Federal Reserve Bank of San Francisco

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Business Review

Monetary Policy: A Letter

... Chairman Burns examines the record of monetary policy, in a letter to Senator Proxmire.

Weakening Boom?

... The Western boom showed signs of weakness even before the onset of the energy crisis.

Fueling Bank-Loan Growth

... Third-quarter loan upsurge helped by sell-off of securities and by expansion of CD funds.

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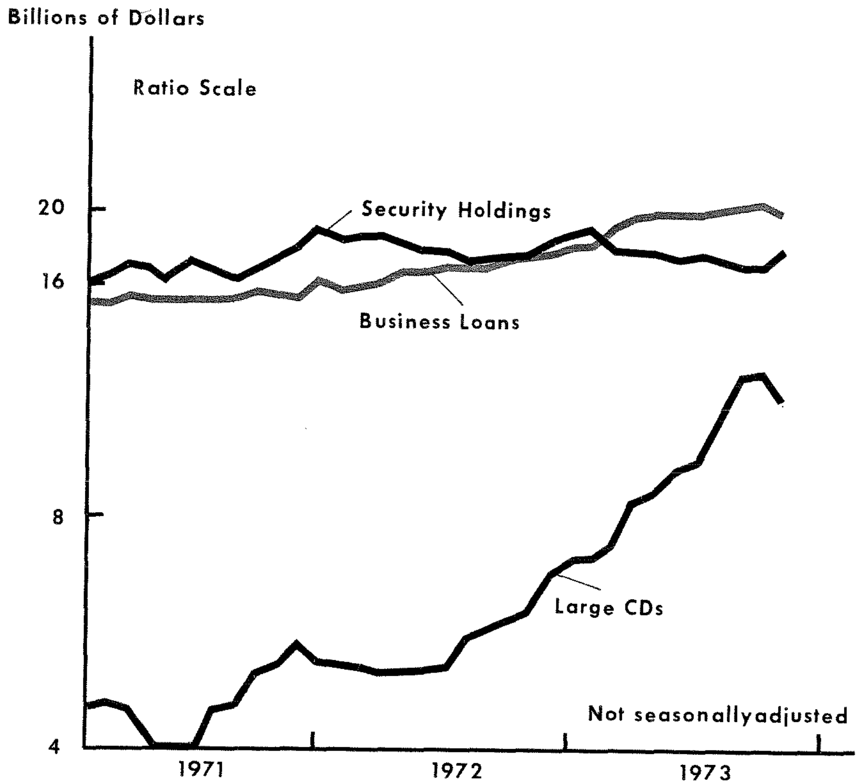
Fueling Bank-Loan Growth

Commercial banks, regionally as well as nationally, continued to meet heavy boom-level loan demands during the third quarter of the year. Money-market rates increased steadily, pushing bank costs for funds to record highs and posing problems of disintermediation. Banks also had to meet higher reserve requirements against demand deposits, as well as newly imposed marginal reserve requirements on certain of their deposit and non-deposit sources of funds. To counter these developments, banks made numerous increases in their prime business-loan rate, to a record 10 percent, and bid aggressively for large-denomination time certificates (CD's), and also for four-year certificates during the relatively brief period in which rate ceilings were removed on these deposit instruments.

In late September and October, however, there was evidence of some slackening in bank-credit demand. Money-market rates moved down from their record highs; also, banks bid less aggressively for funds and (in October) lowered their prime rate generally to 9¾ percent.

Loans at Western banks rose by $2.5 billion in the July-September period. This increase represented a 15-percent annual growth rate, slightly higher than in the previous three-month period but only half as large as the spectacular first-quarter gain. The regional loan expansion lagged somewhat behind the national pace during the summer period, reflecting a slowdown in business-loan growth which actually began as early as last May. On the other hand, mortgage lending in the West accelerated from an already rapid pace and contributed nearly half of the total third-quarter loan increase.

To accommodate these heavy loan demands, District banks reduced their holdings of Treasury securities by $800 million, but partially offset this reduction by adding $350 million in tax-exempt and Federal-agency securities. Banks also increased their borrowings from the Federal Reserve Bank and through repurchase agreements with corporations and public agencies. But the major source of funds for the third-quarter credit expansion came from a $2.1 billion increase in time deposits, mainly in large-denomination CD's.



Business loans finally level off at Western banks . . . security holdings increase, and CD upsurge tapers off

Deposits mixed

Total deposits at District member banks increased by $1.9 billion in the third quarter. This 11-percent annual growth rate was low only in relation to the exceptionally high rates recorded during the first two quarters of the year. Incidentally, it was somewhat greater than the third-quarter gain reported by banks elsewhere in the nation.

A decrease in the demand-deposit component was due to a large decline in U.S. Government deposits, as the Treasury ran down its balances to unseasonally low levels. As monetary pressures mounted, private demand deposits slowed to a 3-percent expansion rate, down from the high 12-percent rate of the January-June period. Even the time-deposit rise, at an 18-percent rate, represented some reduction from the first-half pace as banks began to feel the effects of disintermediation.

Individual deposit components moved in divergent directions, as is evident from an examination of unadjusted data for large District banks. By July and August, disintermediation at these banks was seen in a sharply higher outflow of passbook savings. Their third-quarter decrease amounted to $573 million, or several times larger than the normal seasonal decline reported during the preceding quarter. However, attrition at banks was relatively small compared with the withdrawal rate of savings-and-loan associations.

The more favorable bank experience was surprising, since many major banks retained a 4½-percent rate on savings instead of moving to the 5-percent ceiling permitted under Federal Reserve Regulation Q as of mid-year. However, most District banks increased rates on other consumer-type deposits to their higher ceilings, so that these time deposits rose $886 million in the quarter. Of this amount, over $200 million was in certificates with 4-year maturities—the "wild cards" which were freed from rate ceilings on July 1.

The volume of "wild card" deposits doubled, but this percentage gain was only one-fourth as large as the increase reported by banks elsewhere, perhaps reflecting the less-active bidding for such deposits on the part of Western banks. But these longer-term deposit instruments are now likely to become a less-important source of bank funds, in view of the 7¼-percent rate ceiling that was reimposed on November 1. During October, however, they grew rapidly in response to offering rates as high as 7½ percent.

The most significant change, however, was the $2.6-billion increase in large-denomination negotiable CD's. Last spring's removal of rate ceilings on such deposits permitted banks to bid competitively for corporate and other funds, in contrast to the situation in 1969 and early 1970, when severe attrition occurred because ceilings did not permit CD rates to rise as high as the rates offered on other money-market instruments.

Western banks were particularly aggressive in bidding for CD money during the July-September period; outstandings rose 28 percent in this period alone, substantially above the increase reported by large banks nationally. (But at the end of the quarter, CD's accounted for only one-fourth of time-and-savings deposits at District banks, compared with a one-third share nationally.) Some of the funds acquired through issuance of CD's served to offset the large $855-million decrease in deposits of states and political subdivisions—a somewhat greater-than-seasonal decline.

Record rates

Rising interest rates this summer presented banks with serious cost problems in the face of continued strong loan demand and a restrictive monetary policy. The Federal Reserve discount rate went to a record 7½ percent in mid-August, and the Fed-funds rate and CD offering rates reached 10½ percent or more at their September highs. Banks thereupon took a number of actions in the third quarter to increase their return on earning assets.

They made nine increases, of ¼ percentage points each, in the prime rate for large business borrowers, bringing this rate to a record 10 percent in mid-September. However, in line with the rate guidelines of the Committee on Interest and Dividends, banks made smaller adjustments in rates charged to smaller business customers. Fewer and smaller adjustments also were made in mortgage-loan rates and rates on consumer loans.

For many banks, their most important cost decision was a negative one—not to increase the rate paid on passbook savings to the 5-percent ceiling permitted under the revised Regulation Q. The cost reduction obtainable from maintaining a 4½-percent rate was quite substantial, since savings deposits at District banks exceed $21 billion.

The higher loan rates that were applied to the expanded loan volume produced increases in income for most Western banks, both before and after adjustment for securities transactions. But the wide variation in individual bank performance, already noticeable early in the year, was very marked during the third-quarter. During that period, some major banks recorded lower earnings, either because of special circumstances or because of large borrowings and heavy reliance on high-cost CD's.

Higher required reserves

Required reserves of District member banks rose by $219 million in the third quarter, to $5.7 billion, at least partly because of an increase of about $2.0 billion in deposits subject to reserves. In addition, reserve requirements against net demand deposits were raised by ½ percentage point in mid-July. Also, marginal reserve requirements (over a mid-May base) were imposed in June and early July on large-denomination CD's, as well as on funds obtained from sales of finance bills and funds obtained through issuance of holding-company commercial paper. A further increase in marginal reserve requirements became effective in early October.

As monetary policy became more restrictive, banks borrowed more heavily at the discount window to meet their reserve requirements. Borrowings from the San Francisco Federal Reserve Bank rose from $174 million in the second to $195 million in the third quarter. On the other hand, major District banks reduced their net purchases of Federal funds by about one-fourth to $275 million. (But these aggregate figures do not reveal the continued heavy reliance by some banks on the Fed-funds market as a source of borrowed funds.) Repurchase agreements with corporations and public agencies provided banks with their largest source of borrowed funds—over $2.3 billion, for a one-third increase over the prior quarter. (Data on reserves and borrowings are on a daily average basis.)

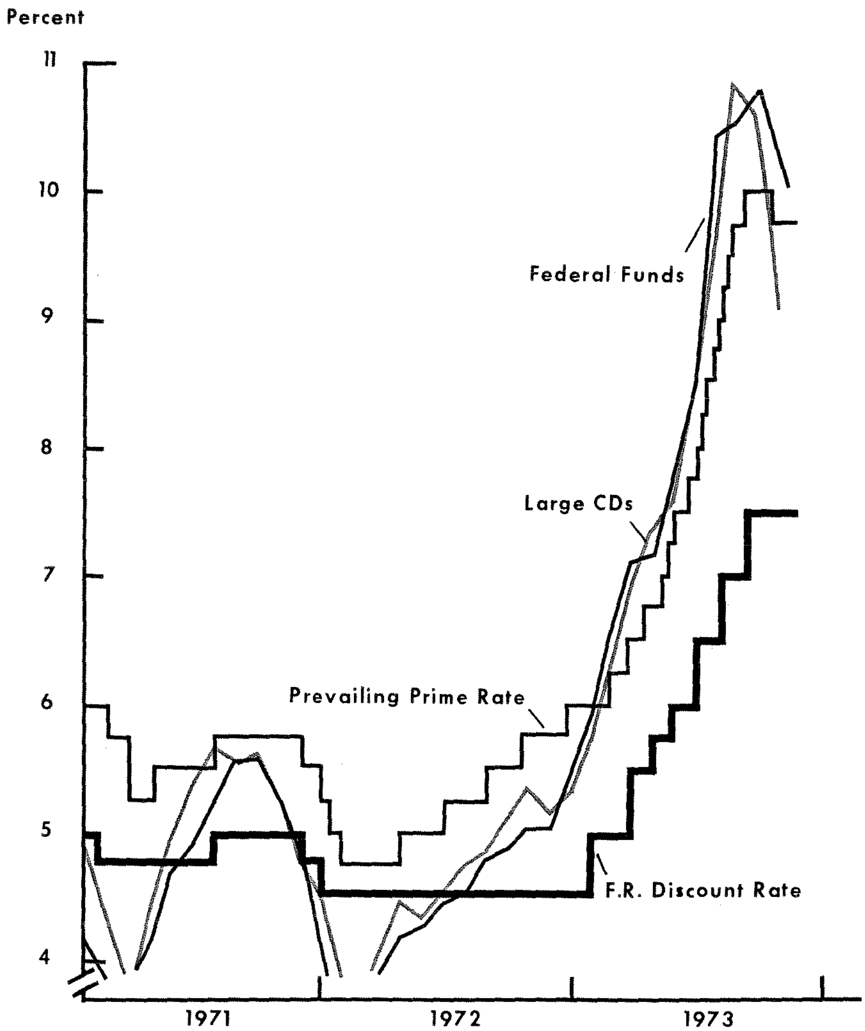
More favorable setting?

As the economy showed signs this fall of gearing down to a more sustainable rate of growth, loan pressure on banks abated somewhat, although pressure on reserves continued restrictive. It should be noted, however, that some of the recent slackness in business-loan expansion was due to the diversion of lending to the commercial-paper market which followed the drop in the paper rate below the banks' prime rate. In addition, some easing in term lending began to occur in the wake of heavier corporate borrowing in the capital markets. With business-loan volume declining and money-market rates falling, banks lowered their prime rate from 10 to 9¾ percent in late October, and some even went as low as 9½ percent.

Mortgage rates at some Western banks dropped from 9½ to 9¼ percent this fall. Although real-estate loans have continued to expand at a relatively rapid rate, a slowdown is expected as residential construction stays on its downtrend. Meanwhile, the high ratio of consumer debt to income apparently is being reflected in a reduced expansion rate in instalment credit. As overall loan demand eases, banks should be able to replenish their holdings of securities and improve the collateral-shortage problems that have been plaguing some of them in recent months.

District banks borrowed less from the San Francisco Reserve Bank in October, but they continued under reserve pressure with the Fed-funds rate holding around 9¾ to 10 percent. The threat of disintermediation lessened, and banks showed a small gain in passbook savings as well as continued expansion in consumer-type time deposits. In this situation, banks bid less aggressively for negotiable CD's, running off over $800 million in these deposit instruments. Banks' earnings prospects improved in October as the cost of CD money fell, but the picture clouded again during November's energy/financial crisis, which saw money-market rates stiffening again.

Ruth Wilson



Bank borrowing costs decline (at least temporarily) in early fall, permitting drop in prime business-loan rate