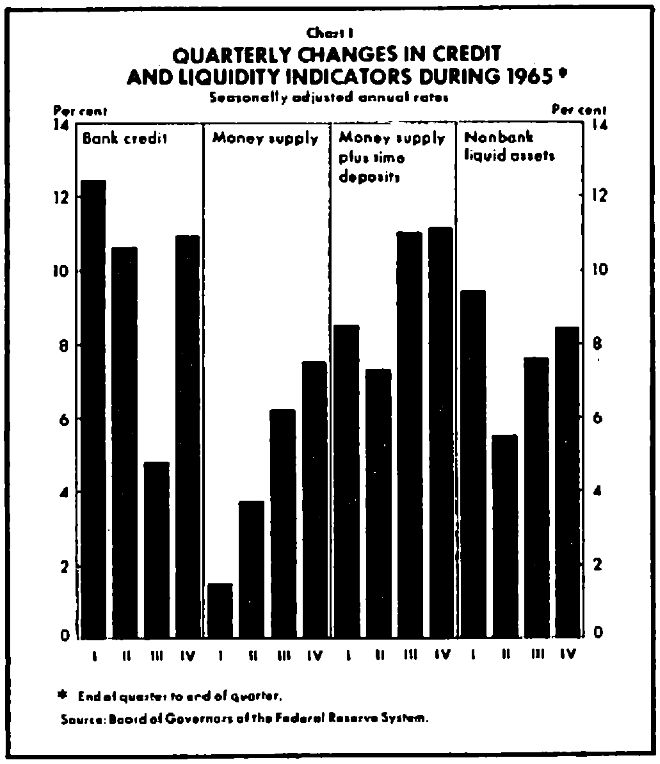
Recent Banking and Monetary Developments

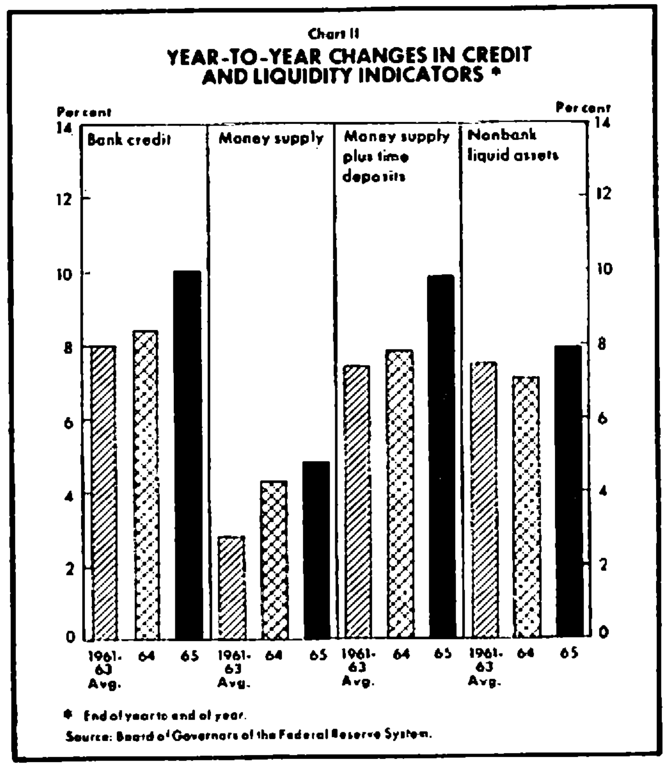
The growth of bank credit accelerated in the fourth quarter, expanding at more than twice the rate of the preceding quarter. Although the Federal Reserve discount rate was increased in early December from 4 per cent to 4½ per cent, bank credit continued to expand at the high rate set in November as the System supplied reserves in volume to ease money market adjustment to higher rate levels.[1]

Special demand factors affecting bank credit in the final three months of 1965 included sizable Treasury financings in October and November as well as unusually large borrowing needs associated with the regular December corporate dividend and tax dates. The ample supply of reserves made available by the System in December enabled banks to meet heavy year-end loan demands without a substantial liquidation of the short-term Governments acquired during the earlier Treasury financings. Indeed, bank holdings of United States Government securities grew substantially during the October-December period as a whole. By the year-end, interest rates in the money and capital markets had moved markedly upward, but the new rate levels were still being tested as market participants attempted to evaluate the many uncertainties in the economic and financial outlook.

The fourth-quarter performance of the deposit liability counterparts of bank credit featured a sharp rise in private demand deposits, associated with the December corporate dividend payment date, and also a drop in the rate of time deposit growth. Government deposits, which had declined steadily since midyear, were lifted by tax receipts in December. Reflecting primarily the expansion in commercial bank deposits, total liquid asset holdings of the nonbank public grow more rapidly than gross national product (GNP) in the fourth quarter.

[1] For details on the discount rate increase and subsequent money and bond market developments see this *Review*, December 1965, pages 254-55, and January 1966, pages 7-11.





BANK CREDIT AND LIQUIDITY

Total bank credit expanded at a 10.9 per cent seasonally adjusted annual rate over the fourth quarter of 1965, exceeding the pace in the two preceding quarters but falling short of the unusually rapid 12.4 per cent advance in the first quarter of the year. Although sharply varying monthly and quarterly rates of growth in total loans and investments during 1965 did, at times, obscure the underlying trend, the 10 per cent pace for the year as a whole was significantly higher than the roughly 8 per cent per year average over the preceding four years of economic expansion. (See Charts I and II.)

A sizable fourth-quarter rise of 12 per cent in total bank loans was led by a December surge in business borrowing stemming from vigorous capital spending by business in addition to large year-end dividend and tax requirements. The reduction of strike-hedge steel inventories, which had been a factor tending to moderate business borrowing during most of the fourth quarter, was less of a restraining factor by the end of the year. Consumer and real estate loans by banks continued their persistent climb characteristic of most of the current expansion. After a substantial decline in the third quarter, the more volatile securities loans rose sharply in October and November, primarily in response to enlarged Treasury financing activities.

Bank investments rose at a substantial 8.8 per cent seasonally adjusted annual rate during the fourth quarter of 1965. The dollar increase was divided about equally between bank holdings of United States Government securities and holdings of "other securities". This was in marked contrast with the pattern of the first three quarters of the year when substantial reductions in holdings of United States Government securities virtually offset bank net purchases of municipals and other securities. The strength in bank investment in Governments was partly attributable to the concentration of Treasury financings in October and November, but the ability of banks to meet very strong year-end loan demands without a large-scale liquidation of these securities reflected to a large extent the willingness of the Federal Reserve System to supply large amounts of additional reserves during the weeks following the rise in the discount rate.

Although investments accounted for a larger share of the bank credit advance in the fourth quarter than earlier in the year, the loan-deposit ratio at all commercial banks continued to move upward. Excluding borrowings by brokers and dealers from the loan total, the loan-deposit ratio for the commercial banking system rose to 63.1 per cent at the end of 1965, up from 62.6 per cent at the end of the third quarter and 58.6 per cent at the end of 1964. At weekly reporting member banks, the loan-deposit ratio stood at 67.9 per cent by the year-end, up only slightly from 67.8 per cent at the end of the third quarter but appreciably higher than the 63.6 per cent at the end of 1964.

The substantial growth of bank credit during the final three months of 1965, coupled with a shift of the deposit mix from time deposits toward the demand deposit category with its relatively higher reserve requirement, involved large open market purchases by the Federal Reserve System to provide for the associated expansion of bank reserves. Federal Reserve bank credit outstanding rose by about $2.2 billion during the fourth quarter. Member bank net borrowed reserves declined from an average of $149 million in October to an average of only $11 million in December —with banks showing positive free reserve positions in the two weeks following the rise in the discount rate. On a seasonally adjusted basis, total nonborrowed reserves grew at an annual rate of 9.7 per cent over the fourth quarter, compared with a 4.2 per cent rate for the year as a whole.

BANK DEPOSITS AND TOTAL LIQUID ASSETS

The rapid growth in total private bank deposits during the fourth quarter was, as noted earlier, highlighted by an extremely large December surge in private demand deposits. Consequently, the seasonally adjusted daily average money supply (which includes currency outside banks as well as private demand deposits) rose at a 7.5 per cent annual rate over the fourth quarter, higher than the rapid 6.2 per cent third-quarter pace and well above the 4.8 per cent increase for 1965 as a whole. (See Charts I and II.) In part, the uneven growth of the privately held money supply during 1965 may have reflected the behavior of Treasury demand deposits. During the first five months of the year, the Treasury accumulated deposits at an unusually fast rate and the private money supply showed little change on a seasonally adjusted basis. Over the remainder of the year, however, Treasury deposits declined by $4.8 billion—much more than is ordinarily the case. With these deposits flowing back into private hands, the private money supply received a substantial boost.

The growth in daily average time deposits over the final three months of 1965 was at a 15.3 per cent annual rate, somewhat below the 16.8 per cent pace for the third quarter. For money supply and time deposits combined, the fourth-quarter rise was at a seasonally adjusted annual rate of 11.1 per cent, slightly higher than in the third quarter.

Nonbank liquid assets, which include commercial bank time and demand deposits and other forms of liquid assets owned by the nonbank public,[2] increased at an annual rate of 8.4 per cent over the fourth quarter of 1965, exceeding the corresponding growth rate of just under 8 per cent in GNP. As a result mainly of the especially rapid growth of privately held commercial bank deposits, the fourth-quarter advance in nonbank liquid assets was also faster than the growth rates in these assets of 7.9 per cent and 7.1 per cent during all of 1965 and 1964, respectively. The other deposit components of liquid assets—including savings and loan shares, deposits at mutual savings banks, and postal savings deposits—grew in total at a 7.3 per cent annual rate over the fourth quarter, down from a 7.9 per cent pace for 1965, and substantially below the 10.8 per cent rate for 1964.

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[2] Total liquid assets include demand deposits and time deposits (adjusted) at all commercial banks and currency outside banks —all measured on a last-Wednesday-of-the-month basis; also, deposits at mutual savings banks, savings and loan shares, postal savings deposits, United States Government savings bonds, and the public's holdings of United States Government securities maturing within one year—all measured on an end-of-the-month basis.