Recent Banking and Monetary Developments

Federal Reserve policy actions taken in late November in defense of the nation's balance of payments had a significant impact on United States short-term interest rates in the fourth quarter of 1964, but did not, on present evidence, lead to any appreciable curtailment in the flow of funds through the banking system and the long-term credit markets. With banks amply supplied with reserves, bank credit and deposits continued to expand substantially, both before and after the policy change. Although there were reports of a slight firming in some bank lending terms, the prime rate remained unchanged after an abortive attempt by a few banks late in November to initiate an increase, and indications are that borrowers still found banks ready to accommodate their loan demands. The continued growth of the banks' over-all loan portfolios led to a further rise during the quarter in the loan-deposit ratio for commercial banks as a group.

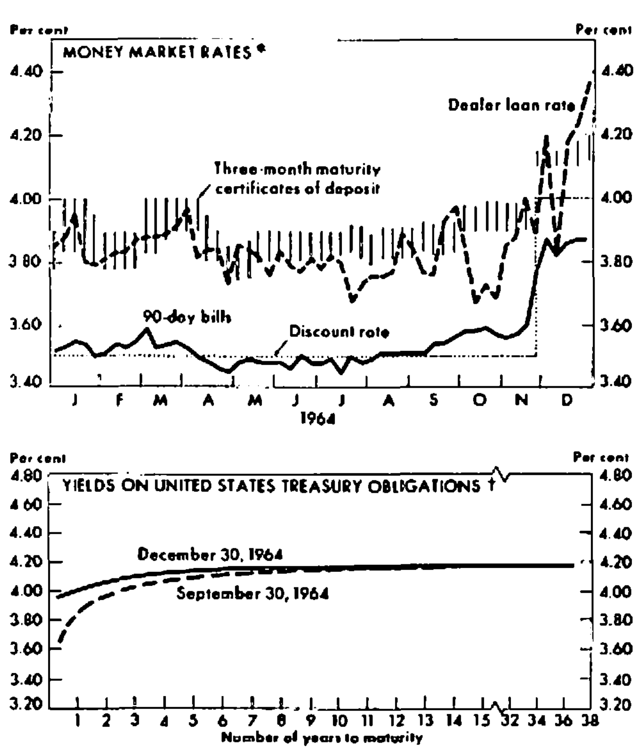
SELECTED INTEREST RATE CHANGES IN THE FOURTH QUARTER

The raising of the Federal Reserve's discount rate from 3½ per cent to 4 per cent in late November, as was indicated at the time, was largely a precautionary move following the rise in the British bank rate from 5 per cent to 7 per cent. It was aimed at offsetting a part of the increased differential between United States and foreign short-term interest rates as well as at discouraging potential speculation against the dollar. There was a marked response of United States short-term rates to the policy change. For example, after having fluctuated in a narrow range above the 3.55 per cent level from late September through most of November, the average issuing rate on three-month Treasury bills rose by about 25 basis points in the period immediately following the discount rate change (see Chart I on next page). Similarly, rates charged by major banks on new loans to Government securities dealers worked higher over the final six weeks of 1964, closing the year in a 4⅛ to 4⅜ per cent range, compared with an average of around 3.80 per cent in most earlier weeks of the year. Secondary market rates on negotiable time certificates of deposit also adjusted upward following the discount rate change.

Long-term interest rates remained generally stable throughout the fourth quarter, as they did earlier in the year. Yields on five-year United States Government marketable securities moved up only about 4 basis points over the quarter and those on ten-year maturities were up only about 2 basis points. Yields on corporate bonds and on secondary mortgages were also stable over the period, while yields on municipal bonds declined to their lowest levels of the year. This stability in long-term rates, combined with the increase in rates in the shorter term market, brought about a general flattening in the yield-maturity curve for Government securities during the quarter. As

Chart I

SELECTED INTEREST RATES



* Certificates of deposit — range of Wednesday offering rates in secondary market.
90-day bills — average issuing rate.
Dealer loan rate — weekly average of daily midpoint of rates quoted on new dealer loans.

† Yield versus maturity curves were developed at this Bank by drawing smooth lines through the scatter of actual market yields on United States Government obligations on the dates shown.

shown in Chart I, the very short-term end of the curve for December 30, 1964 was up about 30 basis points from that for September 30; yet, the long-term end was virtually the same in both curves.

BANK CREDIT, MONEY SUPPLY, AND TIME DEPOSITS

Total loans and investments at all commercial banks rose by $4.3 billion (seasonally adjusted) in the fourth quarter of 1964, and there was no clearly discernible slackening in the pace of the advance following the shift in Federal Reserve policy. The fourth-quarter advance brought the increase in bank credit for the year as a whole to 7.9 per cent, essentially unchanged from the 8.0 per cent rise in 1963.

The general pattern of changes in individual components of total bank credit was roughly the same as in earlier months of the past year. Business loans, in particular, continued their relatively fast growth (10.8 per cent during the year as a whole). Holdings of securities other than Governments advanced in the fourth quarter at the relatively modest pace of earlier months of 1964, following a more rapid rate of increase during the preceding year. Bank holdings of Government securities, on the other hand, turned down again in the fourth quarter following a third-quarter pickup, though the net decline in such holdings for all of 1964 was smaller than in 1963.

The strength shown by bank credit in the fourth quarter was also reflected in the money supply and in commercial bank time deposits. To be sure, the $1.4 billion rise in the seasonally adjusted daily average money supply from September to December was less than the rather unusual bulge in the preceding three months. Variations in the rate of change in this series over such short time spans are not unusual, however, and have to be evaluated cautiously in light of the many other factors involved. In 1964 as a whole, the increase in the money supply amounted to 4 per cent, virtually the same as in 1963.

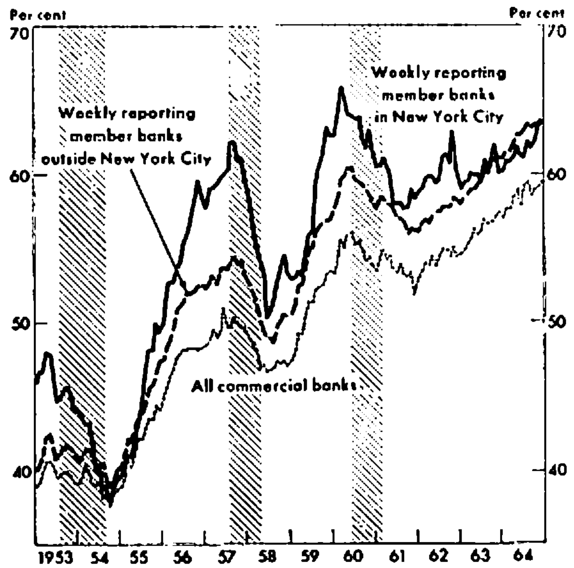
Commercial bank time deposits, on the other hand, showed a smaller rate of gain in 1964 as a whole than in 1963, despite some acceleration in the fourth quarter. To add to their loan potential, a few banks began late in the third quarter to attract funds through the issuance of new short-term unsecured negotiable notes. The amount of such notes outstanding was estimated to be in a range above $100 million by the time of the November change in Regulation Q. Following the increase in time deposit rate ceilings, the outstanding volume of these instruments appears to have declined somewhat as banks began to raise their offering rates on time certificates of deposit. It is still too early to judge fully the effects of these higher rates on time deposits, but time deposit growth did accelerate toward the end of December and through January.

BANK LIQUIDITY

The relatively rapid growth of bank loans over the last two years has resulted in a gradual but widespread reduction in bank liquidity positions. All indicators of bank liquidity are, of course, somewhat arbitrary and difficult to interpret. The implications for the banks' liquidity of the widely used loan-deposit ratios, for example, may change with a different "mix" of demand and time deposits. Over the last few years, the relative proportion of time deposits—which are on average less subject to unexpected withdrawals than demand deposits—has increased for the banking system as a whole and for most individual banks. High loan-deposit ratios therefore may not be so much of a restraint

Chart II

BANK LOAN-DEPOSIT RATIOS *



Note: Shaded areas represent recession periods, according to National Bureau of Economic Research chronology.
* Ratios computed by this Bank (see footnote 1).
Source: Board of Governors of the Federal Reserve System.

on further loan expansion as they previously were. Nevertheless, it appears fairly certain from most reasonable indicators that bank liquidity has been reduced somewhat over the last year or two.

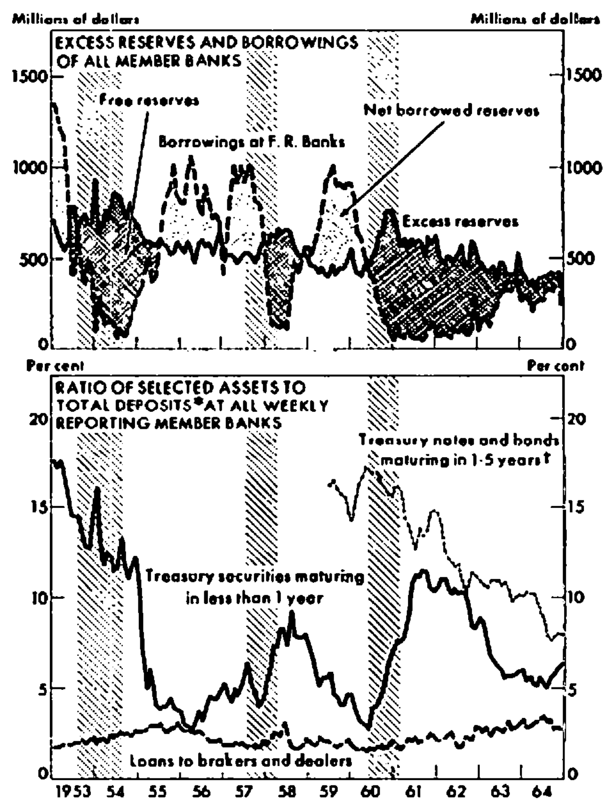
The loan-deposit ratio was up to 59.5 per cent at the end of 1964 for all commercial banks as a group, compared with 58.5 per cent at the end of the third quarter and 57.3 per cent at the close of 1963.[1] At weekly reporting member banks, both in and outside New York City—a group of banks which includes the larger and more aggressive lenders in the major cities across the country—the loan-deposit ratios reached 64 per cent in December (see Chart II). This was a four-year high for the New York City banks and a postwar record for banks outside the money center.

When measured in relation to deposits, there has also been a downward movement in a number of asset categories that are generally considered to be part of bank liquidity positions. Excess reserves—deposits at Federal Reserve Banks, plus vault cash, in excess of the legal reserve requirements—are the most liquid source of funds for member banks, and the absolute amount of such reserves in the fourth quarter of last year averaged $406 million, compared with $451 million a year earlier and $549 million in the final quarter of 1962 (see Chart III). At the same time, member bank borrowings from the Federal Reserve increased, so that member bank free reserves (excess reserves less borrowings) declined from an average of $387 million in the fourth quarter of 1962 to $79 million in the final quarter of 1964. Since deposits at member banks were growing fairly rapidly over this period, the ratio of free reserves to deposits declined even more rapidly.

Treasury securities maturing in less than one year are another asset category that is generally considered part of

Chart III

INDICATORS OF BANK LIQUIDITY



Note: Shaded areas represent recession periods, according to National Bureau of Economic Research chronology.
* Total deposits less cash items in process of collection.
† Data not available prior to July 1959.
Source: Board of Governors of the Federal Reserve System.

[1] Loan-deposit ratio equals loans (adjusted), less loans to brokers and dealers, as a percentage of total deposits (less cash items in process of collection).

a bank's liquid reserve position.[2] For all weekly reporting member banks, such holdings amounted to 6.1 per cent of deposits in the fourth quarter of 1964, about unchanged from the 5.7 per cent level prevailing in the final months of 1963 but considerably below the 8.7 per cent figure at the end of 1962 (see Chart III). While holdings of intermediate-term Treasury securities may be less relevant in assessing bank liquidity, it is interesting to note that these too have declined relative to deposits. In the fourth quarter of 1964, holdings of Treasury issues maturing in one to five years amounted to 7.8 per cent of total weekly reporting bank deposits, compared with an 11.1 per cent share two years earlier.

[2] It should be noted, however, that comparisons over time of bank holdings of Treasury securities may be distorted by the varying timing and amounts of Treasury financings—a distortion that cannot always be eliminated by statistical procedures.

One noteworthy liquid-asset category that has not shown a general downtrend relative to deposits over the past two years is composed of call loans to brokers and dealers for the purpose of purchasing and carrying securities. Such loans amounted to 2.8 per cent of deposits in the fourth quarter of 1964, compared with 2.5 per cent two years earlier.

While bank liquidity positions have been declining, the Federal Reserve has continued to provide the reserves necessary to support substantial deposit and credit expansion. Perhaps this policy stance of the System has been reflected in bankers' willingness to accept some decline in their liquidity positions. In any event, to all appearances, borrowers have continued to be able to obtain new loans readily. However, what the decline in liquidity positions probably does mean is that, with portfolios themselves offering little room for further reallocation to meet future loan demands, the banking system may now be more sensitive to System policy in supplying reserves than earlier in the current business expansion.