Recent Banking and Monetary Developments

The banking and financial system was strongly influenced during the first quarter of 1967 by the continuation of the move toward monetary ease that had been initiated by the Federal Reserve System late in 1966. During the three months ended in March 1967, the System provided member banks with an increased reserve base, and the nationwide net reserve position of member banks moved into surplus for the first time since early 1965. Despite a slackening of the demand pressures in the economy, the growth of bank credit and deposits accelerated.

As the supply of funds available for lending and investing grew, market rates of interest, particularly in the short-term area, continued the decline that began late last year. Commercial banks—whose liquidity positions were improving—cut the prime lending rate from 6 per cent at the start of the year to 5½ per cent by the end of March. The easier atmosphere in the financial markets was enhanced on February 28 when the Federal Reserve System announced the reduction of reserve requirements on certain types of time and savings deposits from 4 per cent to 3 per cent. By the end of the quarter, a reduction of the discount rate—the rate at which member banks may borrow from Reserve Banks—was widely anticipated, and a decrease, from 4½ per cent to 4 per cent, actually took place in early April.

Total bank credit advanced rapidly during the first quarter of 1967. Commercial bank investment portfolios grew strongly, as banks sought to rebuild their liquidity positions and employ newly available reserves. United States Government securities were taken eagerly, and other securities—such as tax-exempt state and local securities—were added in record amounts. Lending by commercial banks, on a seasonally adjusted basis, expanded faster in the first quarter than during the latter part of 1966. In particular, business loans recovered from their relatively slow rate of advance in the second half of 1966, although increasing at a rate well below that of the hectic first half.

Both demand and time deposits rose strongly over the quarter. After falling in January, when accelerated corporation withholding and social security tax payments built up Treasury balances, the money supply increased rapidly. By midquarter, all major types of time and savings deposits at commercial banks were responding to the easier financial conditions. Passbook savings deposits, which had been at a substantial yield disadvantage compared with other savings instruments in recent periods, began to increase in mid-February. Banks found inflows of funds through large-denomination negotiable certificates of deposit (C/D's) plentiful, as market yields on competing instruments fell and, in early January, began to offer rates on new C/D's below the Regulation Q maximum of 5½ per cent. By the end of March, the most frequently quoted rate on C/D's with maturities of ninety days and over was 4.75 per cent, a full 75 basis points below the rates offered at the end of 1966. Even with these rate reductions, total large-denomination C/D's rose by over $3.6 billion in the quarter. The decline in market yields also made small-denomination commercial bank time deposits relatively more attractive, and these deposits grew strongly.

The liquidity position of the nonbank public improved significantly over the quarter and—apart from the strike-distorted final quarter of 1964—advanced relative to economic activity for the first time in three years.

BANK CREDIT AND LIQUIDITY

Rapidly increasing nationwide reserve availability facilitated a very sharp expansion of commercial bank loans and investments during the first quarter of 1967 (see Chart I). Total loans and investments advanced at a 13.9 per cent seasonally adjusted annual rate over the quarter, compared with the 5.9 per cent rate of growth for all of 1966. Given the slow rate of increase of total bank credit in the second half of 1966 (1.9 per cent), the first-quarter acceleration brought the growth of bank credit since mid-1966 to a 6.0 per cent annual rate.

The bulk of the bank credit growth during the first quarter was concentrated in securities purchases, as banks sought to rebuild their liquidity and as the slowing of the economic expansion served to moderate loan demand. Thus, securities holdings increased at a seasonally adjusted annual rate of almost 27 per cent in the first quarter of 1967. Commercial banks added a substantial $3.3 billion to their holdings of United States Government securities, an annual rate of increase of over 24 per cent. Part of this increase reflected a $2.7 billion issue of tax anticipation bills in March, a substantial share of which was taken and held by banks through the end of the quarter. However, Treasury notes and bonds of one- to five-year maturities, which were seen as offering opportunities for capital gains as well as meeting bank liquidity requirements, constituted the bulk of first-quarter acquisitions by banks.

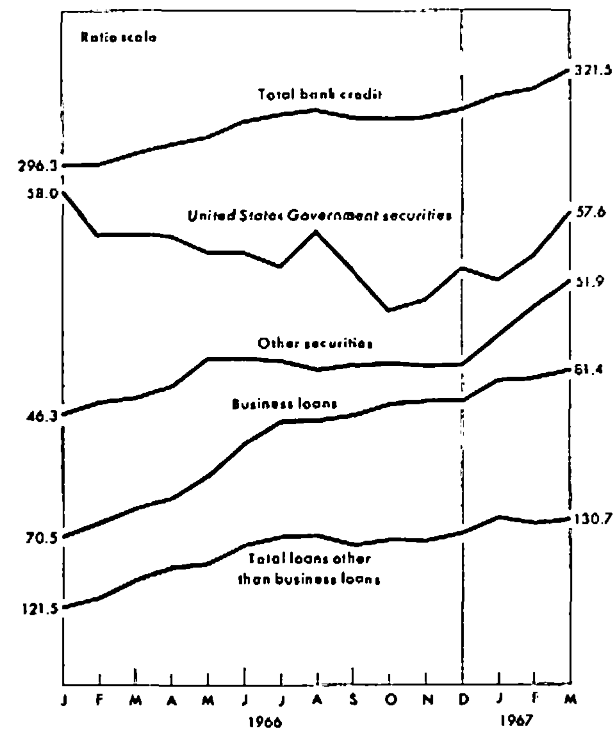
The period also saw a steady buildup in commercial bank holdings of securities other than United States Governments, mainly the tax-exempt obligations of state and local governments. Bank investments in these securities increased $3.6 billion, the largest seasonally adjusted quarterly rise on record, and represented an annual rate of gain of almost 30 per cent. In contrast, such securities holdings had been reduced on balance in the second half of last year, and for 1966 as a whole they had advanced at a rate of only 5.0 per cent.

Total loans outstanding at commercial banks grew at a seasonally adjusted annual rate of 7.5 per cent in the first quarter, with a large part of the $3.9 billion gain reflecting loans to business. While the pace of the business loan expansion (11.6 per cent) was above that of the previous two quarters, it was still somewhat below that of 1966 as a whole because of the exceptionally strong rise in these loans in the first half of 1966. The very small rise in gross national product (GNP) in current dollar terms in the first quarter of 1967—and particularly the sharp drop in the rate at which business added to inventories—may have restrained business loan demand. In addition, part of the heavy corporate borrowing in the capital markets undoubtedly was used to reduce indebtedness to banks. Tax borrowing, on the other hand, was high in the first quarter. A few banks cut their prime lending rate for business borrowers from 6 per cent to 5½ per cent late in January, but most banks followed this move only part way, to 5¾ per cent. The reduction to 5½ per cent did not become general until late in March and probably had only a limited effect on the total volume of first-quarter borrowing.

Chart I

RECENT DEVELOPMENTS IN BANK CREDIT AT ALL COMMERCIAL BANKS

Billions of dollars, seasonally adjusted



Source: Board of Governors of the Federal Reserve System.

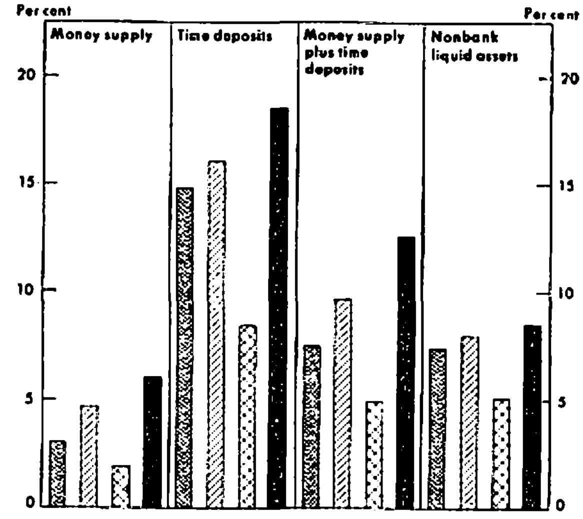
Bank lending to securities brokers and dealers and to nonbank financial institutions reflected the general easing of monetary pressures and declining interest rates. Inventories held by Government securities dealers remained high, and commercial bank securities loans were strong. On the other hand, finance companies found funds readily available in the commercial paper market. Rates on ninety-day finance company paper dropped from 5⅞ per cent at the beginning of January to 4⅞ per cent by the end of March, well below the prime rate at commercial banks.

Consequently, bank loans to nonbank financial institutions fell substantially over the quarter.

Real estate and consumer loans were restrained by the relatively weak conditions in the markets for housing and consumer durables. While banks were reported to be increasingly willing to grant single-family mortgage loans and while average mortgage rates were a bit below year-end figures, overall housing activity was still at low levels. Accordingly, real estate loans advanced at a seasonally adjusted annual rate of only 6.7 per cent in the first three months of 1967, below the performance of both the second half of 1966 and the year as a whole. Reflecting the relatively weak consumer demand for automobiles and other durable goods, the rise in loans to consumers was at a seasonally adjusted annual rate of only 3.1 per cent in the first quarter, well below the pace of recent past periods.

With bank deposits and securities holdings growing rapidly and loan growth moderate, bank liquidity improved over the first quarter for all major classes of banks. For all commercial banks, the aggregate ratio of loans to deposits fell 1.5 percentage points to 64.0 per cent. At New York City banks where ratios had been much higher, the drop was even more pronounced, from a December average of 79.6 per cent to 76.2 per cent in March. However, loan-deposit ratios were still very high by historical standards at the end of March.

Chart II
CHANGES IN LIQUIDITY INDICATORS



Source: Board of Governors of the Federal Reserve System.

BANK DEPOSITS, MONEY SUPPLY, AND RESERVES

As reserve availability increased over the first quarter, bank deposits and the money supply grew rapidly. The money supply—currency outside banks plus privately held demand deposits—advanced $2.6 billion to a seasonally adjusted daily average of $172.9 billion. The public's holdings of currency increased rapidly, and demand deposits turned up sharply to reach record levels. While this increase in the money supply equals a 6.1 per cent annual rate of growth (see Chart II), the annual growth rate over the nine months ended in March 1967 was only 1.4 per cent because the money supply declined during the second half of 1966. In the first quarter, the money supply and time deposits combined grew at a seasonally adjusted annual rate of 12.1 per cent.

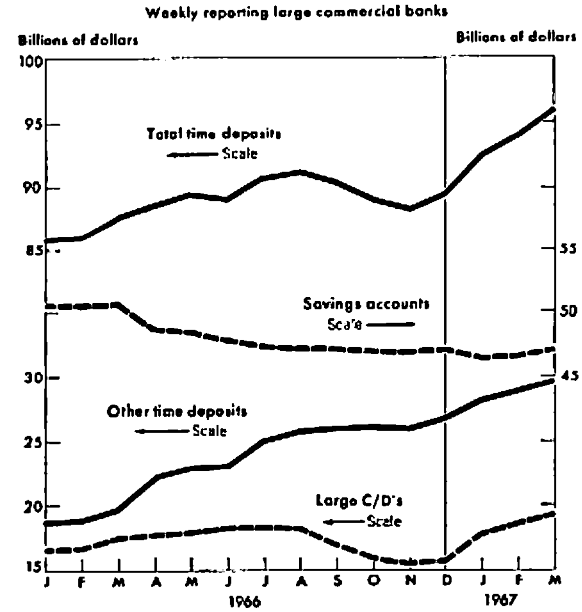
Total time and savings deposits at commercial banks advanced strongly during the quarter—by $7.3 billion. The 18.5 per cent annual rate of growth of these deposits was more than twice the gain of 1966 as a whole and exceeded the strong expansion of 1965.

Time deposits, other than savings deposits, turned up sharply during early 1967, with both large- and small-denomination C/D's advancing strongly. The sharp contraction in the volume of negotiable C/D's in denominations of $100,000 or more that took place in the late summer and fall of 1966 ended in December (see Chart III). The decline in Treasury bill rates during the latter months of 1966 and during most of early 1967 made C/D's a more attractive investment, and by early March total C/D's outstanding at weekly reporting large commercial banks had surpassed the previous peak level of $18.6 billion reached in mid-August 1966. (Despite a strong upsurge in the first quarter, C/D's at New York City banks were still well below their mid-1966 high at the end of March.) For the first quarter as a whole, large-denomination C/D's at weekly reporting banks expanded almost $3.7 billion to a record $19.3 billion. The increased availability of C/D and other deposit funds exerted downward pressure on C/D offering rates, which at large New York City banks started to recede from the Regulation Q maximum of 5½ per cent in early January. By late January, rates at these banks on all maturities were generally below the ceiling, and by the end of March the most frequently quoted rates on all maturities, except the shortest, were down to 4.75 per cent.

During the first quarter, the gain in small-denomination "consumer-type" time deposits at weekly reporting banks was an impressive $2.8 billion. Consumer-type time deposits had risen only about $150 million in the fourth quarter of 1966. To some extent, this relatively small advance reflected the fact that the Federal Reserve System had lowered the maximum permissible rates on these deposits from 5½ per cent to 5 per cent in late September. The resumption of growth in 1967 resulted in part from lower market rates of interest and the reduced incentive to shift from these deposits into market instruments. In the first quarter, passbook savings deposits at weekly reporting banks ended their year-long decline. Although unchanged on balance over the quarter, these deposits rose by more than $600 million between their early-February low and the end of March.

Pressures on member bank reserve positions lessened substantially during the quarter. Nonborrowed reserves increased sharply, as the Federal Reserve System attempted to supply the banking system with sufficient reserves to assure that the availability of credit would be adequate to provide for orderly economic growth. In addition to supplying reserves through purchases of securities in the open market, the Federal Reserve System freed about $850 million of reserves by reducing, from 4 per cent to 3 per cent, the legal reserve requirements on savings deposits, Christmas and vacation club accounts, and the first $5 million of other time deposits at each member bank. The change came in two steps: the first, from 4 per cent to 3½ per cent, became effective on March 2, 1967, and the second, from 3½ per cent to 3 per cent, on March 16.

Chart III
TIME DEPOSITS
Weekly reporting large commercial banks



Note: Large C/D's are defined as negotiable certificates of deposit in denominations of $100,000 or more. "Other time deposits" equals total time deposits, less savings accounts and large C/D's.

Source: Board of Governors of the Federal Reserve System.

As a result of new reserve injections, aggregate member bank borrowings from Federal Reserve Banks were reduced and fell steadily from a daily average of $557 million in December to $199 million in March, the lowest monthly figure since April 1963. Excess reserves, although less volatile and less responsive to money market conditions, rose $39 million over the quarter to $431 million. Consequently, the net reserve position of member banks moved into surplus for the first time since February 1965. While net borrowed reserves had averaged $165 million in December 1966, net free reserves averaged $232 million in March 1967, the highest monthly free reserve level since mid-1963.

The effects of the easing of monetary pressures on commercial banks and the rebuilding of liquidity in the economy generally were broadly reflected in the increased holdings of liquid assets by the nonbank public in the first quarter. These assets grew $12.8 billion in the quarter, a seasonally adjusted annual rate of 8.5 per cent or almost twice the rate of the last three months of 1966. The gain in the public's liquidity was broadly based: Holdings of currency and commercial bank demand and time deposits, share accounts at savings and loan associations, and deposits at mutual savings banks all rose strongly. In particular, share accounts at savings and loan associations grew at a seasonally adjusted annual rate of 10.2 per cent, or three times their 1966 pace. Much of the increased flow of deposits to these institutions has been used to reduce borrowing from the Federal Home Loan Banks, but mortgage acquisitions have also increased.

As the public moved strongly to restore its liquidity position and overall economic activity advanced very modestly in current dollar terms, the ratio of nonbank liquid assets to GNP rose from 78.7 per cent in the fourth quarter of 1966 to 79.3 per cent in the first quarter of 1967. Apart from the strike-distorted final quarter of 1964, this was the first increase in this measure of liquidity in three years. Despite this rise, the liquid asset-GNP ratio remains below the average 1964-66 level.