Banking and Monetary Developments in the Second Quarter of 1968

The growth of total bank deposits and total loans and investments slowed somewhat further in the second quarter of 1968. The reserve positions of member banks were brought under considerably greater pressure in the second quarter than in the first, as the Federal Reserve System took firm steps to moderate increasing inflationary pressures in the domestic economy and to defend the position of the dollar internationally. The discount rate, which had remained at 4½ per cent through most of the first quarter before being raised to 5 per cent in late March, was increased further to 5½ per cent early in the second quarter in action initiated shortly after mid-April. Moreover, net borrowed reserves averaged $360 million in the April-June period, compared with $44 million in the first three months of the year. The Federal funds rate —the rate at which banks with reserve deficits borrow from those banks with excess reserves—averaged almost 6 per cent in the second quarter, up from an average of about 4¾ per cent in the first quarter.

The reduced rate of expansion of total bank credit in the second three-month period of the year was entirely attributable to bank holdings of securities, which failed to increase during the period. Indeed, loan expansion in the second quarter actually increased relative to the first quarter, largely as a result of a sizable pickup in business borrowing related to heavy tax payments and increased inventory accumulation.

Although total bank deposit liabilities grew very slowly in the second quarter, this was due entirely to a steep rundown of Treasury deposits and a falloff in the rate of growth of time deposits. Privately held demand deposits grew quite rapidly as did currency held outside banks. Thus, the money supply—the total of private demand deposits and currency outside banks—rose during the second quarter at a rate nearly double the 4.6 per cent annual rate gain of the first three months of the year. This acceleration in money supply growth was associated with significantly higher average interest rate levels than those of the first quarter, implying that the demand for money increased more rapidly than its supply. Apparently, a very sharp increase in financial transactions, especially on the stock exchanges, resulted in large amounts of money balances being demanded for this purpose.

The slowing of time deposit growth in the second quarter was attributable in large measure to the rise of short-term market rates of interest above the maximum rates payable on time and savings deposits set by Regulation Q. The ceiling rate on large certificates of deposit (C/D's) was raised on April 19, when the discount rate increase to 5½ per cent became effective, in order to help forestall an excessive loss of these deposits. The new maximum rate was scaled up from 5½ per cent on the shortest maturities (30 to 59 days) to 6¼ per cent on the longest (180 days or more); the maximum rate previously payable on large-denomination C/D's had been 5½ per cent on all maturities. However, as short-term interest rates on competing market instruments continued to rise, banks soon found it necessary to offer the new ceiling rates on most maturities, and large C/D's continued to decline though not so much as before. It was not until the end of the quarter, after market rates of interest had fallen sharply on improved prospects for, and final passage of, the tax increase, that banks found it possible to stem and reverse their C/D losses. Indeed, the recent decline in market rates of interest has substantially improved the competitive position of savings and loan associations and mutual savings banks as well as commercial banks.

BANK CREDIT

The growth of total bank credit continued to slow in the second quarter of 1968, as monetary conditions became more restrictive. Loans and investments of commercial banks expanded at a 5.5 per cent seasonally adjusted annual rate, less than the 6.8 per cent annual rate of expansion in the first quarter and about one half the pace recorded in 1967. Moreover, the April-June advance in bank credit was concentrated primarily in the first two months, with little credit growth occurring in June. Over the quarter as a whole, loans accounted for all the growth in bank credit, while total investments remained unchanged. Increasing pressures on banks' holdings of securities were evident throughout the first half of 1968. Gains in holdings of United States Government securities occurred only in February and May, when there were major Treasury financings, and in each case these gains were quickly followed by substantial rundowns. Moreover, investments in other securities began to lessen after the start of the year, and bank holdings of these securities actually declined during the second quarter—the first time this has occurred since the second half of 1966.

Business loans expanded at an annual rate of 12.3 per cent during the April-June period, nearly twice the pace registered in the first quarter of the year, despite a late-April increase to 6½ per cent from 6 per cent in the rate charged by banks on loans to prime business borrowers. The growth in business loans soared to a 19.1 per cent annual rate in April, dropped to 5.4 per cent in May, and recovered again in June to 12.1 per cent. The rapid advance of business loans in April, the most vigorous monthly expansion in the first half of 1968, was associated with heavy tax borrowing at midmonth. The decreased growth in May possibly resulted from some switching of business borrowing from banks to the securities markets following the rise in the banks' prime rate in April. The revival of business loan demand in June partly reflected more than seasonally heavy borrowing for quarterly dividend and tax payments. Moreover, business loan demand was undoubtedly strengthened in all three months by the increased rate of inventory accumulation, particularly among durables manufacturers who were stockpiling steel against the possibility of a strike in August.

In spite of the late-May increase in interest charges on commercial bank consumer credit and moderate growth of consumer spending, these loans expanded at an 8.6 per cent annual rate in the second quarter, only slightly below the rapid pace registered in the first quarter of the year. Real estate loans rose in the second quarter at a moderately lower pace than in the previous three months, while loans to nonbank financial institutions moved up at a 10.8 per cent rate through the second quarter, reversing the 10.5 per cent annual rate of decline in the previous three-month period. Securities loans fell sharply in the second quarter, primarily in the months of April and June, reflecting both the absence of any major Treasury financing in those months and the generally high rates charged by banks on dealer loans.

Although banks' securities holdings did not increase on balance over the quarter as a whole, there were wide swings related to acquisitions and sales of Treasury securities. Bank holdings of United States Government securities fell in April, rose very strongly in May when banks purchased a sizable share of the $3.8 billion of new securities sold by the Treasury, and then declined again in June. Holdings by banks of other securities, mainly tax-exempt municipals, actually contracted slightly in the second quarter after expanding at a 13.7 per cent annual rate in the first quarter of the year and by 26.1 per cent in 1967.

With banks placing a larger share of their new funds in loans, the ratio of loans to deposits at commercial banks climbed to a near-postwar high in the second quarter of 1968, from an average of 63.1 per cent in March to 65.3 per cent in June. At weekly reporting New York City banks, where the ratio has been much higher and the slowing in total deposit growth more pronounced, the ratio climbed from 75.3 per cent in March to 80.0 per cent in June, a rise of fully 4.7 percentage points. However, New York City banks have acquired increasingly large amounts of Euro-dollar balances through their foreign branches and, when these balances are counted as deposits, the level of the loan-deposit ratio for New York City banks is reduced and its recent rate of growth appears more moderate.

MONEY SUPPLY AND TIME DEPOSITS

The daily average money supply grew rapidly during the second quarter, as both privately held demand deposits and currency outside banks increased more than in the preceding three months. Total time deposits, on the other hand, rose much less rapidly than in the first quarter, with weakness evident in all time deposit classifications.

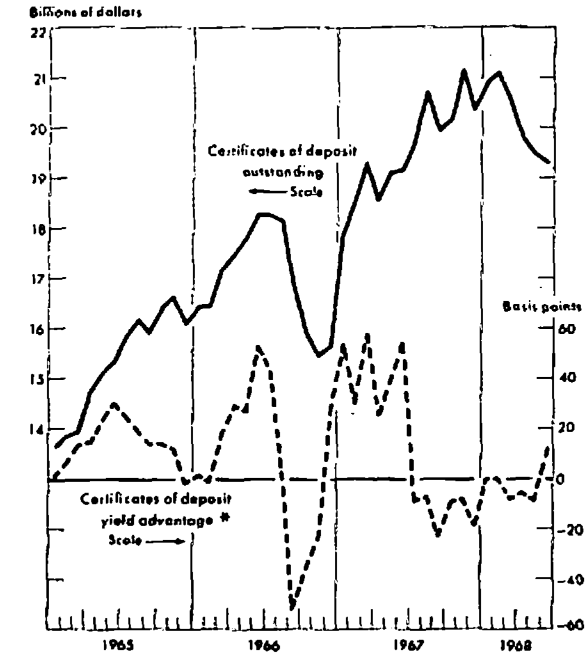
The daily average money supply expanded at a seasonally adjusted annual rate of 8.3 per cent from March to June, compared with only 4.6 per cent in the preceding three-month period. A contributing factor may have been the steep rundown of Treasury deposits, on a seasonally adjusted basis, with a resultant increase in privately held deposits as these funds were spent. However, the accelerated second-quarter rise in the money supply was associated with higher average levels of interest rates than had prevailed in the first quarter, the late May and June declines in rates notwithstanding. This suggests that the demand for money increased even more rapidly in the second quarter than the supply. Accelerated growth in the demand for money cannot be explained by the trend in economic activity inasmuch as gross national product (GNP) actually grew slightly less rapid than in the first quarter. This would ordinarily imply, if anything, a slightly slower rate of increase in the demand for transactions balances needed to support economic activity.

The sharp increase in the demand for money in the second quarter can be explained most plausibly by the surge in financial transactions that occurred during the period. For example, transactions on the national stock exchanges totaled almost $58 billion in the second quarter, 32 per cent higher than in the first quarter or about 130 per cent higher at an annual rate. Little, if any, of this rise in the volume of stock exchange activity can be explained on seasonal grounds. Because of the typically large unit size of these transactions, an expansion of such magnitude undoubtedly required a sizable accumulation of money balances earmarked for this purpose. Further evidence of the recent importance of financial transactions in increasing the demand for money in the second quarter is provided by the statistics on activity in demand deposit accounts (other than interbank and those of the United States Treasury). Total debits to such deposits increased during the second quarter at a 22.2 per cent seasonally adjusted annual rate, compared with 15.5 per cent in the first quarter.

Time and savings deposit growth slowed in the second quarter to a 3 per cent seasonally adjusted annual rate, less than half the rate of expansion during the preceding quarter. Weakness was apparent in all deposit categories, as the increased market rates of interest made it difficult for banks to attract and retain deposits at the maximum rates payable under the various Regulation Q ceilings. Regulation Q ceilings on savings deposits and smaller denomination time deposits continued unchanged at the levels established in late 1966. However, the Regulation Q ceiling on large C/D's (those of $100,000 or more) was liberalized, effective April 19. The new schedule of maximum permissible rates on large C/D's was set at 5¾ per cent on 60- to 89-day maturities, 6 per cent on 90- to 179-day maturities, and 6¼ per cent on maturities of 180 days or more. The 5½ per cent ceiling that had previously applied to all maturities continued in effect for the new 30- to 59-day C/D's. But even after this Regulation Q increase, banks continued to have difficulty attracting C/D funds, as com-

Chart I

CERTIFICATES OF DEPOSIT OUTSTANDING AND YIELD ADVANTAGE



* Average of most often quoted new issue rates on 90- to 179-day certificates of deposit less average yield on six-month Treasury bills.

Source: Board of Governors of the Federal Reserve System.

peting short-term market rates moved still higher (see Chart I). Between the end of March and the end of June, large C/D's outstanding at weekly reporting banks fell by about $1.3 billion, with about half of these losses occurring at New York City banks. Consumer-type C/D's were also weak, and state and local governments ran down their time deposits, possibly in response to difficult borrowing conditions in the municipal bond market.

However, toward the end of the quarter, the competitive position of banks in the time deposit market began to improve greatly. The sharp rise of short-term market yields in the first half of the quarter had carried these yields well above maximum offering rates on comparable-maturity large C/D's. Thus, in the third week of May, the yield on six-month bills was 27 basis points above the maximum 6 per cent rate payable on 90- to 179-day large C/D's under the revised Regulation Q ceilings. But, by the end of June six-month bill yields had dropped below the Q ceiling, and in July banks were able to lower their offering rates to less than 6 per cent.

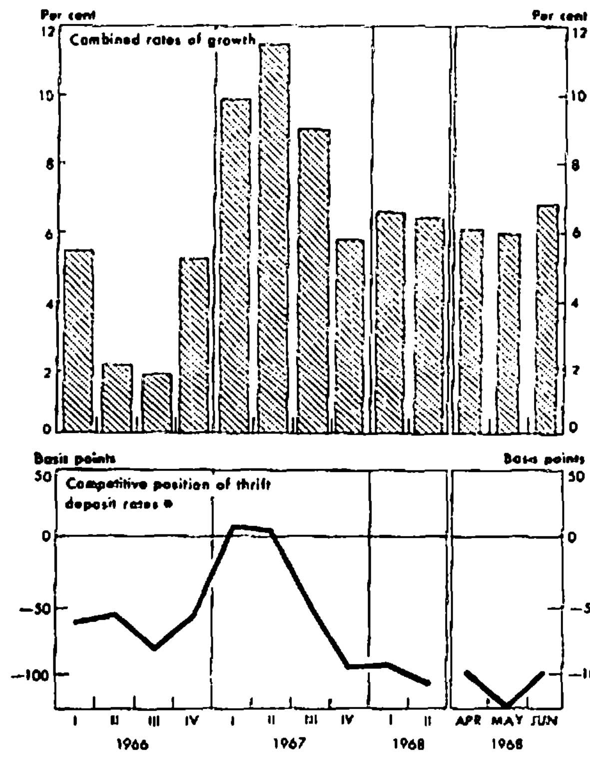
Some large banks were able to offset all or part of their losses of large C/D's during the second quarter by acquiring funds in the Euro-dollar market through their foreign branches. Thus, between the end of March and the end of June, weekly reporting banks expanded their liabilities to their foreign branches by $1.4 billion, twice the increase of the preceding quarter.

NONBANK LIQUIDITY

Liquid asset holdings of the nonbank public advanced at only a 3.8 per cent annual rate in the second quarter, well below the 9.1 per cent rate of gain in the previous quarter. Slowing was evident in almost every major component, with the notable exception of the money supply. Time and savings deposits at commercial banks registered little growth over the quarter because of the pull of higher yielding market instruments. Total deposits

Chart II

RATES OF GROWTH AND COMPETITIVE POSITION OF MUTUAL SAVINGS BANKS AND SAVINGS AND LOAN ASSOCIATIONS



* Measured as an average of thrift deposit rates less average of daily yields on three- to five-year Government securities.

Sources: Board of Governors of the Federal Reserve System, Federal Home Loan Bank Board, and the National Association of Mutual Savings Banks.

and shares at savings banks and savings and loan associations rose 6.3 per cent in the second quarter, slightly lower than the 6.6 per cent rate of growth in the first quarter of the year (see Chart II). In the April-June period, negative spreads between interest rates paid by thrift institutions on their deposits and yields on competing market instruments reached a peak in the second half of May (about 143 basis points in the case of three- to five-year Governments) and more than exceeded the average peak spreads recorded in September 1966. However, the retardation in deposit flows in the second quarter of this year never reached the proportions of the 1966 experience, apparently because these institutions now have considerably less interest-sensitive money than in that earlier year. Thrift institutions were able to expand their mortgage acquisitions at about the same pace in the second quarter of 1968 as in the first, despite the slowing of deposit flows. The acquisition of mortgages, particularly by mutual savings banks, may have been inhibited in late 1967 and early 1968 by legal maximum interest-rate ceilings in many of the Eastern states. However, action has been recently taken to liberalize such ceilings in several states—notably New York, New Jersey, and Pennsylvania.

The reduction in the growth of the public's holdings of liquid assets was accompanied by a strong expansion of economic activity, with the result that the relative liquidity of the nonbank public, as measured by the ratio of total liquid assets to GNP, declined in the first half of 1968. This ratio, which averaged 79.2 per cent in the fourth quarter of 1967, declined to 78.4 per cent in the second quarter of 1968.