FEDERAL RESERVE BANK OF SAN FRANCISCO

No Slowdown

THE over-exuberant pace of business activity may have moderated somewhat during the second quarter, but little or no slowdown was evident in the nation's credit markets. True enough, several sectors increased their borrowings by only small amounts, but credit demands elsewhere were exceptionally strong, especially in the business sector.

The growth of consumer debt decelerated, as a consequence of the reduction in auto sales and the continued uptrend in debt repayment. Federal marketable debt declined more than usual, as a reflection of the welcome and somewhat unexpected tax inflow generated by rising incomes and rising prices. On the other hand, state-local governments — like business firms — raised a record volume of funds in the capital market during the spring months.

Tighter still

In the context of continued strength of credit demands and continued pressures on the price level, monetary policy moved further in the direction of restraint. Borrowings from Federal Reserve Banks jumped sharply, from $551 million in March to $674 million in June, and net borrowed reserves increased over the quarter from $246 million to $353 million (daily average basis). Actually, borrowings and net borrowed reserves were considerably lower than in other tight-money periods, both in dollar terms and in relation to total bank credit. However, they undoubtedly would have been larger but for the rapid growth in recent years of an alternative source of member-bank borrowing, the Federal-funds market.

Even so, evidence of growing monetary tightness was not difficult to find. This was apparent in the slower growth of the money supply, which increased at about a 4½-percent annual rate during the first half of the year—slightly less than the gains in each of the years 1964-65. Tightness was apparent also in a further decline, to a postwar low, in the commercial banks' own liquidity; in June, the loan-deposit ratio reached 67 percent for all banks and 81 percent for the major New York banks. Moreover, evidence of tightness became evident in a further upsurge in interest rates, in some cases to levels unseen since the 1920's.

Higher still

The rise in interest rates reflected the worries attendant upon Vietnam, the balance of payments, and the business outlook. But, primarily, the rise reflected the interplay of basic market forces as corporations, state-local governments, and Federal agencies all trooped to market with record amounts of offerings.

During the spring quarter, corporations floated a record $5.3 billion in new offerings; yields on new issues thereupon rose 30 basis points to 5.31 percent, while yields on top-rated seasoned corporates rose 10 basis points to 5.09 percent. Similarly, state-local governments floated a record $3.2 billion in municipal issues, so as inventories rose and as new-issue calendars expanded, yields on these tax-exempts jumped 21 basis points to 3.64 percent. Meanwhile, higher yields appeared in the mortgage and government bond markets as institutional investors, faced with a reduced inflow of funds, curtailed their investment in long-term debt instruments.

At the short end of the maturity range, commercial-paper rates rose sharply during the second quarter, while Treasury-bill rates moved erratically before advancing strongly during July. By the end of June, the rate on short-term paper reached 5.50 percent. At the same point of time, the 90-day Treasury-bill rate reached 4.47 percent—18 basis points below the mid-April peak—but then,

in late July, it soared to within a shade of 5.00 percent.

The April-to-June slide in bill rates reflected several influences: heavy Federal Reserve purchases to accommodate seasonal reserve requirements, the decline in outstanding Federal debt (especially tax bills), and a good public demand that reduced dealers' bill inventories to very low levels. The record rise in bill yields in July (and a 40-year low in bond prices) reflected the growing uncertainties which followed the late-June hike in the prime rate, the reserve-requirement changes in time deposits, and renewed talk of another rise in the discount rate.

Expanding assets

The nation's commercial banks felt the same pressures which affected the credit markets, as they experienced a $6-billion credit expansion in the second quarter on top of a first-quarter increase of like magnitude. The lending picture continued to be dominated by corporate demand, as business loans expanded at an annual rate of more than 20 percent during the spring period. (A $3-billion gain in business loans at weekly reporting banks was half again as great as the first-quarter increase.) On the other hand, mortgage loans tended to increase at a slower pace, and consumer-loan growth slackened appreciably.

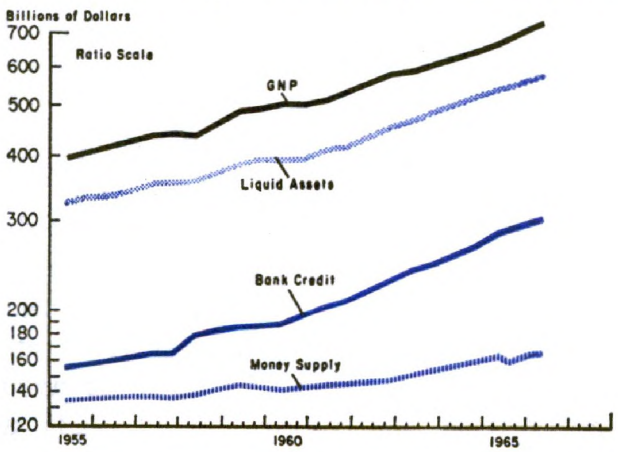
Banks recorded no change in their overall investment portfolio, even in the face of their sharp expansion in business lending. But their portfolio balance changed considerably, as a $1.4-billion increase in holdings of tax-exempts and other securities was offset by a comparable decline in holding of U. S. Government securities. Because of this liquidation of governments (mostly Treasury bills) the liquidity situation of banks tightened considerably; one key liquidity measure, the ratio of short-term governments to deposits, dropped to 5.4 percent by midyear.

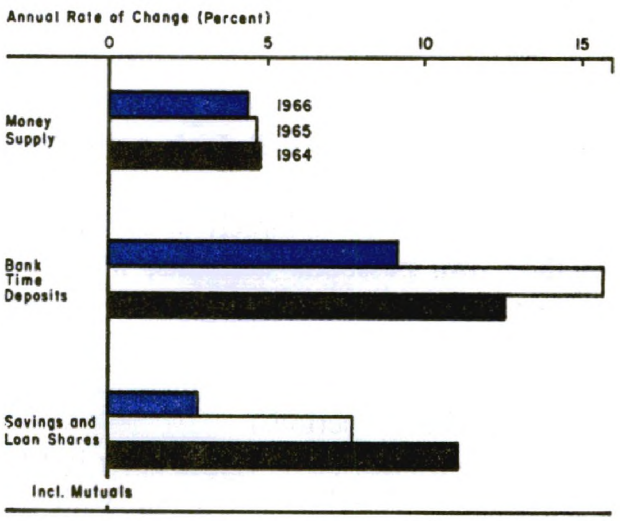
Expanding liabilities

Despite the frenetic activity in bank lending during the spring quarter, most attention centered on the deposit side of the banks' balance sheet—and not only because of the sharp $8-billion gain in total deposits. The main developments of this period were a $4-billion increase in time deposits and an actual decline in savings inflows at the nation's savings-and-loan associations.

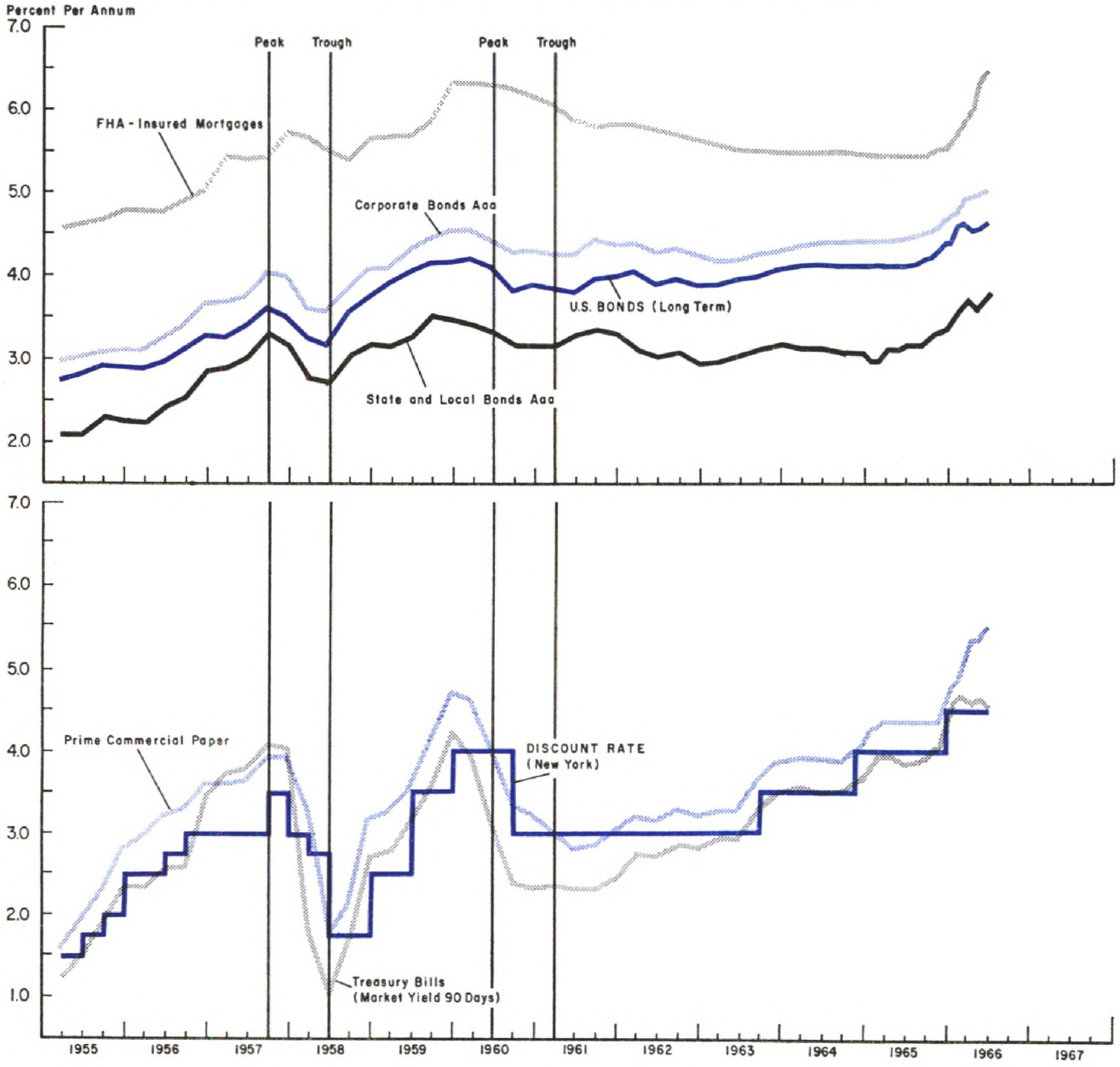
The time-deposit growth was partly attributable to the increased use of high-yield consumer-type savings certificates, but other fac-

Slowdown in growth trend reflects less rapid growth of money supply —and distinctly smaller expansion of money substitutes





Evidence of growing tightness seen in continued rise of interest rates . . . market forces as well as expectations help push yields upward



tors were involved as well. In fact, the large banks holding the bulk of such deposits increased their holdings largely at the expense of their own passbook accounts, which are subject to a 4-percent ceiling under Federal Reserve Regulation Q. (Passbook savings at weekly reporting banks declined $2 billion in the April-June period.)

Above all, banks, S&L's, and other institutions found themselves competing with one another for a limited amount of savings funds in an atmosphere of rising rates. Thus, for the first half of 1966 as a whole, bank time deposits increased roughly at a 10-percent annual rate (seasonally adjusted) as against a 16-percent gain in the full year 1965, and savings-and-loan shares increased at about a 3-percent rate (seasonally adjusted) as against gains of 8 percent in 1965 and 11 percent in 1964.

Official countermoves

In this situation, in order to moderate the growth of bank credit and to restrain the issuance of time certificates, the Federal Reserve Board of Governors raised, from 4 to 5 percent, the amount of reserves which each member bank must maintain against its non-passbook time deposits in excess of $5 million. (The Board reinforced this action in mid-August when it raised the reserve requirement again, to the legal maximum of 6 percent.) But, meanwhile, the Federal Home Loan Bank Board withdrew its earlier restrictions on borrowing privileges of associations posting "excessive" dividend rates.

A number of S&L's posted higher dividend rates (a few ranging as high as 5½ percent on passbook savings plus a ½-percent bonus on longer-term certificates) even before the Bank Board eased its borrowing regulations —and the move to higher rates became widespread throughout the industry in the wake of the Board's announcement. In fact, industry spokesmen credited the rise in rates for keeping the July savings outflow from being as large as originally feared.

During this period, Bank Board Chairman Horne reiterated his earlier request for Congressional authority to set S&L rate ceilings comparable to the authority the Federal Reserve exercises over bank time deposits through its Regulation Q. At the same time, he argued for "coordination" of rate setting by the authorities supervising the commercial banks and the savings-and-loan associations.

Several basic questions remained at issue: How uniformly must administrative regulations apply to financial institutions competing in the same markets? Again, how far must the groundrules be altered to modify the impact of market forces upon the allocation of financial (and real) resources? The questions are not new, but they are increasingly important at this time because of considerations of "equity" and because of their implications for monetary policy. Consequently, they are certain to receive increased attention from regulators and regulated alike in the months ahead.

—Verle Johnston

TWELFTH DISTRICT BUSINESS

Year and Month	Condition items of all member banks (millions of dollars, seasonally adjusted)				Bank debits 31 cities (1957-59 = 100)	Bank rates: short-term business loans	Total nonfarm employment (1957-59 = 100)	Industrial production (1957-59 = 100)		
	Loans and discounts	U.S. Gov't. securities	Demand deposits adjusted	Total time deposits				Lumber	Refined Petroleum	Steel
1959	15,908	6,514	12,799	12,502	109	5.36	104	109	101	92
1960	16,612	6,755	12,498	13,113	117	5.62	106	98	104	102
1961	17,839	7,997	13,527	15,207	125	5.46	108	95	108	111
1962	20,344	7,299	13,783	17,248	141	5.50	113	98	111	100
1963	22,915	6,622	14,125	19,057	157	5.48	117	103	112	115
1964	25,561	6,492	14,450	21,300	169	5.48	120	109	115	130
1965	28,115	5,842	14,663	24,012	182	5.52	125	111	120	138
1965: June	27,059	6,010	14,832	22,492	168	5.47	124	107	120	147
July	27,327	5,813	14,532	22,718	186	...	124	111	125	143
Aug.	27,283	5,881	14,521	22,805	180	...	125	109	122	139
Sept.	27,409	5,894	14,730	23,084	187	5.53	125	111	121	134
Oct.	27,595	6,203	14,705	23,261	188	...	126	114	122	126
Nov.	27,796	6,103	14,653	23,596	184	...	127	111	123	125
Dec.	28,115	5,842	14,663	24,012	187	5.62	128	118	115	121
1966: Jan.	28,497	5,840	14,761	23,869	195	...	129	120	122	128
Feb.	28.748	5,737	14,790	23,904	206	...	130	111	119	135
Mar.	28,938	5,638	15,027	24,164	212	5.89	130	108	117	143
Apr.	29,267	5,309	14,924	24,579	227	...	130	113	122	147
May	29,157	5,128	14,812	24,735	221	...	131	107	125	145
June	29,688	4,919	14,780	25,001	220	6.18	131	...	...	144