE CERTIFICATES OF DEPOSIT, LIABILITIES TO FOREIGN BRANCHES, AND BANK-RELATED COMMERCIAL PAPER*

At weekly reporting banks



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

maturing in 30 to 89 days were suspended, to December 30, CD's outstanding climbed by an enormous $13.1 billion.

The strong growth of CD's during the fourth quarter reflected their enhanced attractiveness to investors, as rates of interest on competing investments declined dramatically. For example, the yield on three-month Treasury bills declined by 130 basis points over the fourth quarter to 5 percent at the end of the year. The rate on dealer-placed prime four- to six-month commercial paper fell even more sharply—by 138 basis points to 5.75 percent. As CD funds poured into the banks, offering rates for CD's were also lowered substantially. By the end of the year, such rates were well below the Regulation Q ceilings for all maturities, including those on short-term deposits that were suspended last June. Thus, the former Regulation Q ceiling on large CD's maturing in 30 to 59 days was 6¼ percent. In early July, after the suspension of the ceiling, offering rates on this maturity of CD's ranged from 7½ to 8 percent. By the end of December, however, the offering rate was down to a range of 5⅛ to 5½ percent.

With the surge in time deposits, the so-called "broad money supply"—private demand deposits and currency plus commercial bank time deposits—expanded at a seasonally adjusted annual rate of 12.7 percent over the October-December quarter. This marked the second consecutive quarter of large divergence in the growth of the narrow and broad money supply measures, for in the third quarter of 1970 the former rose at a 6.1 percent annual rate while the latter increased at a rate of almost 19 percent (see Chart I). For the year as a whole, the broad money supply grew by 11.8 percent, more than double the 5.4 percent growth of the narrowly defined money stock.

Given the heavy inflows of time deposits, commercial banks continued to shift away from nondeposit sources of funds in the fourth quarter. The amount of bank-related commercial paper outstanding, which dropped by about $3 billion in the last seven weeks of the third quarter, fell another $2.2 billion over the final three months of the year. Thus, at the end of December, bank-related commercial paper outstanding totaled $2.3 billion, far below the peak of $7.8 billion recorded in July 1970. In part, the runoff in bank-related paper was induced by the imposition of reserve requirements on funds acquired by banks from the sale of such paper.[1] Loans sold outright to affiliates of large commercial banks declined concurrently with the drop in bank-related commercial paper, falling from a level of approximately $8 billion in July to $2.7 billion at the end of the year.

United States banks considerably reduced their liabilities to foreign branches in the fourth quarter as well. Such liabilities stood just under $10 billion at the end of September, and three months later they amounted to only $7.7 billion, or just one half of their October 1969 high. In an attempt to stem the decline in Euro-dollar borrowings, the Board of Governors of the Federal Reserve System initiated a series of regulatory changes which took effect in the four-week reserve computation period ended December 23, 1970.[2] However, because Euro-dollar rates were substantially higher than rates in the domestic CD market, the relative cost of Euro-dollar borrowings to the banks was high. Thus, banks reduced their liabilities to foreign branches by an additional $1 billion in December, although some of this decline may have been due to special year-end factors. For all of 1970, liabilities to foreign branches dropped by $5.3 billion.

The adjusted bank credit proxy—a measure of bank liabilities which includes deposits subject to reserve re-

[1] See this *Review* (September 1970), page 213.

[2] For a more complete discussion of the measures instituted by the Federal Reserve Board, see this *Review* (December 1970), page 278.

quirements plus Euro-dollar and commercial paper liabilities—expanded at a seasonally adjusted annual rate of 8.3 percent in the fourth quarter, equal to its performance for the year as a whole. Growth of the proxy proceeded very slowly in October but accelerated as the quarter progressed. The buildup in time deposits accounted for much of the increase in the proxy over the quarter.

BANK CREDIT AND LIQUIDITY

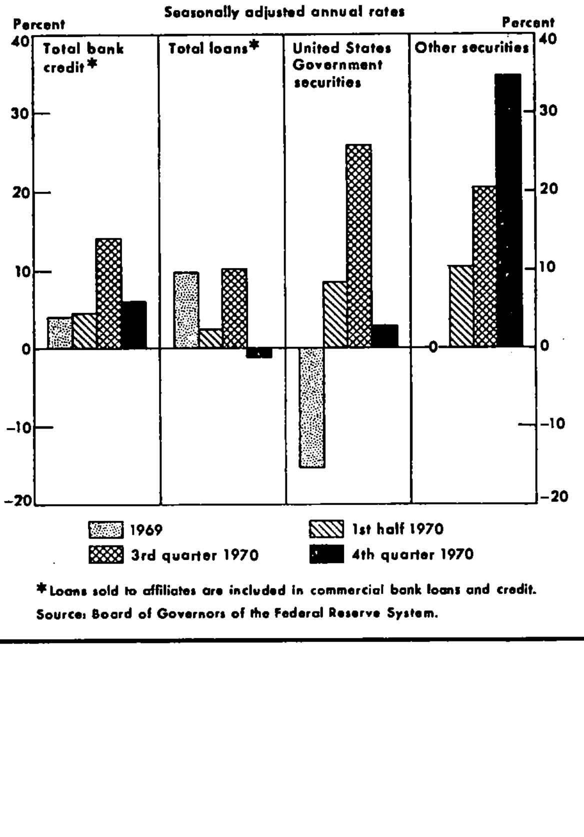
During the fourth quarter, total bank credit, excluding loans repurchased from affiliates, rose at a seasonally adjusted annual rate of 6 percent (see Chart III). This contrasts with a very sharp 14 percent rate of growth during the third quarter, when bank credit was swollen by bank lending to borrowers who were unable to roll over maturing commercial paper. Thus, while the rise in bank credit moderated from the unusually rapid pace of the third quarter, the October-December increase brought the yearly advance in bank credit to 7.4 percent, almost double the rise recorded in 1969.

A change in the composition of total bank credit which was evident in earlier months became more pronounced in the fourth quarter of 1970, as investment holdings rose markedly while bank lending contracted. Total bank loans

Chart III

CHANGES IN BANK CREDIT AND ITS COMPONENTS AT ALL COMMERCIAL BANKS

Seasonally adjusted annual rates



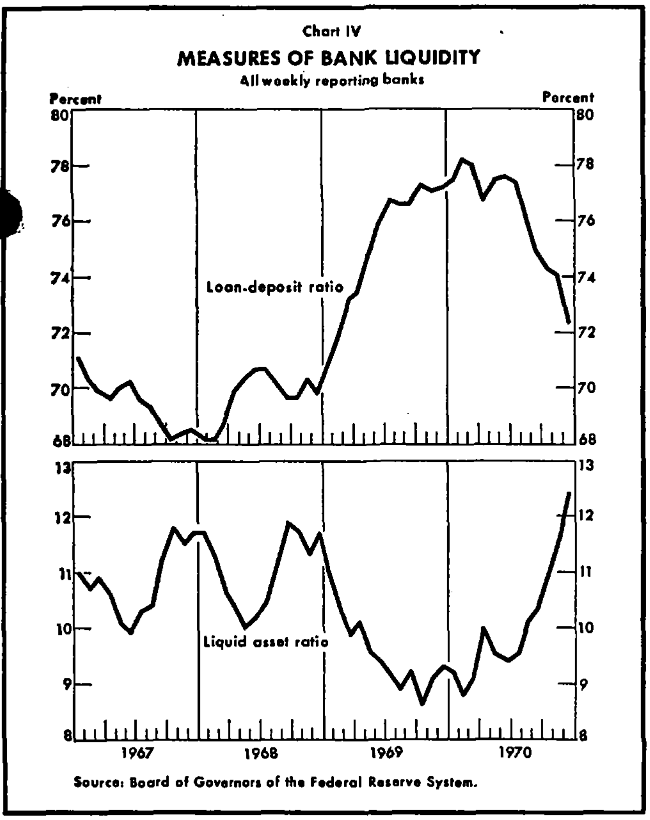
*Loans sold to affiliates are included in commercial bank loans and credit.
Source: Board of Governors of the Federal Reserve System.

declined at approximately a 1 percent seasonally adjusted annual rate during the October-December quarter, after expanding at almost a 5 percent annual rate over the first nine months of the year. Consequently, total loans increased by 3.4 percent for all of 1970. Commercial bank holdings of securities, on the other hand, grew at a rapid seasonally adjusted annual rate in excess of 20 percent in the fourth quarter and by 16.6 percent for the entire year. This is in sharp contrast to the 1969 experience, when securities holdings dropped by 7.2 percent as commercial banks liquidated their investments in order to obtain loanable funds.

In the fourth quarter of 1970, the buildup in bank investment holdings was concentrated in securities other than those issued by the United States Government. This category, consisting principally of obligations of state and local governments, climbed at a 34.5 percent annual rate in the October-December period, compared with the 2.8 percent rate at which banks increased their holdings of United States Government securities during the quarter. While the divergence in growth of the components of bank securities holdings was not so large for all of 1970, it was nevertheless substantial, since banks added Governments to their portfolios at a rate of almost 12 percent and increased their holdings of other securities by 20.1 percent over the entire year.

Large gains in time deposits together with slack loan demand—and particularly a weakness in business loans—contributed to the buildup in investment holdings in the fourth quarter. For the quarter as a whole, business loans outstanding at weekly reporting banks fell by $1.3 billion on a nonseasonally adjusted basis, whereas during comparable periods in 1968 and 1969 these loans increased by $3.8 billion and $3.5 billion, respectively. Reflecting this contraseasonal contraction, business loans at all commercial banks declined at a seasonally adjusted annual rate of 9.5 percent during the final quarter of 1970. This occurred despite two ¼ percentage point reductions in the prime lending rate in November and a third ¼ percentage point reduction in late December, which brought the prime rate to 6¾ percent at the year-end. This was down from 8½ percent a year earlier. Despite this sizable cut, business loans increased by only 2.0 percent in 1970 as compared with the 13.2 percent expansion in these loans in 1969.

Many factors, including the ten-week automobile strike and a sluggish level of economic activity, contributed to the weak performance of business loans. Beyond these considerations, however, the fourth-quarter contraction in these loans was partially attributable to the fact that corporations used some of the proceeds of bond flotations to retire existing short-term debt. In the fourth quarter,



corporate borrowing in the capital market was extremely heavy. Public offerings of corporate bonds alone totaled $7.5 billion, bringing to $25 billion the total of such sales for the year. This was about $12 billion higher than the level of corporate bond flotations in 1969 and about $10 billion greater than the total in 1967, the previous record year.

Among other loan categories, the growth of real estate loans accelerated moderately from the slow pace of the first nine months of the year. Consumer loans were about unchanged on a seasonally adjusted basis in the fourth quarter, following moderate growth in earlier months of the year. Loans to nonbank financial institutions continued to increase at about the same moderate rate as during the previous nine months. The only loan category to put on a strong performance during the final three months of the year was securities loans, which rose sharply along with dealer inventories.

With loan demand weak and time deposit inflows strong, bank liquidity continued to improve in the fourth quarter (see Chart IV). The expanded loan-deposit ratio—the ratio of loans (other than loans to brokers and dealers) to deposits (less cash items in the process of collection) plus liabilities to foreign branches—decreased by about 2.7 percentage points at weekly reporting large commercial banks, reaching 72.2 percent in December. This was the lowest the ratio has been at these banks since February 1969 and, moreover, represented a significant decline from the 1970 high of 78.2 percent registered in February. Inspection of an alternative measure of commercial bank liquidity, the liquid asset ratio,[8] indicates similar marked improvement. At all weekly reporting banks, the liquid asset ratio climbed from 10.3 percent in September to an unusually high level of 12.5 percent in December.

THRIFT INSTITUTIONS

During the final three months of 1970, deposit inflows at the nation's mutual savings banks and savings and loan associations continued to strengthen, thereby extending the strong upward thrust in deposit activity that had begun in the second quarter. Total thrift institution deposits are estimated to have increased at about an 11 percent seasonally adjusted annual rate in the fourth quarter, up somewhat from the 9.5 percent rate of growth registered in the third quarter. This strong performance of deposit flows is attributable, in part, to the very high level of personal savings during recent quarters. Beyond this, however, the competitive position of these institutions improved steadily during the second half of the year, as market interest rates on instruments which compete with the thrift institutions for funds moved progressively lower.

In the fourth quarter, savings and loan associations continued to experience somewhat stronger deposit inflows than did mutual savings banks, and the growth of their mortgage holdings remained more rapid as well. Over the October-December period, deposits and mortgages at savings and loan associations both expanded at an annual rate of about 12 percent, whereas deposits at mutual savings banks rose at a rate of about 9 percent and mortgages at a 3 percent annual rate, according to preliminary estimates.

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[8] The liquid asset ratio is defined as loans to brokers and dealers, loans to domestic commercial banks, Government securities due within one year, balances with domestic commercial banks, bankers' acceptances, municipal tax warrants, and short-term notes as a percentage of total liabilities excluding capital accounts.