Banking and Monetary Developments in the Fourth Quarter

Bank credit continued to expand in the fourth quarter although more moderately than in the third, the money supply grew at an accelerated pace, and member banks experienced increased pressure on their reserve positions. With economic activity extremely strong and an inflationary psychology prevalent, it became increasingly clear that the growth of money and credit was excessive. On December 17 the Board of Governors of the Federal Reserve System approved actions by the directors of nine of the Federal Reserve Banks raising the discount rate by ¼ percentage point to 5½ percent. Similar increases voted by the directors of the other three Reserve Banks were approved two days later. This restored the rate to the level prevailing from mid-April to mid-August, the highest in nearly forty years.

INTEREST RATES AND RESERVE POSITIONS

Money market rates rose substantially during the fourth quarter, with very sharp increases being registered in the closing weeks of the year. The rate for three-month Treasury bills, a key short-term rate that had fluctuated around 5.20 percent in September, peaked at a record high of 6.26 percent on December 24 and thereafter declined only slightly. As a result of the rise in rates, banks found it increasingly difficult to compete for funds through the issuance of large certificates of deposit (CD's). By early December, most banks were paying the CD ceiling rates established in mid-April under Regulation Q. These range from 5½ to 6¼ percent, depending on maturity. In December, CD liabilities at large weekly reporting banks declined substantially, and the net gain for the quarter was quite small.

Reserve positions of member banks came under growing pressure as the quarter progressed, and net borrowed reserves rose to an average of $354 million in December from a September average of $132 million. Member bank borrowings at the discount window increased slightly over the quarter as a whole. The effective rate on Federal funds fluctuated irregularly during most of the period but tended sharply upward during the last two weeks of December; in September it had averaged 5.78 percent, in December the average was 6.02 percent, but in the last two weeks of December the rate rose to an average of 6.10 percent. Rates on Euro-dollar funds increased throughout the quarter and were unusually high toward the end of December when a large number of United States corporations repatriated funds they had previously held on deposit in foreign banks. Thus, the New York City banks, who had made extensive use of this market as a source of funds during the third quarter, found it more costly to do so at a time when reserve pressures were intensifying.

With banks facing sustained strong loan demand and funds becoming more difficult to raise, the prime rate was moved up in December in two successive ¼ percentage point steps to 6¾ percent. The initial round of increases was started on the first business day of December and the second on December 18, the day the increase in the discount rate took effect. On January 7, 1969, the prime rate was raised again, to 7 percent. This is the highest rate in more than four decades.

BANK CREDIT

The growth of total commercial bank credit slowed to a seasonally adjusted annual rate of 10½ percent during the fourth quarter, after having accelerated sharply to a 19 percent rate during the third. However, this decline in the rate of expansion, which became evident during November and was even more pronounced in December, was largely the result of a sizable reduction in bank holdings of United States Government securities together with a sharp decline in securities loans. The composition of the quarter's seasonally adjusted $9.7 billion credit growth reflected the strong loan demand that was associated with the continued rapid rate of economic expansion. Although the overall growth in loans moderated somewhat, there was a record rise in loans other than securities loans. Bank investments, meanwhile, expanded by only $1.2 billion, seasonally adjusted. The modest size of this increase seems to have reflected the hesitancy of the banks to advance their holdings of securities at a time when loan demand was strong and the banks were anticipating a sizable attrition of maturing CD's.

Commercial banks reduced their Government securities portfolios during the quarter by 14½ percent, seasonally adjusted annual rate. In the preceding quarter, seeking to rebuild liquidity, they had acquired substantial amounts of Government securities as well as of other investments. All of the fourth-quarter liquidation occurred in November, when banks were anticipating participation in a $2 billion Treasury tax anticipation bill (TAB) issue for which they could make full payment by credits to Treasury Tax and Loan Accounts. The issue was paid for on December 2. During December, banks sold intermediate- and long-term Governments as well as many of the newly acquired bills, but largely as a result of the TAB issue they were left with a net increase in holdings of Government securities that partly offset the November liquidation. Despite the fourth-quarter reduction, banks increased their holdings of Government securities during the last half of 1968 by a substantial amount.

The fourth-quarter decline in holdings of Government securities was more than offset by purchases of "other securities"—principally tax-exempt obligations issued by states and municipalities—which were added to bank portfolios at a 21 percent seasonally adjusted annual rate. The rise constituted the largest quarterly increase in "other securities" in 1968. In December, however, the rate of increase, seasonally adjusted, moderated substantially.

Loans to securities dealers declined in the fourth quarter from the record level reached in the third. The large third-quarter increase had reflected financing of the record level of inventories built up by United States Government securities dealers over the summer, and the fourth-quarter decline in such loans largely reflected the reductions during the quarter in the average level of dealers' holdings. Loans to Government securities dealers were nonetheless high during the final quarter. Loans to stock market brokers and dealers also remained strong, probably owing to the heavy volume of stock market activity.

The growth rate of business loans—by far the largest single loan category—accelerated quarter by quarter in 1968 and reached a seasonally adjusted annual rate of just over 12 percent in the final quarter, though the pace of expansion moderated somewhat in December. The strong fourth-quarter increase can be related to increases in the rates of business inventory accumulation and fixed investment. Inventories rose in that quarter at an estimated $10 billion seasonally adjusted annual rate, up from the $7.5 billion rate of accumulation in the third quarter, and business fixed investment increased at a record rate of $4.1 billion, considerably more than the third-quarter rise.[1] Perhaps there was also some stimulus to business loans as a result of a slight easing in loan rates for part of the quarter. This temporary easing was exemplified by the changes in the prime rate, which was lowered in late September but raised again in December.

Real estate loans posted a strong 14 percent gain, continuing the marked strengthening that began in September. Contributing to this expansion were the large increases during the quarter in construction outlays and private housing starts; the latter reached a seasonally adjusted annual rate of nearly 1.6 million units in the fourth quarter, the highest in almost five years. Moreover, real estate loans became more attractive after the liberalization of usury law ceilings in a number of states during the summer of 1968.

Consumer loans rose during the fourth quarter by 11 percent, seasonally adjusted annual rate. Although this was a large increase, it was considerably below the third quarter's 14 percent advance. That was the period, however, when the income tax surcharge went into effect, cutting heavily into the growth of disposable income. Consumption expenditures had nonetheless increased sharply that quarter, financed heavily by credit. In the fourth quarter, the growth of disposable income was stronger, but the rise in consumption expenditures slowed dramatically. This was reflected in an increase in the savings rate. However, consumer indebtedness to all types of lenders (bank and nonbank) continued to grow rapidly. Although the rate of increase in loans extended to consumers by banks slowed a bit, at the same time the overall credit demands in the consumer sector affected banks indirectly by giving rise to a record increase in bank lending to nonbank financial institutions. The major borrowers in this category are sales and personal finance companies. The increased volume of such lending may indicate that these borrowers were finding banks a relatively more attractive source of funds as the money markets firmed. Along with rates on other market instruments, those on paper directly issued by finance companies increased throughout the quarter.

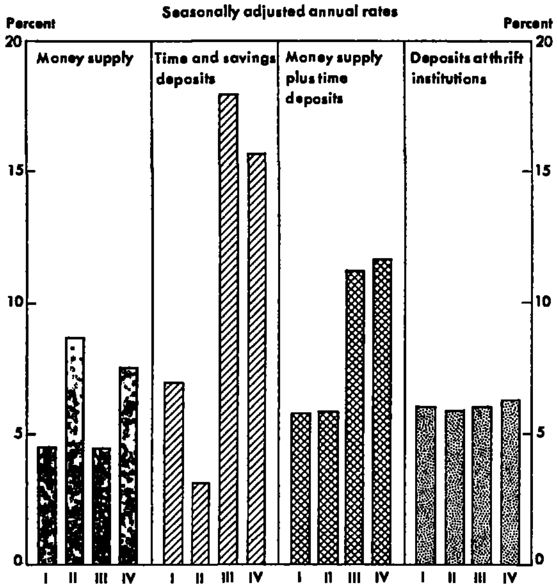
[1] For a more detailed discussion of third-quarter developments in business investment, see "The Business Situation", this *Review*, pages 27-28.

MONEY SUPPLY AND TIME DEPOSITS

The growth rate of the money supply—privately held demand deposits plus currency in circulation outside banks—accelerated in the October-December period to a seasonally adjusted annual rate of 7½ percent (see Chart I). This represented a sizable increase over the third quarter's 4½ percent expansion rate. The recent acceleration, which was especially strong in November, was in part a result of a substantial reduction in Treasury deposits at commercial banks, which added funds to the private sector. In November, Treasury deposits, which had been built up over the summer and early fall, declined by almost $2 billion. The net decline for the quarter is estimated at $1.4 billion. The rapid growth of the money stock may also have reflected increased needs for transactions balances due to the continuing high level of economic and financial activity.

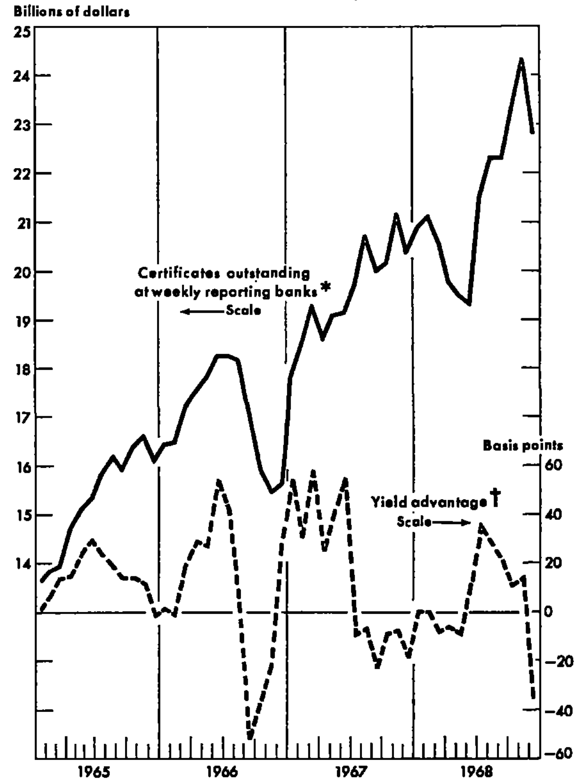
The steep climb in time and savings deposits at commercial banks that began last July and resulted in a third-quarter rise of 18 percent (seasonally adjusted annual rate) continued into the fourth quarter. However, the increase,

Chart I
1968 QUARTERLY CHANGES IN LIQUIDITY INDICATORS
Seasonally adjusted annual rates



Note: Percentage changes are based on the averages of daily figures for the last month of each quarter, except for thrift institutions. Percentage changes at the latter are based on the amount outstanding on the last day of each quarter.
Source: Board of Governors of the Federal Reserve System.

Chart II
LARGE CERTIFICATES OF DEPOSIT OUTSTANDING AND YIELD ADVANTAGE



* Outstanding on the last Wednesday of each month.
† Monthly average of most often quoted new issue rates on 90- to 179-day large certificates of deposit at nine large New York City banks less average yield on six-month Treasury bills.
Source: Board of Governors of the Federal Reserve System.

which amounted to 15½ percent for the quarter, seemed to be moderating toward the end of the year. Most of the third-quarter advance had reflected heavy inflows in the form of large CD's. During October and November, banks were still quite successful in attracting CD's, but as market rates continued to rise, the offering rates on such deposits ran into the limitations imposed by Regulation Q ceilings. By early December, most banks were quoting the ceiling rates on all CD maturities, but these rates were generally lower than those on competing financial instruments and banks began to lose a substantial volume of deposits as the CD's reached maturity. At weekly reporting banks, which include the institutions most active in the CD market, outstanding large CD's grew in October and November by a total of $2 billion and then fell in December by $1.5 billion (see Chart II). These data are unadjusted for seasonal variation, but the December decline was considerably larger than seasonal. Consumer-type time and savings deposits at weekly reporting banks increased by a total of $1.4 billion during the fourth quarter, most of the rise occurring in the month of October. This quarterly gain was virtually the same as the $1.5 billion increase during the third quarter. Although no data are available on the components of time and savings deposits at all commercial banks, the weekly reporting bank figures suggest that the rapid fourth-quarter increase in total time deposits reflected in part an increase in personal savings (which swung from a decline in the third quarter of $6.9 billion, seasonally adjusted annual rate, to a $4.3 billion increase in the fourth) and in part an increase in state and local government time deposits.

THRIFT INSTITUTIONS

The rate of growth of savings flows into thrift institutions advanced moderately in the October-December period, rising to 6.3 percent from the previous quarter's 6.1 percent. Share capital at savings and loan associations continued to grow at approximately the same 6.0 percent rate as in the third quarter, but deposits at mutual savings banks increased their growth from a 6.3 percent rate to an estimated 7.0 percent rate. The continued widening of the spread between rates on deposits at the thrift institutions and rates on comparable money market instruments presumably tended to retard flows to these institutions, but this development was apparently more than offset by gains reflecting the increased rate of personal savings. However, the largest monthly increase in flows occurred in October. As the year drew to a close, these institutions seemed to be having difficulty attracting new funds. The December growth in total deposits and shares at thrift institutions was the smallest, in absolute and relative terms, of the quarter. The sharp rise in the number of odd-lot purchases of Government securities in late December may have indicated that individual savings were being placed increasingly in money market instruments instead of in thrift institutions.

The thrift institutions increased their net acquisitions of mortgages during the fourth quarter by just over 7½ percent, up from 6 percent in the third quarter. Mutual savings banks added to their mortgage portfolios at a 6 percent annual rate, compared with a 4½ percent rate in the third quarter, while savings and loan associations increased their new mortgage lending even more sharply, the rise mounting from an annual rate of 6½ percent in the third quarter to 8½ percent in the fourth. The step-up in mortgage lending was partly a result of the demand for new housing, which remained strong in the fourth quarter despite increased financing costs. At the same time, builders and homeowners may have been accelerating their takedown of the large outstanding backlog of mortgage commitments in order to avoid the possibility of having to renegotiate terms at a later date.