Monthly Review

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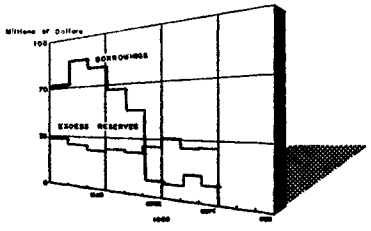
The Money Market and District Banking



MONEY MARKET CONDITIONS influence district bank reserve positions and lending policies.

By illustration, during the first nine-and-a-half months of 1953, there were important shifts in the money market and parallel shifts in district bank reserve positions. From December to mid-May, working balances of district banks were below normal and borrowings were high. But by mid-July their reserve positions had eased, reflecting a net inflow of funds and a reduction in reserve requirements. Then, following moderate drains from routine factors, reserve positions eased again after mid-September, largely because of an inflow of funds from other areas.

Reserve positions, influenced by market conditions, helped shape district bank policies which contributed to business stability and growth.

Federal Reserve Bank of St. Louis

Money market conditions influence district bank reserve positions . . .

THERE IS A CONTINUAL FLOW of checks and other items between the 14,000 commercial banks of the country as banks and their customers conduct their business. In both number of items and in dollar volume the flow is tremendous. Each month the average bank cashes more checks, in dollar amount, than it has total deposits. These outpayments are, of course, offset by an inflow of funds of approximately the same amount. So that, while turning over at a rapid rate, the level of a bank's deposits at the close of business one day is surprisingly little changed from the level on the preceding or on the following day, except in unusual circumstances. And for groups of banks, such as all member banks in the Eighth Federal Reserve District, the percentage variation one day as against the next is even smaller. Not all checks cashed result in an outflow of payments to other banks, as the charge to one customer's account may be matched by a credit to another customer's account in the same bank. Nevertheless, large sums move between banks. The movement of bank money in and out of the Eighth District by way of the Interdistrict Settlement Fund each year amounts to several times the resources of all district member banks.

Although these flows are influenced by numerous factors, they fall into a rough pattern. Normally rural areas lose funds on balance, year in and year out, to a local financial center. This local financial center, in turn, is drained of funds by the money market centers. Completing the circle, the money market banks have an "unfavorable" balance of transactions with certain rural area banks. Thus, there is a circular geographic pattern of movement and the inflows of funds and the outflows of funds are roughly in balance at each stage. One example of this circular pattern is the persistent movement of checks, on balance, from banks in western Tennessee, northern Mississippi, and eastern Arkansas to St. Louis; from St. Louis to New York; and from New York back to banks in the Memphis region.

This circular movement of funds from area to area is a movement of "net" balances—the net of much larger gross flows in both directions between any two points. For instance, there is a persistent net flow of funds from the Memphis region to banks in the St. Louis zone, but so far in 1953 this net flow ($129 million) amounted to only 12 per cent of total transactions between the two regions in the Interdistrict Settlement Fund.[1] Likewise, the Eighth District continuously loses funds to the New York district, but during the first three quarters of 1953 the net flow ($517 million) was only 3 per cent of total transactions in the Fund between the two districts. Although these "net" flows are small percentagewise, they are significant.

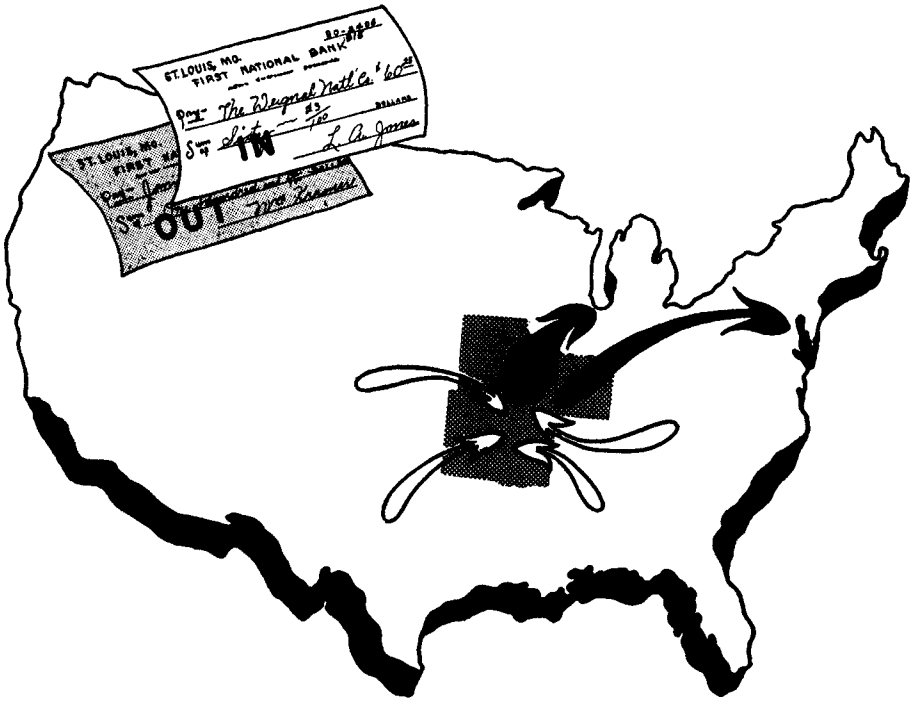
Superimposed on this circular movement of bank money from place to place are other recognizable patterns. For instance, the Eighth District banks tend to pick up funds through these flows in the fall but to lose more funds to other areas than they get in return during the spring. This seasonal pattern reflects the high relative importance of agriculture in the district, including both farmers and businesses that process and distribute agricultural products. Then too, banks in some areas (such as those in the Louisville zone) persistently gain funds, on balance, from other areas, at least for many years at a time. These continuous inflows appear to reflect growth factors, such as net investment in the area by outsiders, or operations of the Treasury conducted so as to cause a drain in its account with an offsetting inflow of funds in private accounts.

In addition to seasonal and growth factors, this circular movement of money is subject to numerous irregular influences. As business activity expands, the volume of checks usually increases, many times influencing the net flow of funds between areas. Over time, as the patterns of doing business change, the direction and size of net flows change. Strikes, weather, and many other factors can temporarily disrupt this stream of checks.

Two important, and largely irregular, influences on the circular flow of payments are market factors and System actions. Money market factors (such as currency and gold movements or Treasury operations) and System actions affect the flow of money and add to or subtract from bank reserves or other cash balances. By absorbing or contributing funds, they influence the flow of funds directly. They also affect the flow indirectly. For when these factors persistently absorb a part of one bank's reserve funds, the bank tends to become more conservative in its credit policy. In other words, it is apt to be more selective in its new loans or investments or it may even sell securities. These actions tend to cause the outflow of funds from this bank, in turn, to decline relative to the inflow. And pressure is thereby passed to other banks, which, likewise, in their turn, may be forced to become more conservative. In this manner, the tightness of bank reserve positions in one area caused by money market factors or System actions is usually transmitted to and influences all banks.

[1] In turn, these Settlement Fund transactions are in many cases net balances of larger gross transactions. Cf., *Bank Reserves and the Flow of Funds*, MONTHLY REVIEW, November, 1952.

Largely through changes in the inter-district movement of funds . . .

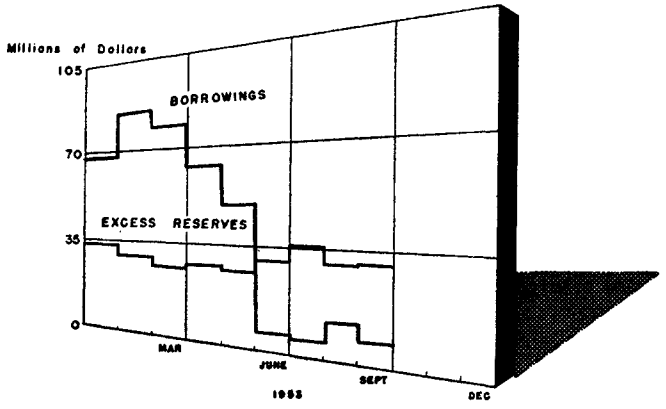


An addition of funds to a bank's reserves by these market, or "routine," factors or by System actions works in just the opposite direction. A bank persistently receiving additional reserve funds usually becomes more lenient in its lending or investing policies. Thus, the outflow of funds from this bank tends to grow relative to the inflow. Other banks, in turn, tend to gain funds and become more lenient in their lending and investing and so the effect fans out to most banks in the nation.

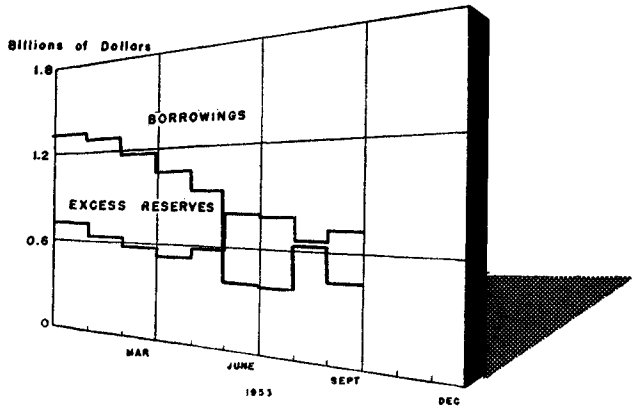
Since the net flow of funds between two areas is only the small difference between total inflows and total outflows, a seemingly insignificant change in total flows becomes a substantial change in the net. For example, if through a tightening of the money market (resulting from, say, an outflow of gold) one per cent of the total flows between the St. Louis district and the New York district is affected, it is estimated that the net outflow from St. Louis to the money market center would double.

Some money market factors influence the stream of monetary payments at virtually every point. Every commercial bank in the nation pays out currency on demand to its customers and every commercial bank accepts currency for deposit. Thus the net movement of currency in and out of banks (a routine market factor) may affect the circular movement of funds at all stages. Many Treasury operations (such as taxing, spending, and sales and redemptions of securities) are also conducted in all regions of the country.

. . . the reserve positions of district banks . . .



. . . parallel those for all banks



In addition to these two money market factors, some Federal Reserve System operations directly affect the circular movement of funds at virtually all points. Federal Reserve "float" (credit given on checks in advance of collection, usually classed as a routine market factor) usually adds to or reduces the reserves of a great many member banks. Reserve requirement changes, likewise, influence directly the amount of free funds held by each member bank. Also member banks in all areas may temporarily add to their supply of reserves by borrowing from their Federal Reserve Bank.

These market and System actions, although decentralized, may not, usually do not, directly affect the reserve positions of all banks proportionately. The actions may be easing bank reserve positions in one area, but absorbing funds in another. Nevertheless, through the flow of payments the net impact of these factors tends to bear upon the reserve positions of all banks.

In contrast to the above factors that directly affect banks in all areas, there are other influences on bank reserves that have their direct effect concentrated in the principal money markets. The major ones are: (1) monetary gold movements, (2) deposits of foreign governments or central banks in the Federal Reserve Banks, (3) a few Treasury operations, and (4) System open market purchases or sales. These factors, however, by constricting or enlarging the stream of payments at the money markets, tend to decrease or increase it at all points.

. . . and lending policies.

Whether or not a bank will expand its loans depends on many factors, important among which are the supply of funds and the availability and cost of obtaining more.[2] Money market conditions affect the supply, availability, and cost of funds.

As pointed out, tightness or ease in the money market influences the supply of loanable funds at individual banks by altering the flow of payments between banks. In addition, money market conditions can affect the cost and availability of funds to banks in many ways without initially and directly altering the flow. Since most banks make at least a part of their reserve position adjustments by buying or selling Treasury bills, tightness in the money market (by increasing yields on Treasury bills) directly increases the cost of obtaining more reserves. Tightness or ease in the market can also influence the cost and availability of additional reserves for district banks through changes in attitudes concerning, and cost of obtaining, interbank loans.

[2] Some of the other principal factors are: (1) the extent of creditworthy demand, (2) liquidity position of the bank, (3) local bank policies, (4) diversification of the loan portfolio, (5) business prospects, (6) experience of lending officers, and (7) earnings considerations.

By illustration, during the first nine-and-a-half months of 1953 there were important shifts in the money market . . .

From the end of December through mid-May the money market was tight. Total borrowings of banks were at near-peak levels and working balances were relatively low. Interest rates, both short and long-term, were working up. The situation reflected: (1) the tightness of funds as the year began, (2) the strong demand for credit, (3) a gold outflow, (4) System sales of securities early in the year, and 5) an increase in the discount rate. Partial offsets were provided by a seasonal currency movement into banks and a continued high level of individual saving.

From the middle of May to the middle of July, the money market went through a transition from tightness to ease. Although bank reserve positions began improving around mid-May, the market was still tight until early June. Interest rates on most issues rose to a peak around the first week in June, but drifted lower thereafter. Early in the period banks gained funds from Treasury operations. System open market purchases added about $1.2 billion over the two months and a lowering of reserve requirements freed a like amount in early July. The easing in those two months was also partly brought about by a slackening in credit demand, especially in the capital market, reflecting both the higher interest rates and more conservative policies by financial institutions.

From mid-July to just after Labor Day, there was a digestion of funds by the market. Banks expanded credit substantially (largely by purchasing Treasury tax-anticipation Certificates) and met a seasonal currency outflow together with a drain from an export of gold. Late in the period, net System purchases provided a partial offset to these losses. Member bank borrowings from the Reserve Banks rose somewhat in the period, but were still low compared with early 1953. Most interest rates remained fairly steady.

In the week after Labor Day, the market eased substantially and remained easy through October 14. At first the additional supply of funds reflected a return flow of currency after Labor Day and an unusually high mid-month expansion in float; subsequently there were sizable System purchases in the open market. In addition there was a less-than-seasonal demand for bank credit.

. . . and parallel shifts in district bank reserve positions. From December to mid-May, working balances of district banks were below normal and borrowings were high.

Thus far in 1953, shifts in the reserve position of district member banks as a whole have reflected the shifts in the money market. District bank reserves were in tight supply through mid-May. Three principal direct causes were: (1) the fully invested position of banks as the year commenced, (2) drains of funds as a consequence of Treasury operations, and (3) a net outflow of money to other areas of the country through commercial and financial transactions. This tightness was relieved somewhat by a seasonal return flow of currency into banks and a contraction in bank credit.

First, at the beginning of January, district bank reserve positions, reflecting the customary peaks in credit and currency demands, were under considerable strain. Last December the pressure on bank reserve positions became unusually heavy. Daily average borrowing from the Federal Reserve Bank of St. Louis during the month amounted to $89 million. By comparison average borrowings were $19 million in December of the previous year. Borrowing from other banks was also sizable.[3] In addition, district member banks had relatively low levels of working balances. Daily average excess reserves were $4 million less than in December a year earlier. Deposits in other banks on a daily average basis were $9 million lower in the month than in the corresponding period of 1951.

Second, district banks were drained of $96 million by Treasury operations during the first four-and-a-half months of the year. This was more than normal for the period and occurred despite a relatively high level of direct Government expenditure in the district which tends to increase reserves. This drain reflected a large volume of income tax collections, cash subscriptions to the Treasury's issue of 3¼ per cent long-term bonds, and increased sales of Savings Bonds in the district.

Third, during the same four-and-a-half months banks lost, on balance, $17 million to banks in other districts through check clearings and wire transfers in the Interdistrict Settlement Fund (payments of $11,277 million and receipts of $11,260 million). These interdistrict movements of funds are the result of commercial and financial transactions of both banks and their customers. It was largely through this flow of checks and other cash items that pressure on bank reserves in the district was equalized with pressure on reserve positions of other banks.

[3] The exact amount of this indebtedness is not available, but an indication of the trend can be obtained from averaging the interbank loans reported weekly by the larger (weekly reporting) banks. The average of these loans during December, 1952, was $28 million. In December, 1951, the average was $3 million.

The money market (as noted above) was tight from the end of December through mid-May, as System sales of securities and a movement of gold out of the country, on balance, directly absorbed reserves of money market banks. Reflecting this tightness, there was a $17 million net outflow of funds from district member banks through the Interdistrict Settlement Fund. Taking into consideration all factors other than interdistrict flows and even allowing for the fact that district banks were drained of proportionately more funds through Treasury operations than banks in other sections, district bank reserve positions were somewhat easier than the reserve positions of other banks. Thus the $17 million net outflow through the interbank flow of funds tended to balance the two situations, as individuals, businesses, and banks sought to put their funds to the most profitable use.

The $17 million net movement of money from the Eighth District was the result of heavy drains to the money markets and gains of funds from other regions. Eighth District banks lost $168 million to the New York district. By comparison the drains to this center in the like period a year ago were greater, but in that period the money market, although relatively easier, was tightening (compared with little change in the current year) and Treasury operations were adding funds to district banks rather than absorbing them.

Largely as a result of the tightness in district bank reserve positions in early 1953 and a slight increase in the cost of obtaining additional reserves (as both the discount rate was increased and prices of securities declined) credit in the district became less readily available. Lenders reportedly became more selective in making loans, terms became tighter, and commitments for future loans became more difficult to obtain. Furthermore, the increased cost of credit discouraged some potential borrowers. The rate on loans to "prime" borrowers rose from 3.00 to 3.25 per cent. And, according to reports, the average rate on advances for financing real estate increased between a quarter and a half of one per cent. Most other rates were marked up a similar amount.

But by mid-July their reserve positions had eased, reflecting a net inflow of funds and a reduction in reserve requirements.

In the two months ended July 15, district member banks received a sizable amount of reserves. Thus the heavy pressure on their reserve positions was largely lifted. Banks received a substantial ($58 million) net inflow of funds from other districts through clearings resulting from commercial and financial transactions. In addition, reserve requirements for member banks were reduced, freeing an

Factors Affecting Eighth District Member Bank Reserve Positions

By Selected Periods from December 31, 1952, through September 30, 1953

Sign Indicates Effect on Reserve Positions

(Millions of Dollars)	Dec. 31, 1952 through May 13, 1953	May 13, 1953 through July 15, 1953	July 15, 1953 through September 9, 1953	September 9, 1953 through September 30, 1953	Cumulative December 31, 1952 through September 30, 1953
Currency movements	+45	+ 7	− 8	+ 1	+ 45
Treasury operations	−96	−27	−14	−25	−162
Interdistrict flow of funds	−17	+58	+ 7	+11	+ 59
Boston	+ 16	+ 4	− 7	+ 1	+ 14
New York	−168	−144	−148	− 58	− 518
Philadelphia	− 2	*	+ 1	+ 3	+ 2
Cleveland	− 44	− 30	− 22	− 9	− 105
Richmond	+157	+ 47	+ 36	+ 33	+ 273
Atlanta	+192	+124	+101	+ 22	+ 439
Chicago	−581	−203	−169	− 56	−1009
Minneapolis	+ 29	+ 19	+ 13	+ 6	+ 67
Kansas City	+152	+108	+107	+ 26	+ 393
Dallas	+206	+101	+ 79	+ 26	+ 412
San Francisco	+ 26	+ 32	+ 16	+ 17	+ 91
Federal Reserve float[1]	+ 8	− 9	− 6	+15	+ 8
Borrowings	+33	−31	+ 4	− 4	+ 2
Miscellaneous factors[2]	+ 6	− 8	+ 1	− 3	− 4
Change in total reserves	−21	−10	−16	− 5	− 52
Estimated change in required reserves[3]	−53	−12	−14	+ 8	− 71
Estimated change in excess reserves	+32	+ 2	− 2	−13	+ 19

* Less than $500,000.
[1] Checks and other transit items credited to the reserve accounts of depositing banks prior to actual collection by the Federal Reserve Bank.
[2] Shifts of funds between member and nonmember banks and certain income and expenditure transactions of the Federal Reserve Bank.
[3] Primarily due to changes in amount and type of deposits in member banks, but early in July reserve requirement ratios were lowered freeing an estimated $37 million for district member banks.

estimated $37 million, and customers deposited $7 million more currency and coin than they withdrew.[4]

The substantial net inflow of funds from other districts reflected the transition to a condition of ease in the money market generated in part by net System purchases of Government securities. District banks received funds directly, when they or their customers sold securities in the money market; and indirectly, when other banks, after obtaining more reserves through security sales to the System, extended their loans or investments.

From May 13 through July 15 district banks lost $144 million net to banks in the New York district. By contrast, in the like period a year earlier (when the money market was tightening) district banks were drained of $174 million, on balance, by the money market. The easing of pressure on banks in the period also affected the flows of funds at other points. District banks gained $333 million net from the Atlanta, Kansas City, and Dallas districts (districts from which the Eighth District normally gains the most funds on balance). In the corresponding two months in 1952, the Eighth District gained $274 million from these three districts.

[4] District banks, however, had to meet some drains of funds in the two-month period. These offset, in part, the net gains from interdistrict transactions and currency inflows and the freed funds resulting from reduction in reserve requirements. Greatest drain resulted from Treasury operations ($27 million); other routine factors absorbed $17 million. The drain from Treasury operations was occasioned by the Treasury's building up its account at the Federal Reserve Bank. This was made possible, despite large expenditures from this account, by sizable tax collections and large purchases by district residents of Government securities. There were $3 billion worth additional Treasury bills and $6 billion of Treasury tax-anticipation certificates sold nationally in the period.

The gain of funds from the middle of May to the middle of July permitted district banks to improve their reserve positions substantially. Daily average borrowings from the Federal Reserve dropped to $4 million in the first half of July from $72 million in the first half of May. Also, these banks increased their working balances. Their daily average excess reserves rose $20 million and their daily average deposits due from other banks jumped $41 million from the first half of May to the first half of July.

The improvement in bank reserve positions halted the tightening of credit. Interest rates generally leveled off and some more sensitive rates moved down slightly in early July. But, for many borrowers, credit was still considered tight.

Then, following moderate drains from routine factors, . . .

Eighth District banks were drained of a moderate amount of funds between July 15 and September 9. Bank customers withdrew currency on balance, largely in anticipation of the Labor Day weekend. Both Treasury operations and Federal Reserve "float" absorbed moderate amounts of reserves. A partial offset to these losses was provided by a net inflow of funds from other districts.

To meet the reserve drains, district banks increased their borrowings from the Federal Reserve Bank from $3 million to a peak of $39 million (on September 6). However, most bank reserve positions were considerably easier than in April when daily average borrowings were about $70 million.

Partly as a result of this loss of reserves, credit in the district continued tight, despite some slackening in the demand. Lenders, with limited funds, continued to be selective. Interest rates remained on the relatively high plateau reached in early June.

. . . reserve positions eased again after mid-September, largely because of an inflow of funds from other areas.

In the two weeks after Labor Day, district residents deposited more cash than they withdrew. Also, banks in the area gained funds from a sharp expansion in Federal Reserve "float" around mid-September reflecting a temporary pick-up in the volume of checks handled. For a time, these factors eased the pressure on bank reserve positions. But later in September and in early October currency again began flowing into circulation and "float" contracted to normal levels.

However, bank reserve positions remained fairly easy largely as a result of a "favorable" balance of interdistrict clearings of checks. In addition, the expansion in loans, being less than expected, failed to absorb fully the reserves which became available in each individual bank for this purpose. From September 9 through October 14, district banks gained $36 million through interdistrict transactions. The net inflow of funds was largely the result of a smaller-than-usual drain to the Chicago and New York areas being more than offset by net gains from most other regions, especially the immediately adjacent districts to the South and West. This gain of funds by district banks through interdistrict clearings was partly seasonal but also reflected the somewhat easier money market conditions. With the easing in bank reserve positions some relaxation developed in bank credit policies.

Reserve positions, influenced by market conditions helped shape district bank policies which contributed to business stability and growth.

District bank lending thus far in 1953 has reflected the change in bank reserve positions. The reserve positions of district banks, in turn, have shown the influence of shifts in the money market. Over the first half of the year, when the money market was tight and bank reserves were under pressure most of the time, district banks became more restrictive in making loans and interest rates were increased. But due to a strong credit demand bank lending was at a high level. A large share of the funds was obtained by selling Government securities to nonbank investors and by borrowing.

Reporting district banks made over a billion dollars of new loans to businesses in the first half of 1953. This was 10 per cent more than in the like period a year ago. Reflecting the large volume of new credit extended, outstanding loans to commerce and industry declined only 11 per cent at district member banks. Normally these advances contract about 20 per cent in the first half-year (and expand roughly the same amount in the last half). The contraction centered in a seasonal decline in advances to food processors and commodity dealers; most other types of businesses increased their borrowings.

Not only did district member banks finance business to a greater extent, but they also extended more credit to other borrowers. Consumer loans rose sharply (an estimated 20 per cent) in the first half-year. The largest increase was in automobile paper, but all other categories also increased. Loans to farmers (other than CCC) were up 11 per cent and advances for the purpose of purchasing or carrying securities rose 5 per cent. New loans made for the purpose of financing real estate roughly matched repayments, a decline in outstanding advances secured by residences being counterbalanced by an expansion of loans secured by commercial, farm and other properties. In addition, these banks increased their holdings of municipal securities by $22 million.

Since mid-year, the demand for credit has declined. Thus, despite the easing of bank reserve positions which helped relax bank credit policies, loans have tended to level off. Business loans have only maintained their seasonal pattern and in recent weeks a further weakening has been indicated. Consumer loans, which had been rising sharply in the first half of 1953, rose about 2 per cent in July, but declined moderately in August and September. Real estate loans have continued their sidewise movement. And indications are that both loans to farmers and those to finance the purchasing or carrying of securities have contracted moderately.

In conclusion, district banks so far in 1953 have contributed substantially to the financial needs of the expanding economy. This contribution was made not only by increasing loans to provide for growth but also by following credit policies that have contributed to business stability. Early in the year when underlying pressures were inflationary and the demand for credit strong, banks contributed to stability by becoming more restrictive in their lending policies. Tighter credit policies by district banks in this period reflected, in part, the tighter money market conditions generally. In recent months as the excessive demand for credit has disappeared, district banks have relaxed the restrictions on their lending somewhat (again reflecting money market conditions) and thus have provided a stimulus to continued business stability.

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