Banking and Monetary Developments in the First Quarter

Bank credit and money supply expansion slowed sharply in the first quarter in response to the Federal Reserve System's policy of restraint. Two weeks before the quarter began, the Federal Reserve discount rate was raised ¼ percentage point to 5½ percent and open market policy was tightened substantially. Furthermore, the Regulation Q ceilings that set the maximum rates which commercial banks may pay on time and savings deposits were kept unchanged at levels curtailing the banks' ability to renew these deposits as they came due, especially in the case of large-denomination certificates of deposit (CD's).

The System's tightening of monetary conditions in late 1968 was reflected in a number of first-quarter developments. Bank credit growth slowed sharply in the first quarter to a 1½ percent annual rate, and the rate of increase in the narrowly defined money supply dropped to 2 percent. By contrast, in the last half of 1968 bank credit rose at a 15 percent annual rate and the narrow money supply rose 6 percent. Daily average deposits subject to reserve requirements — the bank credit proxy — declined at a 5 percent annual rate in the first quarter, after increasing at a 13 percent pace in the last half of 1968. Banks, however, were able to offset nearly half of the first-quarter decline in deposits by increasing their Euro-dollar borrowings. Interest rates on corporate, municipal, and long-term Government bonds moved steadily higher in the first quarter, as did rates on commercial paper. As reserve positions came under increasing pressure, Federal funds rates climbed and member banks borrowed heavily at the discount window. Euro-dollar rates also moved up, as some of the larger banks borrowed heavily in this market in an attempt to replace funds lost through rundowns in large CD's. Commercial banks began to lose large CD's in mid-December, when holders switched to other, higher yielding investments, and continued to lose them in large amounts throughout the first quarter. Nonetheless, banks increased their real estate and consumer loans at rapid rates, and business loans grew at the fastest clip since the second quarter of 1966. Faced with heavy loan demand and substantial losses of large CD's, commercial banks twice raised the prime rate during the first quarter, bringing it to a record 7½ percent on March 17. With loans increasing rapidly and CD liabilities declining, banks were forced to sell large quantities of United States Government securities and to limit greatly their acquisitions of other investments.

Despite monetary and fiscal restraint, the economy continued to expand at an inflationary pace during the winter months. As a result, shortly after the end of the first quarter the Board of Governors approved actions by the directors of the twelve Federal Reserve Banks further increasing the discount rate to 6 percent. In an additional move against inflation, the Board of Governors increased reserve requirements against all member bank demand deposits by ½ percentage point—an action that increased required reserves by about $650 million.

INTEREST RATE DEVELOPMENTS AND MEMBER BANK RESERVE POSITIONS

Most market interest rates moved higher during the first quarter, increasing from already high levels. The bank prime rate—the interest rate which commercial banks charge their most creditworthy corporate borrowers—had been increased twice in December, to 6½ percent on December 2 and then to 6¾ percent on December 18. In early January the prime rate was raised further to 7 percent, and in mid-March was moved up again to a record 7½ percent. Yields on most municipal, corporate, and long-term Government bonds also increased during the first quarter, but by somewhat smaller amounts. Yields on Government securities maturing in three to five years rose 34 basis points over the quarter to an average of 6⅓ percent in March, while new issue rates on high-grade corporate bonds rose about 55 basis points to 7½ percent in March. Rates on prime four- to six-month commercial paper rose more steeply, climbing 65 basis points to 6.8 percent in March. Throughout the quarter, most of quoted bank offering rates on large CD's were uniformly at their Regulation Q ceilings, which range from 5½ percent on the shortest maturities to 6¼ percent on the longest.

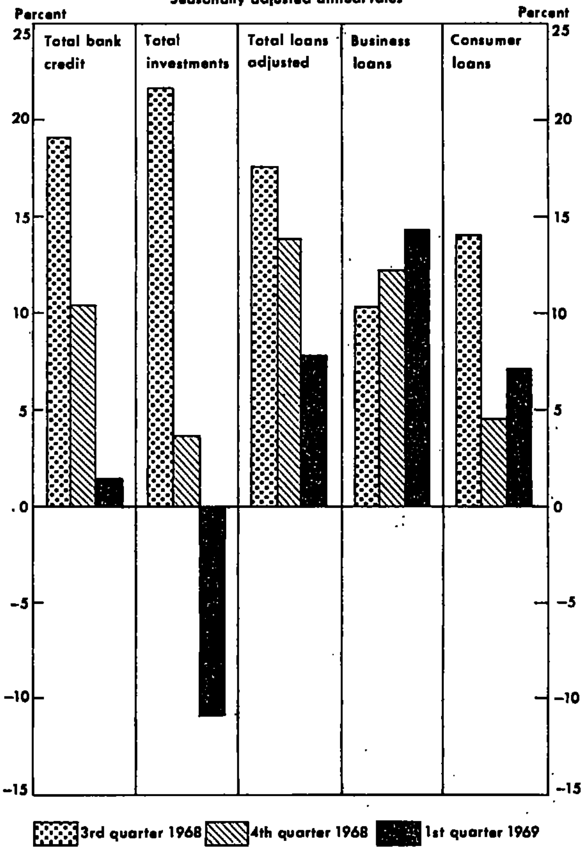
Treasury bills provided an exception to the general upward trend in market interest rates in the first three months of the year. Rates on three-month Treasury bills, which had reached a record 6¼ percent in late December, fell slightly over the quarter to just under 6 percent by the end of March. The low level of new Treasury borrowings, together with a broadly based demand for bills, helped reverse the strong upward pressure on bill rates that had prevailed throughout the last quarter of 1968.

Reserve positions of member banks came under greater pressure during the quarter, and discount window borrowings increased substantially. Reserves required to be held against demand and time deposits fell $233 million from December to March. However, nonborrowed reserves—those supplied through open market operations—dropped $605 million. Consequently, member banks found it necessary to increase their borrowings at Federal Reserve Banks from an average of $752 million in December to $918 million in March. At the same time, member bank excess reserves were reduced from an average of about $450 million in December to a 37-year low of $180 million in March. These developing pressures on marginal reserve positions were associated with a steady rise in interest rates on Federal funds, which climbed from an average of 6.0 percent in December to 6.8 percent in March.

Chart I

CHANGES IN BANK CREDIT AND ITS COMPONENTS AT ALL COMMERCIAL BANKS

Seasonally adjusted annual rates



BANK CREDIT

The growth of total commercial bank credit slowed sharply to a seasonally adjusted annual rate of 1½ percent in the first quarter (see Chart I). Bank credit growth had been at a 19 percent annual rate in the third quarter of 1968, but had dropped to about half that pace in the final three months of the year. The further decline in the rate of bank credit expansion during the first three months of this year was reflected in a large reduction in bank holdings of Government securities together with a sizable decline in securities loans. Consumer, business, and real estate loans continued to expand rapidly in response to strong credit demand associated with rapid economic growth and continued inflationary expectations. Thus total loans, excluding securities loans, expanded at an 11 percent rate with business loans leading the advance. Total investments were reduced at an 11 percent rate, the first overall contraction of investments since 1966, with all the drop attributable to net sales of United States Government securities.

Commercial banks reduced their holdings of Government securities at a 30 percent seasonally adjusted annual rate during the quarter. This was the most rapid rundown of banks' Government securities portfolios in at least two decades, and it left their total dollar holdings of these securities at the lowest level in nearly two years. Sales of securities were particularly rapid in February, when loan demand was at its peak for the quarter. However, banks continued to be net sellers of Government securities in March despite takings of sizable amounts of the March 3 Treasury bill offering, which could be purchased by crediting Treasury Tax and Loan Accounts. Banks in the first quarter continued to add to their holdings of other securities, principally tax-exempt municipal bonds, but additions to these investments dropped to a third of the pace set in the preceding six months.

Heavy nonbank demand for Treasury obligations in the first quarter and a low level of Treasury borrowing contributed to a reduction in the inventories of Government securities dealers. Municipal bond dealers also cut back their inventories as prices trended lower in that market. Additionally, the demand for stock market credit fell, as the problem of delivery "fails" moderated substantially and as speculative activity subsided. Consequently, bank securities loans fell at an extremely rapid 62 percent annual rate from December to March. As is usually the case, securities loans moved in a quite erratic week-to-week pattern during the quarter. Thus, although the trend was strongly downward, there were several brief periods when securities loans outstanding were increased. Generally these increases were associated with Treasury financings, during which Government securities dealers temporarily added to their inventories.

Business loans grew at a seasonally adjusted 14½ percent annual rate in the first quarter of 1969, the most rapid quarterly increase since the second quarter of 1966. This heavy business loan demand was probably related to a variety of factors. Spending for inventories and plant and equipment was substantial during the first quarter, leading to heavy business demand for funds generally. In addition, tax payments in January and March absorbed large amounts of corporation funds. Finally and perhaps most importantly, it is probable that businesses borrowed heavily in January and February in anticipation of higher cost and reduced availability of credit at banks. In this connection, business loan growth moderated sharply in March, especially following the midmonth prime rate rise, though growth in April appears to have again been sharp.

Bank real estate and consumer lending also expanded strongly during the first quarter, although real estate lending slowed somewhat from the pace set last fall. Real estate loans increased at an 11¾ percent annual rate, compared with a 14 percent fourth-quarter gain. Construction activity advanced strongly in the first quarter, contributing to the further expansion of mortgage loans despite the increased pressures on banks' loanable funds. Consumer loans outstanding grew at a fairly rapid 7 percent seasonally adjusted annual rate, up from the 4½ percent fourth-quarter increase. In the first quarter, consumer borrowing reflected the step-up in consumption expenditures in the face of greatly reduced growth in disposable personal income. Moreover total consumer borrowing from all sources increased more rapidly during the first quarter than did consumer borrowing from banks.

The loan-deposit ratios of banks moved higher during the first quarter, reflecting the pressures on bank liquidity that arose from strong loan demand and reduced deposit growth. For all commercial banks the ratio of loans to deposits reached 66 percent in February and 67 percent in March. Both levels exceeded the previous postwar record reached in the fall of 1966. At the New York City weekly reporting banks, loan-deposit ratios jumped from 80 percent in December to 88 percent by the first quarter's end, more than 6½ percentage points above the highest 1966 levels. However, this latter development can be placed in better perspective by including Euro-dollar borrowings in the denominator of the ratio since, among New York banks especially, these borrowings were a major source of funds for new loans during this quarter. Inclusion of such liabilities in the denominator reduces the March loan-deposit ratio for New York banks to 75 percent, slightly below the 1966 peak measured on the same basis.

MONEY SUPPLY AND TIME DEPOSITS

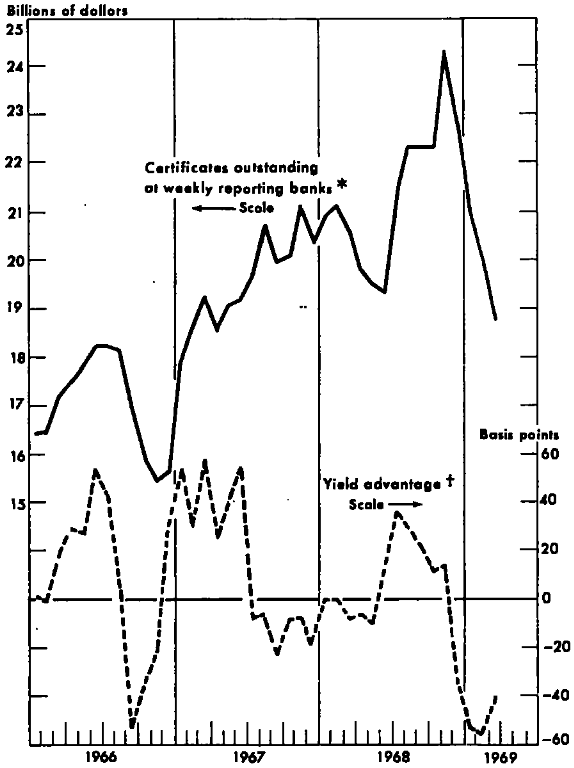
The daily average money supply—privately held demand deposits plus currency in circulation outside banks—grew at a 2 percent seasonally adjusted annual rate over the first quarter, much below the 6½ percent rate for the preceding twelve months. The first-quarter money supply increase was comprised of a ½ percent annual rate gain in private demand deposits and a 7½ percent rate of increase in the currency component. This slowing of money supply growth appears for the most part to have reflected the tighter monetary policy prevailing since last December. Treasury deposits with member banks increased $0.7 billion during the quarter, but this development probably contributed little to the slowing of the private money supply since increases in Treasury balances ordinarily reduce private money holdings substantially less than dollar for dollar. There may, however, have been some reduction in the demand for money balances associated with the sharp decrease in the volume of stock market transactions during the quarter.

After large gains in the summer of 1968, time and savings deposit growth at commercial banks slowed in the closing months of the year and then became negative in January when banks lost large CD's in volume (see Chart II). CD losses moderated later in the quarter, but nevertheless totaled $4 billion for the period from the end of December to the end of March. By early last December, market offering rates on new CD's had reached the ceilings imposed by Regulation Q, and rates on other short-term securities continued to rise. In late December, six-month Treasury bills yielded over 60 basis points more than 90- to 179-day CD's, and three-month Treasury bills were yielding about 80 basis points more than CD's of less than 90-day maturity. By the end of the first quarter, rates on Treasury bills had moderated somewhat, and their yield advantage over CD's, though still wide, had dropped to about 30 basis points in the case of six-month bills and about 45 basis points in the case of three-month bills. Savings deposits also declined marginally during the quarter, other time deposits rose somewhat, and total time and savings deposits contracted at a 6½ percent annual rate.

In an effort to regain the deposits lost through the CD runoff, the larger commercial banks—particularly those in New York City—borrowed heavily in the Euro-dollar market. Large commercial banks in New York City increased their liabilities to their foreign branches by about \$2.5 billion during the quarter, even though Euro-dollar interest rates remained near or above 8 percent. All commercial banks with overseas branches registered an increase in Euro-dollar liabilities totaling \$3.9 billion. While Euro-dollar borrowing may have little or no impact on aggregate banking system resources, this offshore market has increasingly become a major vehicle by which funds are reallocated within the domestic banking system, especially in periods when Regulation Q ceiling rates on large CD's place severe pressures on the larger banks in the country.

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.

THRIFT INSTITUTIONS

The growth of savings accounts at thrift institutions was little changed in the first quarter despite a sharp reduction in overall consumer saving. Share capital at savings and loan associations and deposits at mutual savings banks together registered a seasonally adjusted annual-rate increase of 6 percent, not significantly different from that of the preceding quarter. Savings and loan associations maintained their recent growth trend of about 6 percent, while mutual savings bank deposits slowed to a 6¼ percent annual rate of increase following an accelerated 7 percent gain in the fourth quarter of last year. Thus, the thrift institutions so far appear to have been little affected on balance by the increased monetary restraint exerted by the Federal Reserve System.

The sustained growth of savings capital at the thrift institutions has permitted their mortgage lending—principally on residential properties—to increase at a solid pace. The mortgage portfolios of the savings and loan associations rose at an annual rate of 8.4 percent in the first quarter, after seasonal adjustment, while mutual savings banks' mortgages climbed 6.2 percent. In both cases, these latest increases were slightly higher than average 1968 gains.