Research Department
Federal Reserve
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Curtains for '74

Although operating in a recession atmosphere, commercial banks in 1974 faced record money rates fanned by rampant inflation and heavy business-credit demands. The more successful banks adjusted well to this unorthodox mix, racking up record profits from a massive expansion in loans at record rates of return. But some banks fared badly, however, because of large loan losses, foreign-exchange difficulties and securities losses. The strains which developed as the year progressed brought about a fundamental reassessment of bank goals, as managements shifted their focus to the soundness of their basic structure rather than asset growth and expansion of banking markets. In sum, last year left a legacy of major problems which banks will have to surmount in 1975.

Chronology

After two and a half months of relative stability in early 1974, the financial scene was beset by rising money rates which reached all-time highs in mid-summer. Heavy business-credit demand converged on the nation's financial markets, and most importantly on the banks. By midyear financial markets became severely strained as business firms ran into trouble meeting their credit needs in the commercial paper and capital markets, and as bankers themselves became more cautious and restrictive in their lending policies.

The narrowly-defined money supply (M_1) grew at annual rates of 5.5 and 6.5 percent, respectively, in the first two quarters of the year, but at only a 1.6-percent rate in the tighter July-September period. Then, as signs of a deepening recession became increasingly evident, Federal Reserve policy eased somewhat; at its September meeting, the Federal Open Market Committee sought "to achieve bank reserve and money-market conditions consistent with moderate growth in monetary aggregates over the months ahead." But money-supply growth responded disappointingly with only a 4.1-percent rate of growth for the final quarter.

The Fed shifted reserve requirements in September and late November, primarily with the intention of lengthening the maturity structure of bank liabilities. This week it made a more overt move toward ease by reducing reserve requirements on demand deposits by a full percentage point, to 16.5 percent, on deposits over $400 million. Also, it reduced the discount rate in two separate steps, to 7¾ percent in December and to 7¼ percent early this month.

Despite 1974's exceedingly difficult economic environment, total bank credit increased to a record $686 billion—a $51 billion (8-percent) gain, almost all of which was recorded in the first half of the year. Loans accounted for the vast bulk of the increase; for the second year in a row, banks added only modestly to their security portfolios, although this was due mostly to a net reduction in holdings of U.S. Treasuries.

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Business loans dominated the overall expansion with a $25-billion (16 percent) increase, almost equal to the massive 1973 expansion. Business loans increased at a very rapid pace until about midsummer, but then the expansion rate became erratic, and in December business demand declined dramatically. The strong credit demand evident for most of the year stemmed from inflation-induced increases in operating costs (particularly for carrying inventories), from supply and energy shortages, and from delayed completion dates on business-investment projects.

CD difficulties

To finance 1974's strong credit expansion, banks again relied more heavily on "liability management" than on more traditional capital sources of funding. Demand-deposit growth was relatively small, reflecting the late-year slowdown in the money supply. Savings and time deposits (other than large CD's) expanded about $30 billion, slightly less than in 1973. But large-denomination negotiable CD's—the largest single source of funds—expanded by $29 billion, or considerably faster even than the preceding year's $19½-billion increase.

Heavy reliance on these high-cost and highly volatile funds caused problems for banks, particularly around mid-year when financial markets became badly strained. As investors shifted their funds to only the largest and strongest banks, other banks outside the top tier found it difficult to obtain money, even at premium rates. (Meanwhile, banks generally found it difficult to match their relatively short-maturity CD's with their longer-maturity loan assets.) In addition, CD funds were very expensive; offering rates reached 12 percent in midsummer.

Banks obtained relatively few funds from outright sales of loans to their foreign branches, holding companies and affiliates. However, they borrowed a record amount through purchases of Federal funds, notwithstanding record rates which reached an all-time high of 13.55 percent at mid-year. Member-bank borrowing at the Federal Reserve discount window also exceeded any previous level, partly because of the money squeeze but also because of the heavy borrowings of the troubled Franklin National Bank. These funds cost 8 percent during most of the year—a record, although far below the cost of other sources of funds.

In the first half of 1974, banks had trouble covering the rapidly rising cost of the funds which they needed to accommodate their strong loan demand. They had lowered the prime rate from 9¾ to 8¾ percent during the relatively calm opening months of the year, but as money rates began to soar they pushed up the prime to a record 12 percent

in early July. Banks held the prime at that level until early October, somewhat after market rates turned downward, and thereafter they kept the prime from falling as rapidly as the rates on the funds they borrowed. At year-end the prevailing prime of 10½ percent was more than 3 percent higher than the Fed-funds rate. This high and widening spread—a normal phenomenon for the recession phase of the business cycle—naturally helped to boost profit margins, and it also played a role in moderating loan demand and in building up bank reserves as a cushion to absorb loan losses.

Legacy for '75

In assessing the 1975 outlook, we should remember that many banks deliberately slowed their rate of loan expansion in late 1974 to bring their assets and liabilities into better balance. Banks also reexamined the quality of their assets, increased their loan-loss provisions for risk assets, and initiated steps to improve their capital ratios. Many of these corrective actions are still being pursued—necessarily so, because banks are going into 1975 in a less liquid position and with reduced capital ratios. Banks which turn to the capital markets for funds may get little help there because of the heavy volume of corporate offerings, not to mention the huge Treasury demands caused by soaring Federal deficits.

Bank loan demand has declined seasonally in recent months, and it is not likely to explode again as it did in 1973 and 1974. However, the financing of involuntary accumulations of inventories and rising receivables, at still high prices, should help to sustain business-loan demand in coming months. Banks again may have to carry some borrowers who are not able to obtain accommodation in the capital market. Meanwhile, the deteriorating economy could worsen the problem of loan losses as increasing numbers of firms encounter liquidity problems.

With consumers boosting their savings, as they normally do during recessions, and with bank deposit rates again becoming competitive, banks should benefit from an improved inflow of relatively inexpensive household deposits this year. Also, with business capital expenditures probably lagging, a larger pool of corporate funds could become available for investment in CD's. In the near-term, some of the proceeds from the current heavy volume of corporate issues also may be invested in CD's, since the expenditure of such funds normally is spaced over time. The recent sharp decline in the cost of funds, along with a lagged adjustment in the prime rate, could generate wider profit margins for some banks, although others could find their profits limited by a slowdown in loan expansion and actual losses on some loans.

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