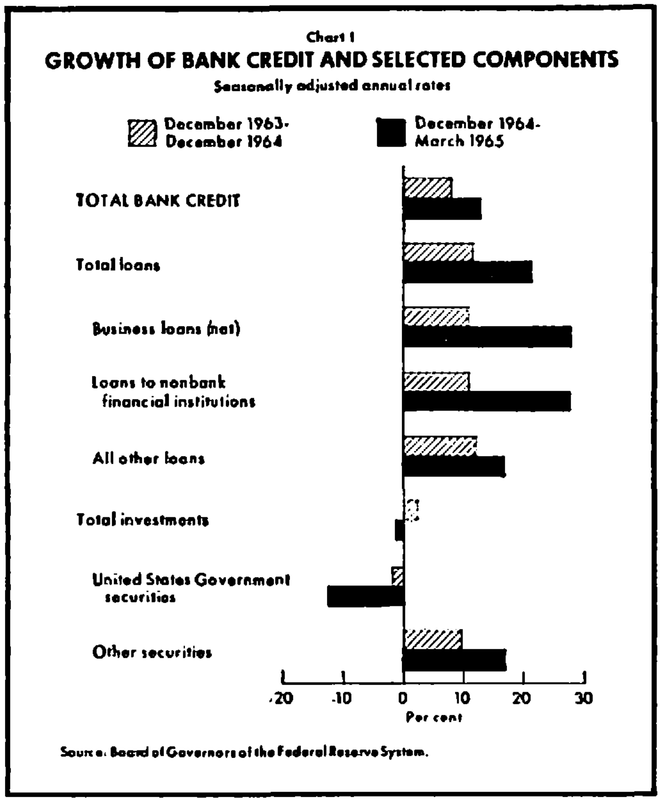
Recent Banking and Monetary Developments

Commercial bank credit increased rapidly in the first quarter, both reflecting and facilitating the substantial rise in economic activity during the period. Business loans at commercial banks grew in the quarter at a rate more than twice as fast as during all of 1964. Bank credit may well have risen more rapidly than credit at other types of financial institutions since banks were able to attract an increased share of the public's deposits following the liberalization of Regulation Q in late November 1964. Nevertheless, total nonbank liquidity expanded at an accelerated pace in the first quarter, and over the past six months has in fact grown more rapidly than over-all economic activity. A large amount of the reserves needed to support the credit-deposit expansion at commercial banks was supplied through Federal Reserve open market operations. However, part of the increased reserve needs accompanying the surge in deposits had to be met by heavier borrowing at the "discount window", and member banks also drew down their excess reserve positions during the period. Toward the end of the quarter the banking system was operating consistently with net borrowed reserves.

BANK CREDIT IN THE FIRST QUARTER

Total bank credit at all commercial banks rose by $8.5 billion, seasonally adjusted, in the first quarter, or at an annual rate of 12.8 per cent (see Chart I). This was the largest absolute and percentage increase in bank credit in any three-month period since the second quarter of 1958, and more than half again as large as the 8 per cent growth rate that has characterized most of the current business expansion of more than four years' duration.

This surge in bank credit in the first quarter undoubtedly reflected to a large extent the increased credit demands generated by the rapidly growing economy. But a part of the rise in bank credit was at the expense of competitive sources of funds. Interest rates on borrowing from nonbank sources generally rose during the quarter whereas bank loan charges apparently did not. (For example, the rate of discount on directly placed six-month prime commercial paper rose from 4 per cent to 4¼ per cent over the quarter.) Prime borrowers — who have access both to the commercial paper market and to the banks for their credit needs — thus had an increased incentive to tap banks for funds rather than to issue commercial paper. Partly as a result, the seasonally adjusted volume of total commercial paper outstanding declined sharply in the first quarter after having increased by 24 per cent in 1964. It might also be noted that the latest quarterly survey of bank interest rates — which covered rates charged during the first fifteen days of March — showed a sharp rise since early December in the proportion of new loans made at the unchanged prime rate.



Nearly all categories of bank loans showed an accelerated growth in the first quarter, the only notable exceptions being real estate and agricultural loans. Partly to help meet this loan demand, banks reduced their holdings of Government securities during the quarter. Nevertheless, their total investments declined only slightly as the rate of acquisition of other securities, such as municipals, actually increased. The rearrangement of portfolios in favor of loans led to a further rise in loan-deposit ratios over the quarter, with the ratio for all commercial banks as a group reaching a postwar record of 60.3 per cent in March.

Business loan demand was especially strong during the quarter. The total of such loans grew by \$4.0 billion (seasonally adjusted), or at an annual rate of 27.8 per cent — much larger than the 1964 expansion of 10.8 per cent. The data relating to member banks reporting weekly suggest that demands were widespread among the different industrial groupings, though part of the over-all expansion undoubtedly was attributable to the effects of three temporary special factors. Steel-using industries financed some of their strike-hedge stockpiling of inventories through bank loans; the East and Gulf Coast dock strike early in the year necessitated bank borrowing to finance inventories of goods awaiting shipment abroad; and business loans to foreigners (and possibly also to American companies operating abroad), in the early weeks of the year, were sought and made prior to the official steps taken in February to restrain foreign lending of banks as part of President Johnson's balance of payments program.

Loans to nonbank financial institutions apparently also grew substantially over the quarter, particularly in February and March as rates on commercial paper edged higher, making bank borrowing a relatively more attractive source of funds for such borrowers. Toward the end of the quarter, commercial bank loans for the purpose of carrying securities rose sharply, reflecting to some extent sales to the public of two large recent stock offerings and reductions in loans to securities dealers by New York agencies of foreign banks.

TIME DEPOSITS, MONEY SUPPLY, AND TOTAL LIQUID ASSETS

As a counterpart of the sharp rise in bank credit in the first quarter, total deposits held by the banking system

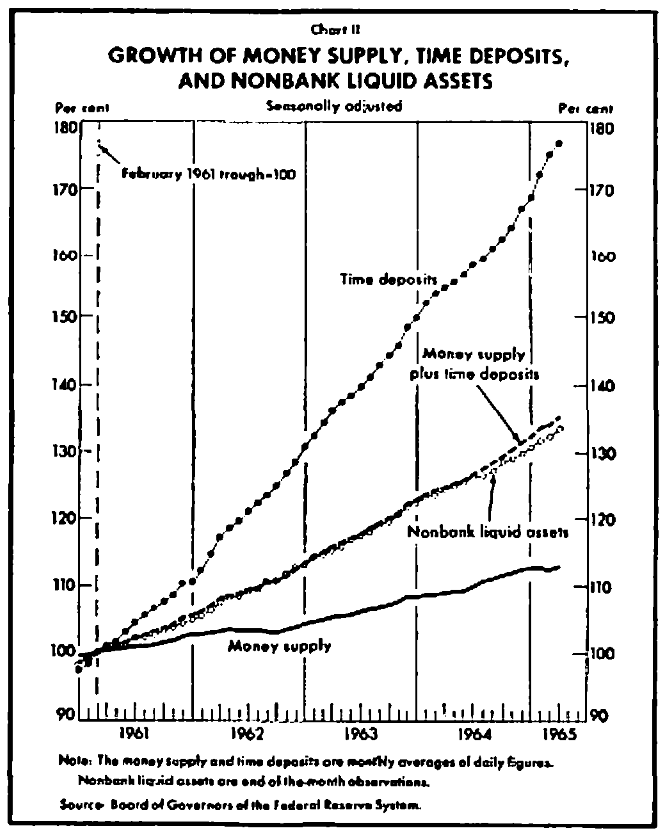
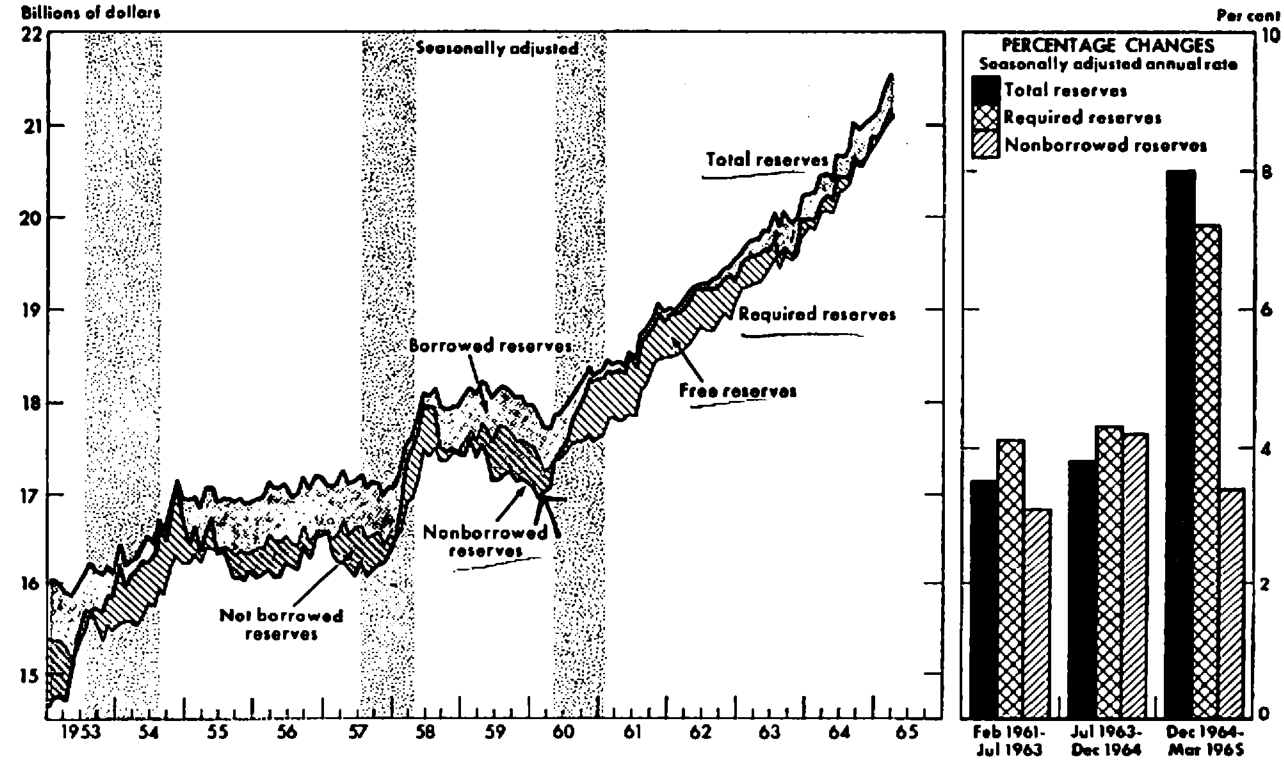


Chart III
GROWTH OF MEMBER BANK RESERVES



Note: All reserve data are adjusted for changes in required reserve ratios. The difference between total reserves and nonborrowed reserves is member bank borrowings from the Federal Reserve Banks. Free reserves, usually defined as excess reserves less borrowings, may also be represented as the difference between nonborrowed reserves and required reserves. When required reserves are larger than nonborrowed reserves, the difference is termed net borrowed reserves. The shaded bands covering months in 1953-54, 1957-58, and 1960-61 represent recession periods, according to National Bureau of Economic Research chronology.

Source: Board of Governors of the Federal Reserve System.

also expanded substantially. The bulk of the growth occurred in time deposits. Banks had raised the rates paid on time deposits late in 1964, shortly after the change in Regulation Q effective November 24. These higher rates made banks more effective competitors in the market for liquid savings, especially after the start of a new quarterly interest period in January. As a result, bank time deposits surged in January and February of this year (see Chart II), with the annual rate of growth over the first quarter as a whole amounting to 18.7 per cent. (During 1964, time deposits grew by 12.6 per cent.) Deposits and shares at mutual savings banks and savings and loan associations, in contrast, grew less rapidly than earlier — the increase in the first quarter amounted to 7.4 per cent at an annual rate, compared with a rise of 10.8 per cent in 1964.

The rapid growth in time deposits early in the year was probably also to some extent at the expense of growth in demand deposits. Demand deposits, as well as the daily average money supply[1] actually showed a net decline over the first two months of the year, after adjustment for normal seasonal influences. The money supply picked up in March, but the growth for the quarter as a whole — at an annual rate of 1 per cent — was well below the 4 per cent per annum growth rate that had characterized the preceding two years. Interestingly, a temporary surge in time deposits and a slowing in the growth of the money supply also developed in the months following the July

[1] Defined to include demand deposits at commercial banks other than those of the United States Treasury (and certain other adjustments) plus currency held by the nonbank public.

1963 and January 1962 changes in Regulation Q. In these previous periods, it should be noted, the growth of the money supply subsequently accelerated while growth in time deposits slowed down to rates more nearly comparable to those prevailing before the Regulation Q changes. Developments in March and April suggest that a similar pattern is being repeated this year.

Since part of the more rapid growth in time deposits in the first quarter thus came at the expense of growth in other forms of liquid assets, total liquid asset holdings of the nonbank public[2] did not advance as fast as those of time deposits alone. Nevertheless, total nonbank liquidity did increase at a seasonally adjusted annual rate of 8.6 per cent over the quarter, or somewhat more rapidly than during 1964 when the advance was 6.9 per cent. Moreover, the ratio of nonbank liquid assets to gross national product has increased by 0.5 percentage point since the third quarter of 1964, to 82.4 per cent for the first quarter of 1965, showing that the growth in such liquidity over the past six months has outpaced the growth in over-all economic activity. This contrasts with developments during the period from mid-1963 through mid-1964 when nonbank liquidity and over-all economic activity appeared to be growing at roughly the same rate.

BANK RESERVES

The accelerated growth in commercial bank deposits in the first quarter placed pressure on bank reserve positions. Total member bank reserves, of course, have grown throughout the current business expansion, in contrast to the experience of the two preceding business upswings, and the growth in reserves actually speeded up in the first quarter (see Chart III). There was less growth than previously, however, in that portion of total reserves which banks obtained through the net effects of Federal Reserve open market operations. Nonborrowed reserves (seasonally adjusted) grew at an annual rate of 3.4 per cent in the quarter, compared with a 4.7 per cent increase in 1964. In order to meet the expanded total reserve needs, member banks as a group therefore had increasing need to resort to the Federal Reserve discount window, and member bank borrowings for the quarter as a whole averaged $372 million, compared with $327 million in the preceding three-month period. During the first six weeks of the quarter, the banking system operated on average with free reserves of just under $100 million. But with continued strong credit expansion and a more restricted growth of nonborrowed reserves, banks operated with net borrowed reserves averaging just under $40 million for the remaining seven weeks.

[2] Total nonbank liquid assets include demand deposits and time deposits (adjusted) at all commercial banks, currency outside banks, deposits at mutual savings banks, savings and loan shares, postal savings, United States Government savings bonds, and the public's holdings of United States Government securities maturing within one year.