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Monthly Review

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Also in this issue:

Federal Reserve Bank of Atlanta

Adjusting Reserves Through the Federal Funds Market

The Record of District Banks

During 1961, Sixth District commercial banks lent almost $9 billion of a special kind of money called Federal funds. Last year District banks also borrowed over $6 billion of this item. Although such transactions are unfamiliar to most persons outside the banking community, they have since the early 1950's become part of the regular operations of an increasing number of banks.

"Federal funds" is a shorthand expression for funds, or deposits, that member banks hold at Federal Reserve banks. Member banks are required by the Federal Reserve System to set aside certain percentages of deposits as reserves, held either as deposits at Reserve banks or as cash in their own vaults. In a given week, some banks may have reserves that exceed System requirements, and these are known as excess reserves. It is these excess reserves that are available for lending or "trading" in the Federal funds market.

Banks, particularly those in financial centers, are subject to considerable swings in their reserve positions. On any day some banks may find themselves with substantial excess reserves. At the same time, others may have reserve deficiencies or, at least, less excess reserves than they desire to hold. Thus the market for Federal funds helps meet the needs of both groups of banks. Those with a temporary surplus of excess reserves can lend or "sell" Federal funds to banks desiring them and, thereby, earn interest at a stipulated rate of return; otherwise, such funds might well remain idle. The purchase of Federal funds enables a bank to adjust its reserve position without having to borrow from the Federal Reserve Bank.

The growth and increasing importance of Federal funds trading in recent years has caused the Federal Reserve System to give attention to the scope and structure of this market and its relation to the money and Government securities markets. The trading of Federal funds by District banks fits into the national pattern. Federal funds activity of banks in this region has been influenced by changing national credit conditions and by growth of the funds market.

The District Pattern

Recently about 35 District banks have been participating in the Federal funds market. Although larger than in earlier years, this number still represents only 8 percent of the member banks in the District. The banks that trade actively, however, are among the largest in the District, and the volume of their transactions is substantial. Large banks tend to dominate the Federal funds market for two reasons: First, individual Federal funds transactions are large in amount, usually in units of a million dollars or more; second, only banks that have specialists managing their reserve positions on a day-to-day basis are

likely to be active Federal funds participants, and these banks tend to be larger ones.

District banks trade in Federal funds almost entirely with banks outside this area. About three-fifths of the dollar volume of both purchases and sales during the period from September 1959 through April 1962 was transacted with the large New York City banks. Indeed, the big New York banks are the hub of the Federal funds market, as well as of other segments of the money market. Their importance in Federal funds trading reflects their size, the great volatility of their reserve positions, and their correspondent relationships with banks throughout the country. One stock market firm acts as a broker, bringing together lending and borrowing banks that may not be linked as correspondents. Banks in the San Francisco District, which rank just after those in New York City in volume of Federal funds transactions, also accounted for a relatively large portion—about one-seventh—of gross transactions by District banks.

Percent Distribution of Federal Funds Purchases and Sales by Reporting Sixth District Member Banks

September 1959-April 1962

	Purchases	*Sales*
By Seller or Purchaser		
Banks	100	92
Government Security Dealers	*	8
Others	*	0
*Banks by Location***		
New York City	64	62
Twelfth District, San Francisco	21	9
Sixth District, Atlanta	3	6
All other banks	12	23
By Type of Transaction		
One-day		
Unsecured	96	34
Secured	1	64
Over one-day	3	1

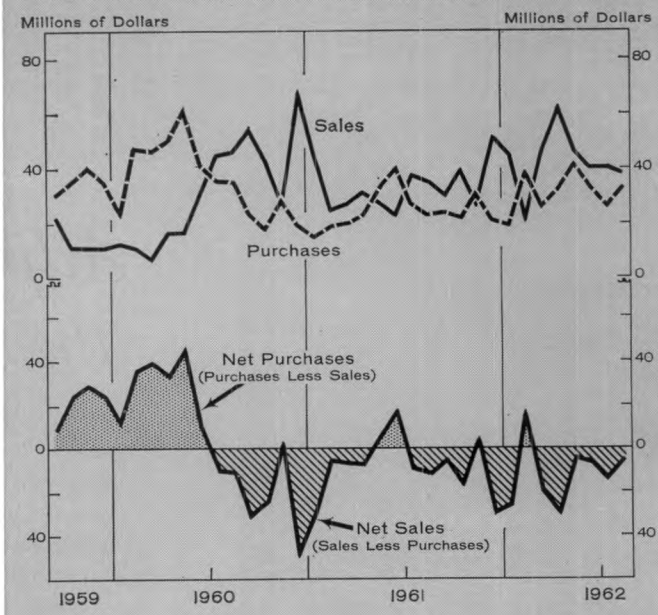
*Less than 0.2 percent.
**Percent distribution among banks only.
NOTE: Totals may not add to 100 percent because of rounding.

Banks in the District, like those in other parts of the country, have lent some Federal funds to U. S. Government securities dealers. Amounts of sales to dealers varied substantially during the 1959-62 period, depending upon dealers' needs for inventory financing. On the average, about 8 percent of total Federal funds sales by District banks during this period were to dealers. Since dealers are primarily in the market as borrowers, District banks rarely purchased Federal funds from them.

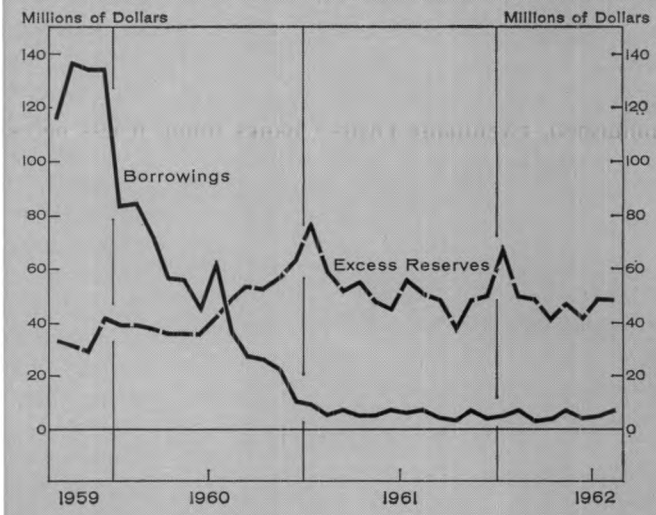
Almost all Federal funds purchases by District banks are made on a one-day unsecured basis. This is the most readily handled type of transaction. It is often arranged by telephone and is consummated by telegraphic transfer of reserve credit. The following day a return wire transfer effects repayment of the loan.

Nearly two-thirds of the amount of sales by District banks, however, are on a secured basis for the day. U. S. Government, state, or municipal securities may serve as collateral. The chief advantage of secured transactions is that the usual legal limit on the size of a loan to a single

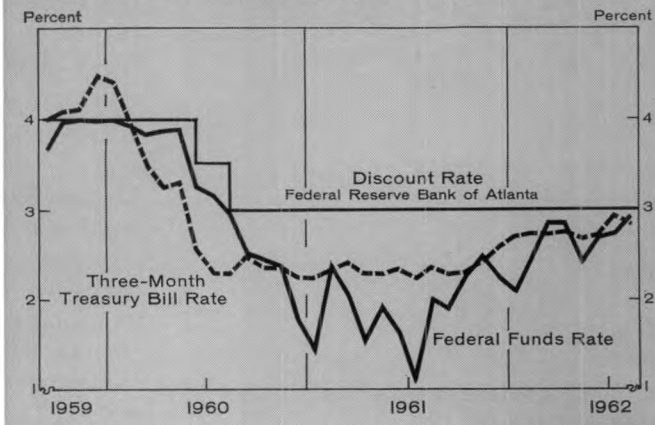
Since early 1960, District member banks that actively participate in the Federal funds market have increased Federal funds sales and reduced purchases.



During the second half of 1960, an increase in excess reserves of member banks was accompanied by a shift from net purchases of Federal funds to net sales. Borrowing from the Atlanta Federal Reserve Bank declined further.



As credit conditions eased in 1960, the Federal funds rate dropped below the Federal Reserve discount rate and below the three-month Treasury bill rate.



borrower does not apply to them. This is an important consideration when District banks lend to the large New York City banks.

Federal Funds Activity Adjusts To Shifting Credit Conditions

During the past three years, dollar volumes of Federal funds purchases and sales at District banks have varied substantially. A most pronounced shift occurred in mid-1960. Purchases dropped suddenly from a high level and sales rose sharply. Since July 1960, sales have generally exceeded purchases.

Only a minority of banks mirrored the overall shift from a predominantly borrowing to a lending position in the market. At other banks—those that characteristically operate largely on one side of the market—either purchases decreased or sales rose, depending upon which side of the market the banks were on. Still other banks, largely borrowers of Federal funds, had dropped out of the market before mid-1960. These observations, it should be noted, are only for banks that began regularly reporting transactions in 1959. Since their activity accounts for the bulk of total trading, however, they should be representative of all banks in the market.

What brought about the overall shift in position in the Federal funds market at District member banks? After credit demands began to weaken in early 1960 and the Federal Reserve authorities switched from a policy of restraint to one of ease, pressures on bank reserves diminished. Eventually District banks found it less necessary to borrow from commercial banks, as well as from the Federal Reserve Bank, and they became more eager to engage in Federal funds lending.

Obviously, not all Federal Reserve districts could simultaneously have shown less Federal funds purchases and more sales. The large New York City banks, which tend to keep fully invested and to maintain their excess reserves at minimal levels, on balance, remained borrowers of Federal funds. These banks were the ones that largely absorbed the increased volume of Federal funds lending by District banks.

The amount of Federal funds that a region's banks sell and buy in any short period depends not only upon the need for or availability of reserves, however. It depends also upon the extent to which banks normally active in the Federal funds market are at that time using this market or are using an alternative means of reserve adjustment, such as borrowing from the Federal Reserve Bank or varying their portfolio of short-term Government securities. In considering alternatives, banks take account of such factors as convenience, traditional preference, and, perhaps most important, the comparative gains or costs involved.

Some of the variation in Federal funds sales by District banks was probably due to changing relationships between the yields on Federal funds and on three-month Treasury bills. When in late May and June 1960 the bill rate dropped sharply below the Federal funds rate, certain banks tended to "invest" in Federal funds sales as a short-term asset, rather than in bills. During early 1961, when the Federal funds rate fell below the bill rate, those banks were more inclined to buy bills.

On the borrowing side, District banks at times probably sought Federal funds rather than Federal Reserve Bank credit because of an interest rate advantage. When many banks shifted from Federal Reserve to Federal funds borrowing in early 1960, factors other than comparative costs must have been significant, for the rate on most Federal funds transactions was still the same as the Federal Reserve discount rate. Beginning in early 1961, however, when the funds rate was frequently far below the discount rate, banks bought substantial amounts of Federal funds and borrowed little from the Federal Reserve Bank.

Changing relationships between the Federal funds rate and three-month Treasury bill yields do not seem to influence Federal funds borrowing as they do lending. One might, for example, have expected banks to sell bills rather than borrow Federal funds when in the spring and summer months of 1960 the three-month bill rate was below the Federal funds rate, but they did not do so. Convenience was probably a more important factor then than cost: Liquidating bills is not a practical alternative if a reserve deficiency is expected to last only a few days. Then, too, at that time holdings of short-term Government securities may have been less than the banks desired.

We have seen that in the short-run the main determinant of the volume of Federal funds transactions by District banks and of the relative amounts of purchases and sales is the basic monetary and credit situation. In the longer run the volume has grown because more banks have participated in the market. If past influences continue, the interaction of these short- and long-run factors should shape the future of Federal funds activity in the District.

ALBERT A. HIRSCH

Mississippi's Economy Continues to Expand

Mississippi's economic performance has been characterized by widespread gains since the low point of the previous business cycle in February 1961. If the trend continues through the rest of 1962, the gap may be modestly narrowed between the per capita income of the state's citizens and those of the United States generally. Per capita personal income in the state totaled $1,229, compared with $2,263 in the U. S. in 1961, the latest year for which