~~August 8, 1969~~

To Members of the Federal Open Market Committee and Reserve Bank Presidents not now serving on the Committee

From Alfred Hayes, Vice Chairman, Federal Open Market Committee

I thought the members of the Open Market Committee and other Bank presidents might find the attached memorandum of interest. It presents a review of some of the problems involved in interpreting the banking and monetary statistics in view of the recent change in Regulation D, the proliferation of nondeposit liabilities, and the extensive sales of loans by banks. These developments raise difficult questions for monetary policy, and I believe that this memorandum provides a useful discussion of some of the analytical questions.

RECENT STATISTICS ON BANK CREDIT AND MONEY SUPPLY

Analysis of the current banking and monetary statistics is extremely difficult in view of the recent change in Regulation D and the proliferation of nondeposit liabilities and other techniques designed to provide funds as the pressure on the banks intensifies. However, after adjusting for these developments as far as possible, "bank credit" as described below appears to have increased so far this year at an annual rate of close to 5 percent. While the various proxy measures suggest lower, or even negative rates of growth, there are reasons to believe that these measures may understate the growth of bank credit. Taking into account the deposits affected by the change in Regulation D, the money supply has probably increased at an annual rate of about 4 percent so far this year.

Bank Credit. Current bank credit developments are particularly difficult to interpret in view of the recent change in Regulation D, the rapid increase in the banks' nondeposit liabilities, and their substantial sales of loans to affiliates and others. In the circumstances, the last-Wednesday all commercial bank credit figures seem to be more reliable than the various proxy measures because the Wednesday figures are distorted by fewer of these special adjustments and transactions.

Preliminary estimates of last-Wednesday all commercial bank credit for July show a 7 1/2 percent seasonally adjusted annual rate of growth, bringing the growth rate from the end of December 1968 to 3 1/2 percent (see line 1 of Table I). However, one of the principal shortcomings of the last-Wednesday figures is the distortion that may result from relying on single-date figures in analyzing credit developments. If the July figure is taken as an average of the last-Wednesdays in June and July, and the figures for other months are calculated in the same manner (in order to get away from the distortions of single-date measures), total bank credit grew in July at a 3 1/2 percent seasonally adjusted annual rate, and at a 4 percent rate from December to July (line 2 in Table I). During the second half of 1968, total bank credit calculated in this fashion increased at a 14 1/2 percent seasonally adjusted annual rate.

Commercial banks' outright sales of loans to affiliates and others, which are written-off the banks' balance sheets, have risen rapidly in recent months, from $2.0 billion on May 28, 1969 to $3.5 billion on July 23 (of which $2.6 billion were sold to affiliates and $0.9 billion to others). Whether such loan sales should be added back into the bank credit figures is a difficult question. A good case can be made for assuming that bank holding companies and other affiliates are part of the commercial banking system, and that loans transferred from a bank to its holding company still represent credit extended to the public by the banking system. Thus, it can be argued that loans sold to affiliates should be added into the bank credit figures. This adjustment increases the rate of growth of bank credit in July from 3.4 percent to 4.9 percent (line 3 in Table I), and the December to July growth rate from 3.8 percent to 4.9 percent (assuming that the great bulk of the loan sales took place this year). The case for adding back into the credit figures loans sold to others is much weaker, since it is difficult in principle to differentiate such loan sales from sales of securities which, of course, are not added back into the credit figures. Nevertheless, the results of this adjustment are shown in the bottom line of Table I.

The conventional daily average bank credit proxy measures indicate a much weaker July performance than the last-Wednesday figures. However, as mentioned above, the proxy figures are becoming increasingly suspect as the banks develop nondeposit sources of funds, and, as credit extended by nonmember

TABLE I

TOTAL BANK CREDIT
(Seasonally Adjusted Annual Rates of Growth)

	June	July	December to: June	December to: July
1. Last Wednesday	-1.2	7.7	3.0	3.7
2. Average of two Wednesdays	0.6	3.4	3.9	3.8
3. Average of two Wednesdays + loan sales to affiliates	2.4	4.9	4.9	4.9
4. Average of two Wednesdays + loan sales to affiliates and others	3.1	5.8	5.2	5.3

banks (which is excluded from the proxy, but included in the Wednesday figures) has been growing faster than that extended by member banks. Therefore, the Wednesday figures are probably a more reliable guide to current developments.

The daily average bank credit proxy including liabilities to foreign branches declined at a 13 1/2 percent seasonally adjusted annual rate in July, with private demand, Government, and time deposits all falling on a seasonally adjusted basis. The July weakness in the proxy brought the rate of decline since December 1968 to 3 percent (see Table II, line 2).

The proxy figures for August may be distorted by the change in Regulation D which required banks to include "London checks" and "bills payable checks" in deposits subject to reserve requirements beginning July 31, 1969. Before taking this adjustment into account, it was expected that the proxy including liabilities to foreign branches would fall at an annual rate of 8 1/2 percent (FRBNY estimate) to 10 percent (Board staff estimate) as time deposits continue to decline rapidly. It is still not clear how large the Regulation D adjustment will be, but the information now available suggests that it will increase daily average demand deposits by about $3 billion, with $2 1/4 billion of the increase occurring between December 1968 and July 1969. An adjustment of this size, if concentrated in August, would convert the proxy from an 8 1/2 percent rate of decline to an increase of 1 1/2 percent. It would also reduce the rate of decline in the proxy over the first eight months of the year from 3 1/2 percent to 2 1/2 percent (see line 2 in Table II).

In view of the commercial banks' efforts to develop nondeposit sources of funds on a large scale, we have been attempting to develop a broader proxy measure, one that might more accurately indicate the banks' ability to extend credit than the conventional proxy measures. Three variants of this broader proxy--which has been termed the "total liability proxy"--are given in

Table II. The total liability proxy adds to the proxy including liabilities to foreign branches: security and loan RP's, loan participations, net purchase of Federal funds from nonmember banks, due bills, London checks, Eurodollars borrowed directly from foreign branches, and liabilities to branches in U. S. possessions. Taking these transactions into account strengthened the proxy considerably in recent months. In July, for example, the total liability proxy declined at an 8 1/2 percent seasonally adjusted annual rate (Table II, line 3) as compared to a 13 1/2 percent rate of decline for the proxy including liabilities to foreign branches (line 2). And for the first seven months of the year, the total liability proxy shows no change whereas the conventional proxy shows a 3 percent rate of decline.

The total liability proxy may be further refined by adding in loans sold outright (and off the selling banks' balance sheets) to affiliates and others. As can be seen in Table II (line 4), adding loan sales to affiliates to the total liability proxy adds about 2 percentage points to the growth rate in July and gives the proxy a small (1 1/2 percent) positive rate of growth from December through July. Line 5 in Table II shows the total liability proxy plus loan sales to affiliates and others. Calculated on this basis, the proxy increased at a 3 percent seasonally adjusted annual rate in the December to July period, as compared to a 3 percent rate of decline in this period given by the proxy including liabilities to foreign branches.

It should be noted that the construction of the total liability proxy and its variants involves data from a number of sources which differ in frequency, scope and quality. In addition, some of these data are seasonally adjusted while others are not. Thus, the total liability proxy must be used with caution. There is, moreover, little, if any, basis for projecting a number of the components of the total liability proxy. The change in

TABLE II

BANK CREDIT PROXY GROWTH RATES
(Seasonally Adjusted Annual Rates)

					December to:	
	June	July	August[p/]	June	July	August[p/]
1. Simple proxy	-13.5	-21.0	-11.4	-4.5	-6.8	-7.3
2. Proxy including liabilities to foreign branches	- 4.1	-13.4	- 8.4	-1.1	-2.9	-3.6 (-2.4)[a/]
3. Total liability proxy[b/]	3.4	- 8.5		1.6	0.0	
4. Total liability proxy plus loan sales to affiliates	4.6	- 6.6		2.8	1.4	
5. Total liability proxy plus loan sales to affiliates and others	4.9	- 5.5		3.2	3.2	

a/ The proxy including liabilities to foreign branches adjusted to reflect an increase in daily average demand deposits of $2.25 billion between December and August (to $3.0 billion) as a result of the change in Regulation D, effective July 31, 1969.

b/ The proxy including liabilities to foreign branches expanded to include: security and loan RP's, loan participations, net purchases of Federal funds from nonmember banks, other liabilities, due bills, London drafts, liabilities for Euro-dollars borrowed directly from foreign banks, and liabilities to branches in U. S. possessions.

p/ Projected.

FRBNY estimates.

Regulation D memtioned above, by incorporating "London checks" and "bills payable checks" in deposits, will reduce, but not eliminate, the discrepancy between the proxy including liabilities to foreign branches and the total liability proxy.

Money Supply. The daily average money supply increased at a 3 percent seasonally adjusted annual rate in July, bringing the rate of growth of the money supply so far this year to 2 1/2 percent. During the second half of 1968 the money supply increased at a 6 percent annual rate. The money supply is expected to remain virtually unchanged in August apart from the change in Regulation D which, as already noted, will add some $3 billion to demand deposits. If the increase is all allocated to August, at least initially, it would push the projected money supply growth rate for the month up to about 18 percent. The December-August growth rate would be raised from 2 percent to about 4 percent, if it is assumed that $750 million of these additional deposits were outstanding in December.

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