Banking and Monetary Developments—Third Quarter of 1965

Commercial bank credit and private deposits again displayed vigor during the third quarter. Demands for business and other nonfinancial loans continued to show sustained strength in line with the broad expansion in over-all economic activity. On the other hand, a substantial decline in securities loans took place, and the growth of loans to nonbank financial institutions slowed considerably. Both these loan categories had increased sharply earlier in the year as these borrowers turned to the banking system for a larger share of their credit needs. Bank loan terms continued to firm.

On the deposit side of bank balance sheets, a large portion of the considerably more than seasonal rise in Government deposits during the first half of the year was paid out to private holders in the third quarter. These transfers were a factor in pushing up appreciably both the private money supply and commercial bank time deposits. Indeed, total liquid asset holdings of the nonbank public continued to expand at a faster pace than the growth of gross national product. On a net basis, the shift of deposits from Government to private ownership showed up especially in time deposits. Since these deposits have a lower required reserve ratio than Government or private demand deposits, total member bank required reserves actually declined in the third quarter after a sizable increase in the first half of the year.

BANK CREDIT AND LIQUIDITY

Total loans and investments at all commercial banks moved irregularly upward over the summer months, with the increase in the third quarter amounting to $3.9 billion (seasonally adjusted). Over short periods, the erratic fluctuations in the bank credit series obscure underlying trends; however, it does appear in retrospect that the rapid surge in bank credit that marked the early months of the year began moderating around mid-April. Since then, the rate of growth of bank credit has dropped lower, to around roughly 8 per cent per annum or approximately the rate of growth experienced during the first four years of the current business expansion (1961-64). Nevertheless, for the first nine months of 1965 as a whole, the bank credit growth rate exceeded that of the corresponding period a year earlier.

Along with a somewhat slower growth in the total, there have been several sharp shifts in the composition of the credit growth since early in the year. Perhaps the most marked shift has been in commercial bank securities loans and in loans to other nonbank financial institutions. Such loans expanded quite sharply during the early months of the year and were up appreciably for the whole first half of the year. During that period, some of the bank credit growth was at the expense of competitive sources of funds. With the higher rates permitted on time deposits under Regulation Q after November 1964, corporations placed larger shares of their short-term funds in time certificates of deposit, restricting what otherwise might have been a flow of funds into commercial paper and repurchase agreements. At the same time, securities dealers found that the New York agencies of foreign banks could no longer grant them lines of credit as ample as before the institution of the President's balance of payments program in February 1965. As interest rates on commercial paper and repurchase agreements rose, nonbank financial institutions and securities dealers relied more heavily on commercial banks for their short-term credit needs. Although the surge in total bank credit began moderating around mid-April, the growth in these financial loans remained strong throughout most of the first half of the year.

During the third quarter, in contrast, commercial bank securities loans dropped sharply, and indeed the decline apparently completely offset the first-half increase. At the same time, it appeared that the growth of loans to nonbank financial institutions slowed to less than half the pace of the first six months of the year. The growth of bank credit aside from these two loan categories, on the other hand, remained quite substantial. Indeed, for the third quarter as a whole, total bank credit excluding securities loans and loans to nonbank financial institutions increased at about an 8½ per cent annual rate—somewhat below the pace of the first quarter of the year, but virtually identical to the rate for the second quarter and for all of 1964.

As an echo of the lack of interest earlier in the year on the part of corporations in commercial paper and repurchase agreements with securities dealers, the amount of such obligations maturing around the September dividend and tax dates was smaller than usual. Thus the need on the part of securities dealers for bank loans to replace the maturing repurchase agreements was much less than on earlier dividend and tax dates. Moreover, with generally firm conditions prevailing in the money market, dealer financing costs at the banks rose significantly. This factor, along with expectations of higher interest rate levels, led dealers to lighten their over-all positions and thus reduced their over-all credit needs. At the same time, there was a further tightening in the terms of bank credit available to nonbank financial institutions. Even the prime borrowers among these institutions had to face higher bank loan rates by the end of the quarter. In response to the tightening in terms, the nonbank financial institutions began to rely more heavily on sources other than banks for their short-term financing needs.

As already noted, most other loan categories apparently continued to expand rapidly during the third quarter, albeit not quite so fast as during the very early months of the year. The growth rate of business loans in the third quarter, at 14 per cent per annum, continued to run ahead of the almost 12 per cent increase in 1964—although it was less than the very rapid annual rate of nearly 23 per cent over the first half of this year. Banks have made large amounts of term loans to businesses throughout the year in helping to finance expanded capital expenditures. There also appeared to be some increased interest on the part of banks in high-yielding consumer and real estate loans.

The substantial buildup in loans as business borrowers continued to be accommodated, combined with a very modest accumulation of total securities (and actual declines in Government securities), resulted in a further marked shift in the composition of bank assets. Although the volume of total investments at commercial banks is now higher than at the beginning of the current expansion, holdings of Government securities were down by the end of September to only $56.2 billion on a seasonally adjusted basis, about the lowest level since mid-1960. Holdings of short-term Governments have declined quite sharply over the past year. The shift in the composition of bank earning assets toward loans and longer term price-sensitive securities has taken place against a general economic background in which prospective credit demands of bank customers are considerably larger than at the beginning of the present business expansion.

The reduction in bank liquidity positions is also reflected in steadily rising loan-deposit ratios. By the end of the quarter, the loan-deposit ratio at all commercial banks as a group was up to 62.5 per cent, 1.1 percentage points higher than at midyear and 4.0 percentage points higher than a year earlier. At weekly reporting banks in New York City, the loan-deposit ratio was up to 69.8 per cent by the end of the quarter as against 61.8 per cent a year earlier. While the loan-deposit ratios for banks outside the money centers increased over the quarter, they remained lower than the ratios at the money market banks. Nevertheless, the banks outside the money centers felt sufficient pressure on their liquidity positions to step up their requests for participation by big-city correspondents in meeting local loan demands.

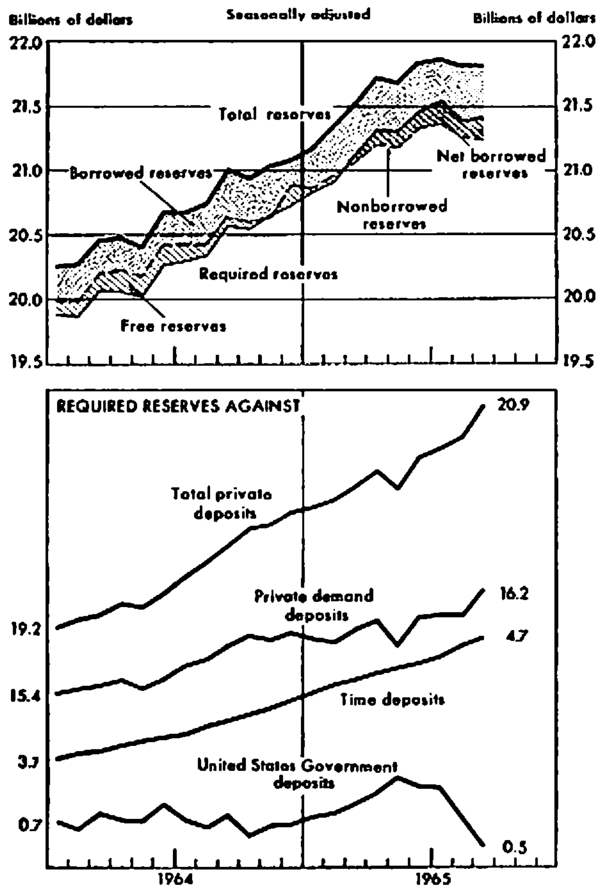
Large loan demands and the increased pressure on bank liquidity have led to a gradual tightening of bank loan terms over the year. As noted earlier, some banks have announced selective increases in loan rates, especially to nonbank financial institutions but also to other borrowers. According to the most recent quarterly survey of interest rates, the average rate charged by New York City banks on short-term loans in the first two weeks of September, at 4.68 per cent, was about 4 basis points higher than in June, while the rate on term loans was up by 7 basis points to 4.77 per cent.

DEPOSITS, TOTAL LIQUID ASSETS, AND BANK RESERVES

Total private deposits rose sharply in the third quarter. Indeed, the growth in the seasonally adjusted daily average money supply (which includes currency outside banks as well as private demand deposits) amounted to a 6.2 per cent annual rate, considerably above the pace earlier in the year and also above the 4.3 per cent growth in 1964. At the same time, daily average time deposits rose at a seasonally adjusted annual rate of 16.8 per cent. Thus, the growth of the money supply plus time deposits was at an annual rate of 11.5 per cent in the third quarter, well above the 8 per cent rate of 1964 and the first half of this year. On the other hand, United States Government deposits—which had expanded by almost 70 per cent in the first six months of the year—fell to near the beginning-of-the-year level during the third quarter as the Treasury used the large balances accumulated earlier to meet heavier than seasonal expenditures. The transfer of these deposits from Government to private ownership contributed substantially to the rapid rise in the money supply and in private time deposits.

Along with the rapid growth in private deposits at commercial banks, there were also fairly sharp gains in other forms of liquid assets owned by the nonbank public. Thus,

MEMBER BANK RESERVES



Note: 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.
Source: Board of Governors of the Federal Reserve System.

savings and loan shares, deposits at mutual savings banks, and postal savings deposits, as a combined aggregate, grew at an annual rate of 9.0 per cent (seasonally adjusted) during the quarter, compared with 7.3 per cent in the first half of the year. Total liquid asset holdings of the private nonbank sector[1] were also up by nearly 9 per cent annually during the quarter, somewhat more than in the first half of the year. In the year ended in September 1965, the growth of total nonbank liquid assets has been more rapid than even the substantial growth of GNP, which over that period amounted to about 6½ per cent.

Although bank credit and deposits both increased during the third quarter, these gains took place without an increase in member bank reserves. Indeed, total member bank reserves actually declined slightly over the quarter as did required reserves (see chart). These developments reflected the sharp shift in deposit composition that occurred during the period. As noted earlier, Government deposits expanded rapidly during the first half of the year, accompanied by an accelerated growth of total reserves partially destined for the support of these deposits. Thus, while the growth of required reserves against private deposits during the first half of the year was about in line with earlier years of the current business expansion, total required reserves (which include reserves required against Government deposits) expanded at an annual rate of 7.0 per cent, nearly half again the rate of earlier years.

During the third quarter, in contrast, the sharp decline in Government deposits freed some $460 million of member bank reserves that had been built up earlier in the year. Because private deposit growth was concentrated in time deposits—which have of course a lower required reserve ratio than demand deposits—the increase in private deposits absorbed only about $410 million of the reserves released by declining Government deposits. Consequently, there was a net reduction of about $50 million in total required reserves over the period. Thus, a reduced need for reserves to meet requirements against deposits, combined with some restraint on the part of the banks in meeting loan requests, resulted in bank demands for nonborrowed and total reserves that were less than in the previous quarter.

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[1] 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.