Banking and Monetary Developments in the Third Quarter

The pressures of continued strong monetary restraint were clearly evident in the third quarter of 1969. The major banking and monetary aggregates all grew more slowly, or fell more rapidly, than they had during the first half of the year, and interest rates moved to still higher levels. Over the span of the quarter, total bank credit outstanding actually declined somewhat after seasonal adjustment, the shrinkage of time deposits at commercial banks accelerated sharply, and the growth of the narrowly defined money supply slowed to a barely perceptible pace. Though commercial banks continued to reduce their holdings of investments in order to meet loan demands, the cumulative impact of restraint was also reflected in a slower expansion of the aggregate loan portfolio of banks and of the major individual loan categories as well. The evidence also suggests that the impact of monetary restraint was felt to an increasing degree by banks outside the major money centers.

In the face of further heavy deposit losses, banks continued to exploit various channels for attracting nondeposit funds. The borrowing of Euro-dollars from foreign branches and other banks abroad has for some time been a very important source of such funds. Recent months, however, have seen a proliferation of other devices, the most important one being issuance of commercial paper by bank holding companies which, in turn, may purchase financial assets from their affiliated banks. The volume of bank-related commercial paper expanded rapidly over the quarter. The rise in domestic banks' liabilities to their foreign branches, on the other hand, moderated during the summer, and September saw an actual decline. To some extent the latter development may have been related to two regulatory actions by the Board of Governors of the Federal Reserve System. These actions were aimed at removing a special advantage to those member banks that have access to Euro-dollar borrowings as a means of adjusting to domestic credit restraint. First, the System acted early in the summer to eliminate some of the attractiveness of Euro-dollar borrowing by closing a loophole in the regulations governing reserve requirements. Effective July 31, member banks were required to include in demand deposits subject to reserves the so-called "bills payable checks" and "London drafts" issued in settling transactions with foreign branches. Then, effective early in September, marginal reserve requirements were placed on member bank borrowings from their own foreign branches or from other banks abroad, on domestic assets sold by member banks to their foreign branches, and on credit extended to United States residents by such branches.

INTEREST-RATE DEVELOPMENTS AND MEMBER BANK RESERVE POSITIONS

The pressures of sustained monetary restraint, coupled with persistent demands for credit, resulted in a continued rise in market interest rates throughout the third quarter. Yield advances on United States Government securities were especially pronounced, partly reflecting continued selling by commercial banks. The rate on three-month Treasury bills climbed 65 basis points over the quarter to an average of 7.08 percent in September, while the average yield on Government securities maturing in three to five years rose 94 basis points to 7.58 percent. Yield increases on intermediate- and longer term Treasury issues were particularly sharp in September, when the Treasury carried out a large refunding in a period which also saw a very substantial volume of new corporate issues reach the markets. The Treasury offering included three notes of varying maturities priced at the highest yields on comparable issues in more than a century. The average rate on new issues of high-quality corporate bonds rose about 40 basis points over the quarter to 8 percent in September, and rates on commercial paper and bankers' acceptances also continued to move higher. Throughout the period the offering rates quoted by commercial banks on large certificates of deposit (CD's) remained at the Regulation Q ceilings, which range from 5½ percent on the shortest maturities to 6¼ percent on the longest, yet banks experienced an increased attrition of these deposits as competing interest rates rose further. After the interest-crediting period at the end of the second quarter, banks also lost substantial amounts of other time and savings deposits.

Reserve positions of member banks remained under pressure from open market operations during the third quarter. In addition, the amendment to the Federal Reserve Board's Regulation D, requiring banks starting July 31 to count as deposits subject to reserve requirements bills payable checks and London drafts arising out of transactions with their foreign branches, had the effect of raising required reserves rather substantially for some banks. This action resulted in an immediate increase of approximately $3 billion in "net demand deposits"—deposits subject to reserve requirements—centered largely at the major New York City banks. There was a small decline in total member bank reserves during the third quarter, and nonborrowed reserves — those supplied through open market operations—were virtually unchanged between June and September. Net borrowed reserves fluctuated throughout the quarter around the very high June average of about $1 billion. The effective rate on Federal funds increased from an average of 8.9 percent in June to 9.2 percent in August, and stayed at that level in September.

BANK CREDIT

The pressures on bank credit availability intensified over the summer. The expansion of loans and investments at banks had already slowed in the first half of the year, when growth fell to a 3 percent annual rate from 15 percent in the last half of 1968. In the third quarter, a small rise in July was not quite large enough to offset declines in August and September, and bank credit actually declined about ½ percent at an annual rate (see Chart I).

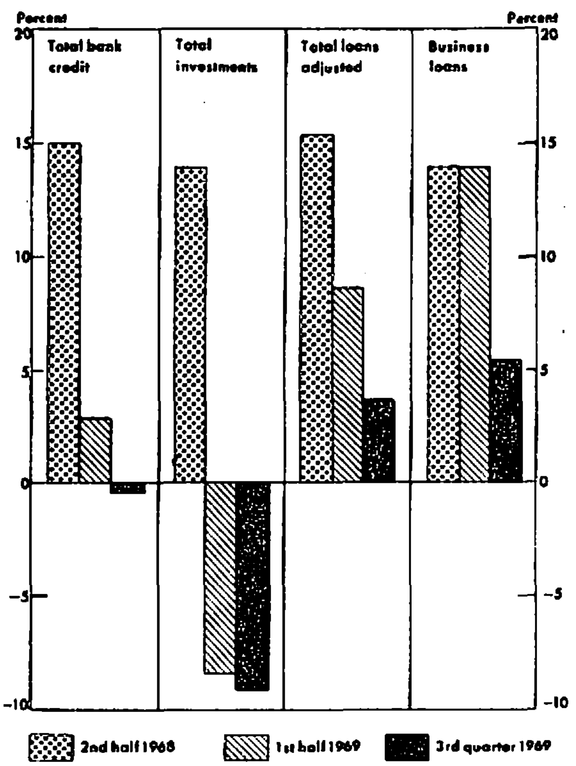
Throughout the first nine months of the year, banks reduced their securities investments in order to accommodate borrowers. The aggregate runoff of investments was a bit steeper in the third quarter than in the first half of the year. Holdings of other securities, comprised largely of tax-exempt state and local obligations, fell at a sharply faster rate, but the decline in United States Government securities moderated substantially. The rate of loan expansion slowed appreciably in the third quarter, suggesting that banks were finding it increasingly difficult and expensive to finance loan growth through sales of securities. It might be noted, however, that the interpretation of bank credit data has become increasingly complicated this year, as banks have resorted in growing measure to the sale of loans—mainly to their foreign branches and to affiliated holding companies—in an attempt to adjust to the pressures of monetary restraint. Such sales result in an understatement of the volume of credit originated through the banking system. The available data suggest, however, that these loan sales have not been of sufficient magnitude to distort the general picture of a progressive slowdown in bank credit that is evident from the trends in banks' balance sheet positions discussed below.

A decline in bank loans to securities dealers, following a moderate rise in the second quarter, contributed to the third-quarter slowdown in aggregate loan expansion. Securities loans tend to vary with dealers' inventories, and these remained stable throughout most of the summer at a volume about one half as large as that during the summer of 1968. Nevertheless, the growth of loans other than securities loans was also restrained. Without adjustment for bank sales of loans, total loans excluding securities loans expanded at a seasonally adjusted annual rate of 4½ percent in the third quarter, compared with a 10½ percent rate of increase registered in the first half.

There was a considerable reduction in the growth rate of business loans during the third quarter (see Chart I). These credits, which generally account for about one third of total bank loans outstanding, grew at a seasonally adjusted annual rate of 5½ percent during the July-September period, far below the rate of about 14 percent registered in both the first half of 1969 and the second half of last year. However, the sale of loans to foreign branches and domestic affiliates often involves business loans and thus can be assumed to have limited the rise this year in business loan holdings reported on bank balance sheets. Nevertheless, even after adjustment for the effect of such loan sales, there was still a substantial moderation in business loan growth in the third quarter following some slowing in the preceding quarter. Data from the weekly reporting banks, not adjusted for seasonal variation, indicate that the weakness in business loans during the third quarter was concentrated at banks outside New York and Chicago. Business loans at these banks declined by almost $800 million during the third quarter, compared with virtually no change over the same period in each of the two preceding years. On the other hand, there was a strong increase in business loans at banks in New York City, while the volume outstanding at banks in Chicago remained at about the June level. This pattern was strikingly different from that of the first half of this year and suggests that banks outside New York and Chicago were beginning to feel the burden of restraint more keenly.

The deceleration in the growth of real estate and consumer lending, which initially appeared in the first quarter, continued into the third. Real estate loans showed the more pronounced slowdown, growing at an annual rate

Chart I
CHANGES IN BANK CREDIT AND ITS COMPONENTS AT ALL COMMERCIAL BANKS
Seasonally adjusted annual rates



of 4 percent in the third quarter as compared with 10½ percent in the first six months of 1969. Bank loans to consumers, after expanding at a 7½ percent rate over the first half of the year, slowed to about a 6 percent growth rate in the summer.

The volume of outstanding loans to nonbank financial institutions turned down in June and continued to fall on balance through the third quarter. Over the quarter as a whole, the decline was at an annual rate of 9½ percent, seasonally adjusted. Interest-rate differentials may have been a factor in this development. In June, the month in which the recent downturn began, banks raised the prime lending rate a full percentage point to 8½ percent. Although market interest rates continued to advance over the summer, the commercial paper market remained an attractive alternative to borrowing from banks. Thus the seasonally adjusted volume of directly placed commercial paper—paper primarily issued by finance companies—registered a considerably larger increase in the third quarter than it had in the second.

Commercial bank holdings of United States Government securities declined on a seasonally adjusted basis for the fourth successive quarter. The pace of the runoff has slowed, however. The $1.5 billion drop in the third quarter virtually equaled that of the preceding three months but was only about one third the size of the liquidation in the first quarter of the year. On the other hand, seasonally adjusted bank holdings of other securities—principally state and local government obligations—fell by $1.4 billion in the July-September period, compared with a decline of only $0.5 billion in the second quarter. Banks reduced their positions in municipal securities at a time of considerable uncertainty about Congressional action that might affect the tax-exempt status of state and local obligations. The stepped-up pace of liquidations of other investments relative to investments in Government securities may also indicate that banks were finding it difficult to make further reductions in Government securities portfolios. A large proportion of Government securities is pledged as collateral against Government demand deposits with banks.

MONEY SUPPLY AND TIME DEPOSITS

The rate of growth of the narrow money supply was markedly reduced in the third quarter. The daily average money supply—privately held demand deposits plus currency in circulation outside banks—remained about unchanged on a seasonally adjusted basis during the third quarter, down from a rate of about 4¼ percent in the first half of the year. The slowdown brought the money supply growth rate for the first nine months of 1969 to 3 percent, sharply below the increase of a bit more than 7 percent registered in 1968.

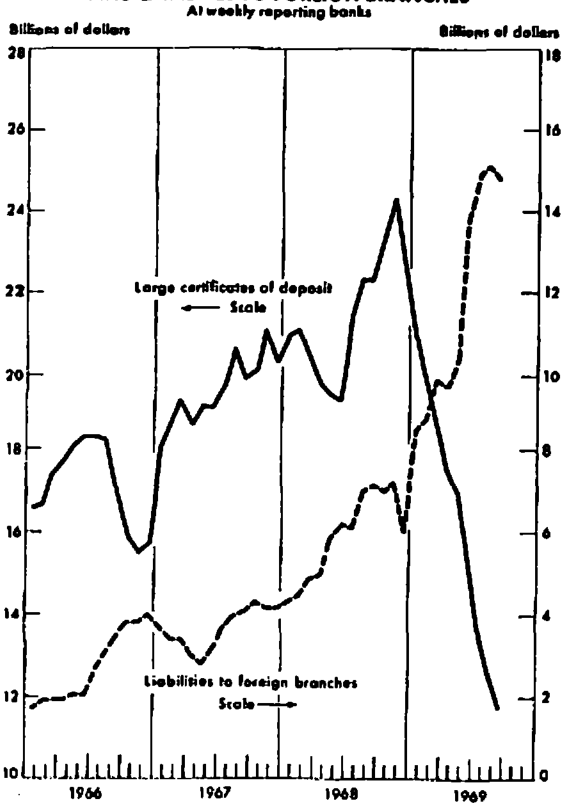
The regular annual revision of the money supply statistics was released in September. As is usual, this revision incorporated new data provided by the semiannual commercial bank call reports and a recalculation of seasonal adjustment factors. This year, in addition, the demand deposit component was subject to a further revision—first published on an interim basis in August—to correct for an understatement introduced by the growing volume of cash items in process of collection associated with Euro-dollar transactions. In the bank data used in estimating the money supply, aggregate demand deposits are reduced by the amount of cash items in process of collection, to avoid a double counting of deposits. Under previous procedures, certain checks written in the settlement of transactions involving banks' foreign branches were counted in cash items by banks receiving them but were not required to be counted in the deposits of the banks remitting them. This resulted in an understatement of demand deposits in the hands of the public and thus a growing downward bias in the money supply. The understatement ceased as of August, when Federal Reserve regulations were amended with respect to the definition of member bank demand deposits subject to reserve requirements. At that time, data were collected for an estimate of the magnitude of the past understatement. The net result of this change, together with the regular September revisions, was to raise the money supply growth rate in 1968 and the first half of 1969 to a slightly faster pace than had been previously reported.

The decline of time and savings deposits at commercial banks accelerated in the third quarter. Daily average time and savings deposits, seasonally adjusted, fell at an annual rate of 13 percent, compared with a 4 percent rate of decline in the first six months of the year. The sharp increases in market rates on competing short-term securities led to an increase in CD attrition at many banks. Banks not only continued to experience heavy losses of maturing large CD's—those in denominations of $100,000 or more—but also found it increasingly difficult to retain other time and savings deposits, especially after interest payments had been credited at the end of the second quarter. Weekly reporting bank data, which are not adjusted for seasonal variation, indicate that time deposit losses in the third quarter centered at banks outside the major financial centers. About two thirds of the $3.5 billion third-quarter decline in large CD's outstanding at weekly reporting banks (see Chart II) occurred at banks outside New York and Chicago. These banks also sustained more than one half of the total reduction of $2.4 billion in other time and savings deposits. These third-quarter developments represented a shift from the pattern in the first half. In that period, CD losses had been concentrated at New York and Chicago banks, which accounted for $4.5 billion of an aggregate $7.5 billion decline. By the same token, weekly reporting banks in New York and Chicago experienced a moderate decline in other time and savings deposits in the first half of 1969, while banks outside those cities had increased somewhat their holdings of such deposits. The third-quarter shift in the pattern of deposit losses at weekly reporting banks further suggests that the impact of restrictive monetary policy was being felt in growing degree by banks outside the two main financial centers. It remains true, nevertheless, that over the first nine months of 1969 banks in New York City and Chicago lost a volume of CD's equal to about two thirds of the amount outstanding at the end of 1968, whereas the loss at banks outside these centers was only about one third of the end-of-1968 level.

Chart II

LARGE CERTIFICATES OF DEPOSIT AND LIABILITIES TO FOREIGN BRANCHES*

At weekly reporting banks



* Outstanding on the last Wednesday of each month.

Source: Board of Governors of the Federal Reserve System.

In an effort to replace funds lost in the outflow of time deposits, the larger banks continued to rely upon the Euro-dollar market as a source of funds. However, the $1 billion third-quarter increase in commercial bank borrowings from their own foreign branches was considerably smaller than the advances of almost $4 billion registered in both the first and second quarters. Bank liabilities to their own foreign branches in fact declined by about $400 million in September after the Board of Governors of the Federal Reserve System amended its Regulations D and M, placing 10 percent marginal reserve requirement on member bank Euro-dollar borrowings above those outstanding in a base period. Banks also used the domestic commercial paper market as a source of funds throughout the third quarter. Indeed, the volume of outstanding commercial paper issued by bank-affiliated holding companies and subsidiaries increased by more than $1.2 billion during the period to a level of $2.5 billion. In many cases a holding company or subsidiary purchases loans from its affiliated bank, and thus channels funds it obtains through the issuance of commercial paper to the bank for lending and investing. However, on October 29, the Board of Governors of the Federal Reserve System announced that it was considering an amendment to its Regulation Q that would subject such bank-related commercial paper, or similar obligations, to the interest-rate ceilings that apply to large CD's. The Board stated that the proposed changes are necessary because the purposes of reserve requirements and interest-rate ceilings were in danger of being frustrated, to a substantial degree, as a result of the issuance of bank-related commercial paper. Moreover, in a separate but related action, the Board ruled that commercial paper issued by subsidiaries of member banks is in the same status as obligations issued directly by the banks and is, therefore, covered by existing provisions of Regulations Q and D.

THRIFT INSTITUTIONS

The continued increase in market rates of interest cut heavily into savings deposit growth at thrift institutions during the third quarter. Paralleling the experience of commercial banks, both the savings and loan associations and the mutual savings banks sustained small outflows of funds in July, on a seasonally adjusted basis, after quarterly interest payments were credited to funds held on deposit during the April-June period. Subsequently, flows to these institutions began to improve somewhat, but the seasonally adjusted 2 percent annual rate of deposit growth posted in the third quarter was only half the second quarter's gain. Despite the pressure of reduced deposit growth, mortgage lending by savings and loan associations and mutual savings banks slowed only slightly during the third quarter. Mortgage holdings grew at about a 6 percent annual rate during the period, compared with a 7½ percent expansion in the second quarter. Over the first nine months of this year the increase in mortgages held by the thrift institutions was somewhat larger than the increment recorded during the same period of 1968. The Federal Home Loan Bank Board has actively supported the mortgage market this year by reducing the requirements for savings and loan associations' liquid asset holdings and by maintaining an expansive policy with regard to advances made to the associations. During the third quarter alone, the savings and loan associations increased their borrowing from the Federal Home Loan Banks by $1.5 billion, bringing the total net borrowing for the year to $2.7 billion or only about $400 million less than funds obtained through increases in deposits.