FUNDAMENTAL REAPPRAISAL OF THE DISCOUNT MECHANISM

RESERVE ADJUSTMENTS OF THE EIGHT MAJOR NEW YORK CITY BANKS DURING 1966

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The following paper is one of a series prepared by the research staffs of the Board of Governors of the Federal Reserve System and of the Federal Reserve Banks and by academic economists in connection with the Fundamental Reappraisal of the Discount Mechanism.

The analyses and conclusions set forth are those of the author and do not necessarily indicate concurrence by other members of the research staffs, by the Board of Governors, or by the Federal Reserve Banks.

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C O N T E N T S

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Introduction

By the end of 1965 the economy had already accomplished an expansion unmatched for vigor or endurance by any other business upswing of the post-World War II period. The margin of unused productive capacity and manpower resources had narrowed considerably, and inflationary tendencies were on the rise. During the ensuing nine months, demand pressures in the economy failed to abate. Business expenditures on plant and equipment accelerated further, spending on services by states and municipalities rose, and Federal government outlays increased sharply as a result of an escalation of the Vietnam conflict and an expansion of domestic social programs. Pressures in the credit markets were intensified through September 1966 as the corporate and government sectors competed for funds in an atmosphere of increasing monetary restraint. Capital market yields soared to their highest levels in more than three decades, and demands made on the commercial banking system induced near-crisis conditions. Functioning in their traditional role of major supplier of business credit to the nation, the eight large New York City money market banks[1] were the focal point of these pressures.

Sources of pressure on the New York City money market banks

The heavy corporate demands for bank credit during 1966 reflected to a considerable degree an acceleration in the payment schedules for corporate Federal income taxes and employees' withheld income and social

1. Chase Manhattan Bank, First National City Bank, Manufacturers Hanover Trust Co., Chemical Bank New York Trust Co., Morgan Guaranty Trust Co., Bankers Trust Co., Irving Trust Co., and Marine Midland Grace Trust Co.

security taxes, which increased corporate working capital requirements in 1966 by an estimated $4.1 billion. These sharply expanded needs for funds occurred at a time when corporate liquidity was at low ebb and the volume of internally-generated cash flow had begun to shrink. Throughout the economic expansion that began in 1961, corporations had allowed their holdings of cash and liquid assets to run down to minimum levels in order to expand productive capacity, build up inventories, and acquire a very large volume of trade receivables. After the first quarter of 1966, moreover, the rapid growth of corporate profits came to a halt. As 1966 progressed, corporations' projections of their own cash flows proved increasingly overoptimistic in the light of actual developments, and the need for additional bank borrowing rose accordingly.

In addition to increased working capital needs of corporations, several other factors exerted pressure on the City banks during 1966. A portion of the growing number of requests for business loans represented a spillover of demand from the capital markets. With yields on new bond flotations moving rapidly to three-decade highs, many corporations sought to avoid expensive long-term borrowing by financing investment outlays temporarily at relatively favorable bank lending rates. Secondly, life insurance companies and savings banks requested loans, under lines of credit that had seldom been used in the past, in order to take up prior investment commitments. Cash inflows at both these types of financial intermediaries were seriously diminished during 1966 by the process of disintermediation set in motion by the sharp increase in market yields on securities relative to those available on institutional savings. Moreover, life insurance companies were subjected to heavy cash withdrawals through borrowing by policyholders at low contractual rates of interest, and for other related reasons, while savings banks experienced some loss of savings to the commercial banks, which were permitted to pay higher rates of interest on certain types of accounts.

Finally, requests for bank accommodation by businesses anticipating further interest rate increases were a constant and significant source of pressure on the banks. Throughout the first three quarters of 1966, banks were deluged with requests for business loans that were generated not only by specific investment projects or working capital needs, but also by a strong desire to obtain an adequate liquidity margin for possible future needs. In borrowing for anticipatory purposes, many businesses activated lines of credit that had been dormant for long periods in the past. Equally symptomatic of the spreading uncertainties regarding the future cost and availability of credit were the large-scale attempts by corporations to obtain additional bank lines of credit, increases in existing lines, and conversions of existing lines into formal, legally binding commitments for revolving credits or term loans in exchange for the payment of a customary commitment fee.

The prevailing belief during this period that interest rates must continue to head upward was caused by the increasing congestion in the capital markets, mounting demands for credit at commercial banks, and a step-up in military activity in Vietnam. The mood of pessimism was reinforced by the absence of fiscal measures to restrain inflation and its implication for monetary policy.

Monetary policy actions during the 1966 boom

Between the end of 1965 and September 1966, the Federal Reserve System utilized all of the instruments of general monetary control and also attempted to apply selective monetary pressures in its efforts to brake the boom. In December 1965 the discount rate was raised from 4 per cent to 4 1/2 per cent, signaling a shift from the mild restraint that had prevailed during most of 1965 to a more positively restrictive policy. This increase brought the discount rate temporarily into line with other money market rates, which had been moving up rapidly. In the strong upward surge of interest rates that followed, however, the discount rate was left far behind the market. In order to avoid the possibility of a further interest rate escalation, the System refrained from raising the discount rate again in 1966, but continued to scrutinize member bank borrowings carefully as requests at the discount window mounted.

Subsequent to the discount rate change in December 1965, gradually increasing pressure was applied to member bank reserve positions through System open market operations, and aggregate net borrowed reserves of the banking system rose steadily from about $100 million in the final 1965 week to nearly $600 million in the last week of September 1966. Reserve requirements against time deposits other than savings accounts were raised to the statutory ceiling of 6 per cent in two increases of one percentage point each, the first effective in July and the second in September.[2] Throughout the period of rising credit demands, officials of the System expressed increasing concern over the inflationary threat in the economy and the urgent need for credit restraint. Moral suasion took the form of periodic informal counseling of member banks by officers of the individual Reserve Banks as well as public speeches and statements of System officials. Member banks were urged to curtail their lending and to become more selective in granting loans so as to avoid extending credit for speculative ventures, for corporate acquisitions, or for other non-productive purposes.

Maintaining the 5 1/2 per cent interest rate ceiling on large-denomination negotiable certificates of deposit (C/D's), in the face of a sharp increase in yields on competing types of money market instruments, was one important way in which the System attempted to restrain the growth of bank credit during 1966.[3] In refraining from raising the

2. These higher percentages applied only to "other time deposits" in excess of $5 million at each member bank. Reserve requirements against time deposits below this limit and savings deposits remained unchanged at 4 per cent. Subsequent to these increases, the statutory maximum reserve requirement against time deposits was increased to 10 per cent.

3. However, the maximum interest rate payable on multiple-maturity time deposits was reduced to 5 per cent for maturities of 90 days or more and 4 1/2 per cent for 30- to 89-day deposits, effective July 20, and the maximum rate payable on single-maturity time deposits of less than $100,000 was reduced to 5 per cent, effective September 26. Previously, no distinction had been made between the single- and multiple-maturity categories of other time deposits. The reductions in the ceiling rate on multiple-maturity and smaller denomination single-maturity deposits affected those deposits most directly competitive with deposits or shares in savings institutions.

C/D rate ceiling, the System sought not only to affect the availability of bank credit but also to avoid stimulating further upward interest rate adjustments in the credit markets, and, thereby, to alleviate some of the pressure on mutual savings banks resulting from disintermediation. By July, the existing C/D rate ceiling posed a serious threat to the ability of the money market banks to attract new funds. Since 1961, when it first began to become an important outlet for surplus funds of corporations and other large investors, the C/D had been a major source of new funds for commercial banks, particularly the New York money market institutions. Although the rates payable on these instruments had always been subject to regulation, the ceiling under Regulation Q had been adjusted upward whenever necessary by the System in response to changes in other market rates of interest. The last such adjustment had been made in December 1965, simultaneous with the increase in the discount rate.

The accelerating business demands for credit were regarded by the System as the most threatening single element in the bank credit picture. The growing apprehension within the System over the strength of bank business lending was eventually made public in a letter issued by the System to member banks on September 1, near the peak of the financial market pressures. In this letter, which called attention to the 20 per cent annual growth rate in bank business loans over the first eight months of 1966, the System stated that "Federal Reserve credit assistance to member banks to meet appropriate seasonal or emergency needs... will continue to be available as in the past" and that "a greater share of member bank adjustments should take the form of moderation in the rate of expansion of loans, and particularly business loans." The letter warned that this goal would be kept in mind by the individual Reserve Banks in granting credit at the discount window and, at the same time, it offered the privilege of discount accommodation for extended periods of time to those banks cooperating in achieving this goal. The September 1 letter attracted much comment and gave rise to various interpretations. In the meantime, officers of the individual Reserve Banks continued to examine carefully trends in loans, investments, deposits and borrowings of banks that were problem or potential problem borrowers.

Liquidity of the money market banks at the opening of 1966

A lion's share of the pressure on the banking system resulting from the combination of excessive credit demands and monetary restraint during 1966 fell on the eight large money market banks in New York City. Over the post-World War II period, the role of the New York City banks as a major supplier of business credit had hardly diminished, despite the more rapid economic growth of many regions outside the industrial northeast and mid-Atlantic states. In 1966, the large New York City banks held about 29 per cent of total business loans outstanding at all member banks, only a slightly lesser share than the 31 per cent in 1946.[4] Some explanation for the continued prominence of the New York City banks in business lending may lie in the widespread trend toward the integration of industry during the postware period

4. Ratios are computed on the basis of data for New York City member banks classified as reserve city banks (or central reserve city banks prior to July, 1962). The eight major money market banks account for 92 per cent of the total assets of this group.

through mergers and consolidations. With the substantial increase in the relative size of individual business units, the City banks, possessing unusually large legal lending limits, have remained almost uniquely capable of accommodating the nation's prime borrowers. They may also have continued to be regarded by corporate business, in general, as an unfailing source of funds during periods of credit stringency.

In contrast, resources of the major New York City banks have shown a distinct tendency to decline relatively during the same era. Between 1946 and 1959, the City banks' share in total deposits of all member banks declined from 22 per cent to less than 17 per cent. Although it rose temporarily to 20 per cent during the years 1960-65 through the aggressive promotion of negotiable C/D's, this share fell to less than 18 per cent by the end of 1966 as a result of a sharp decline in C/D liabilities.[5]

The decline in the ability of the money market banks to attract funds by means other than the issuance of negotiable certificates of deposit appears to be a secular phenomenon directly related to a revolution in the management of corporate funds that has been taking place over the postware period. Throughout this era of generally restrictive monetary policy and rising interest rates, corporate financial managers have become increasingly aware of the cost of holding uninvested cash and of the possibility of simultaneously pursuing the goals of liquidity, safety, and income. Consequently, more corporations now hold demand balances with commercial banks to minimum working levels and invest

5. See footnote 4.

surplus cash in a widened array of a high-quality money market instruments. During 1966, however, the banks generally demanded larger compensating balances when making loans to corporations. Although corporate programs to economize cash have had an impact throughout the banking system, their effect has been more severe at the money market banks in New York City which have traditionally relied on corporate demand deposits as a major source of loanable funds. While the negotiable C/D has enabled the major New York City banks, in effect, to recoup some portion of corporate funds previously lost to the money market, it represents an extremely volatile and expensive source of funds for these institutions. On balance, it appears that demands for loan accommodation at the City banks have tended to increase faster than the means to satisfy these demands.

Although reductions in the burden of required reserves have permitted the City banks to utilize a progressively larger proportion of their funds for the acquisition of earning assets, this development has only partially mitigated the effects of the relative loss of deposits to banks in other regions of the country. Over the post-World War II period, required reserves of the major money market banks in New York City increased little, in absolute terms, despite a sharp growth in total deposits. This decline in the effective ratio of required reserves to total deposits, from a peak of 22 per cent in 1948 to about

9 per cent in 1966, occurred under the combined influence of successive reductions since the Korean War in reserve requirements against demand deposits under Regulation D (partly through the elimination of the central reserve city classification in July 1962) and a shift in the composition of deposits in favor of time and savings accounts.[6]

The eight New York City money market banks were, at the end of 1965, less well-equipped to handle an oncoming barrage of credit requests than they had been at any previous time during the postwar period. Over the course of the cyclical expansion begun early in 1961, these banks had allowed their liquidity to fall to a historically low level. By the end of 1965, the loan-to-deposit ratio of the eight institutions, as a group, had risen to 73 per cent, compared with 63 per cent for all commercial banks. The New York City money market banks entered 1966 with their liquidity at unprecedentedly low levels and with a very large proportion of their deposits rather precariously held; more specifically, highly volatile negotiable certificates of deposit accounted for nearly one-sixth of the total.

<u>Sources of new loanable funds</u>

The New York City money market banks responded to the acceleration of credit demands in 1966 primarily through intensive efforts to maximize their ability to meet these demands and, secondarily, through the adoption of programs to ration demands

6. See footnote 4.

and to scale down lending operations. At the start of the year, the negotiable certificate of deposit promised to be the major source of loanable funds for these institutions, as it had been in 1965. The maximum interest rate payable on time deposits under Regulation Q had just been raised (in December 1965, simultaneously with the discount rate increase) to a flat 5 1/2 per cent for all maturities over 30 days, from former rates of 4 per cent on 30- to 89-day maturities and 4 1/2 per cent on maturities of 90 days or more. The 1 to 1 1/2 percentage point increase in the rate ceiling had restored the banks to a favorable competitive position relative to other issuers of money market instruments and had apparently allowed them ample maneuvering room in their efforts to attract funds.

As a result of the rapid upward movement in money market rates beginning early in 1966, however, the City banks raised C/D offering rates frequently, attaining the new ceiling rate within a fairly short time. As early as March, one New York City bank posted the ceiling rate of 5 1/2 per cent on the 9- to 12-month maturity category of C/D's. Other City banks soon joined in the move to the ceiling by raising rates first on the longest maturity and then on progressively shorter maturities. By the beginning of August, an offering rate of 5 1/2 per cent was in effect "across the board" at most New York money market banks.

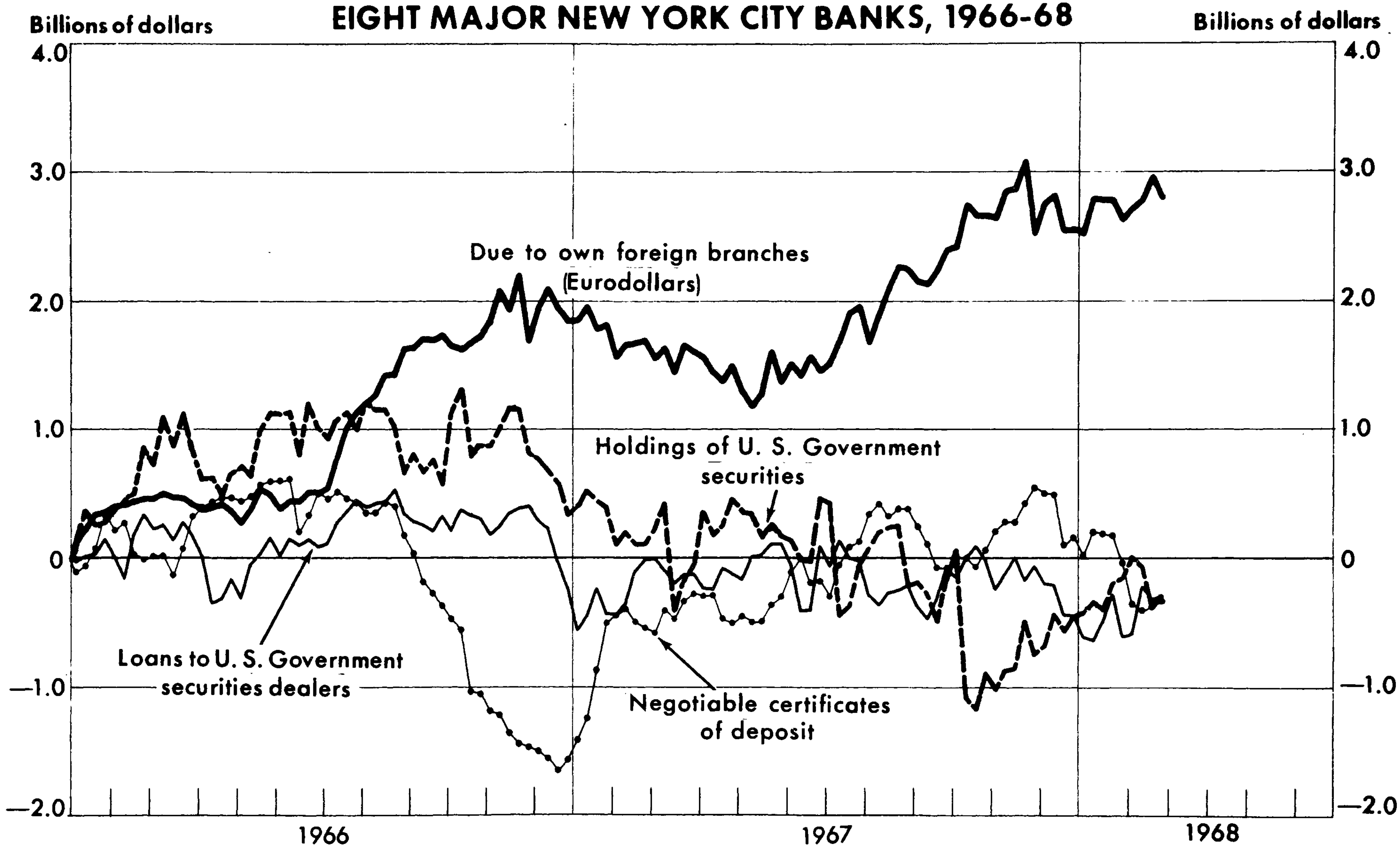
Late in August, however, the negotiable C/D, except in the shortest maturity category, had little appeal for investors. Money market rates (discount basis) had risen to 5 7/8 per cent on prime four- to six-month commercial paper, 5 3/4 per cent on 90-day bankers' acceptances, 5 5/8 per cent on three- to six-month directly placed finance company paper, and about 5 per cent and 5.40 per cent, respectively, on three- and six-month Treasury bills. These rates were equivalent to investment yields ranging upward from about 5.14 per cent and 5.63 per cent, respectively, on three- and six-month Treasury bills to 6.10 per cent on prime commercial paper, compared with the 5 1/2 per cent yield on C/D's. Subsequently yields increased further, through mid-September in the case of Treasury bills and through mid-October in the case of commercial paper; briefly during the fall, three-month Treasury bills, as well as the longer bill maturities, enjoyed a yield advantage over C/D's. Yields on commercial and finance company paper remained stable at their peak levels through the end of the year, while market yields on Treasury bills and on bankers' acceptances declined after reaching their respective peaks in mid-September and late November. Nevertheless, the longer Treasury bill maturities maintained their yield advantage relative to C/D's until the latter part of November and bankers' acceptances, along with commercial paper, continued to yield higher than C/D's through the year-end. Thus, despite a general easing of market tensions in early fall, the negotiable C/D did not become a competitive money market instrument again until just before the turn of the year.

Because of the changing structure of money market rates, the C/D performed very poorly during 1966 as a magnet for new loanable funds, contrary to indications at the end of 1965. As Chart I shows, this instrument drew a negligible sum into the City banks during the first eight months of the year in spite of the frequent and substantial upward rate adjustments. Increases in offering rates during January and February did attract some new money, but further increases were necessary in March in order to stem the unfavorable tide of net C/D redemptions that developed in that month and to prepare the banks for heavy seasonal credit demands during the tax period. The March rate increases led to a $0.6 billion expansion in the volume of outstanding C/D liabilities by mid-April. This improved flow of C/D funds enabled the City banks to supply without much difficulty the unusually large corporate credit demands that developed as a result of the Treasury's accelerated tax payment schedule. Borrowing needs of U.S. Government securities dealers were also heavy at this time as the dealers attempted to replace funds lost through the expiration of repurchase agreements with nonfinancial corporations around the tax date.

During May, the money market banks raised C/D offering rates again, leaving little room for further adjustments under the legal maximum, and by early August the 5 1/2 per cent rate was quoted on all maturities by the majority of the eight banks. The rate increases during the summer permitted the City banks to hold their C/D liabilities

Chart I

CUMULATIVE GAIN OF FUNDS THROUGH INCREASE IN LIABILITIES OR DECREASE IN ASSETS EIGHT MAJOR NEW YORK CITY BANKS, 1966-68



Note: Data are based on Wednesday levels, except loans to U. S. Government securities dealers, which are based on the daily average amount of Federal funds and New York Clearing House funds loaned to dealers during weeks ended on Wednesday. The latter include funds supplied to dealers under repurchase agreements.

Source: Federal Reserve Bank of New York.

fairly constant, but they failed to generate additional funds to enable the banks to handle renewed seasonal tax-related pressures, loan requests from nonbank financial institutions, and an extraseasonal demand for business loans.

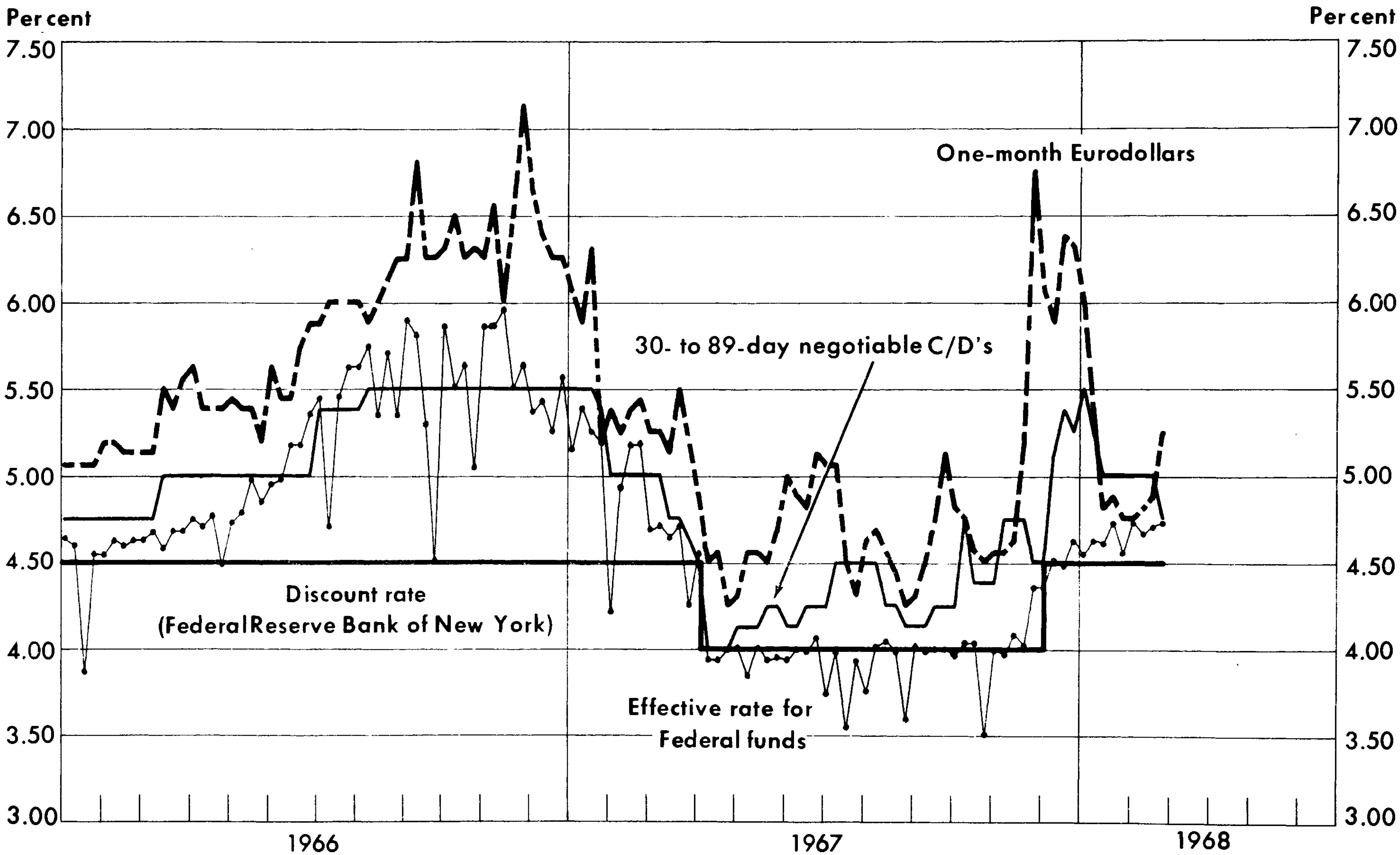
The larger-than-seasonal demand for business loans that began to appear early in May and persisted into the fall of 1966 reflected, to a considerable extent, a substantial increase in the volume of anticipatory borrowing by corporations. Over the summer, expectations of increases in interest rates and concern over the future availability of credit became widespread. These apprehensions were bolstered by evidence of increasing monetary restraint and by an awareness that the money market banks, then offering the maximum permissible rate on C/D's, would be severely limited in their ability to expand loans further. While precautionary borrowing was, thus, generated by the actual and prospective situation in the money and credit markets, it contributed to existing pressures. As credit demands became increasingly urgent, the New York money market banks were subjected to rapid withdrawals of C/D funds beginning in the latter part of the summer. During the brief span between mid-August and mid-December, C/D liabilities of the large City banks fell by $2.1 billion.

In early summer of 1966, the New York City banks anticipated the large losses of funds that eventually occurred as a result of C/D redemptions. Those which had foreign branches were prepared to meet them by borrowing Eurodollars through these branches. Although the Eurodollar market is generally a costly source of funds, the relatively strong surge of money market rates in the United States toward the end of 1965 had resulted in a considerable narrowing of the differential between domestic money market and Eurodollar rates. During the first half of 1966, for instance, rates on Eurodollars were only about 3/8 of a percentage point higher than rates on comparable maturities of negotiable C/D's sold in New York City (Chart II). This interest rate differential widened over the balance of 1966 as interest rates abroad reversed their course. Nevertheless, the cost disadvantage to the City banks of acquiring Eurodollars was partly compensated for, throughout 1966, by the fact that these liabilities are not subject to reserve requirements or to assessments by the Federal Deposit Insurance Corporation.

Eurodollar borrowings constituted the only major source of new funds for the money market banks during 1966, and they were the principal means by which the City banks survived the severe drains resulting from net runoffs of C/D's during the last four months of the year. As Chart I shows, liabilities to own foreign branches at the eight money market banks climbed sharply between June and December from a plateau reached in the first quarter of 1966. For the year as a whole, cumulative borrowing of Eurodollars by the City banks amounted to $1.8 billion, an amount roughly equivalent to the decline in C/D liabilities. As a group, these banks began to step up their Eurodollar borrowing fully two months before the heavy redemptions of

Chart II

SELECTED SHORT-TERM INTEREST RATES, 1966-68



Note: Data plotted are the seven-day average rate on Federal funds for week ended Wednesday, the rate most often quoted on Wednesday by nine large New York City banks on new negotiable certificates of deposit, and the Wednesday rate on Eurodollar deposits.

Source: Federal Reserve Bank of New York.

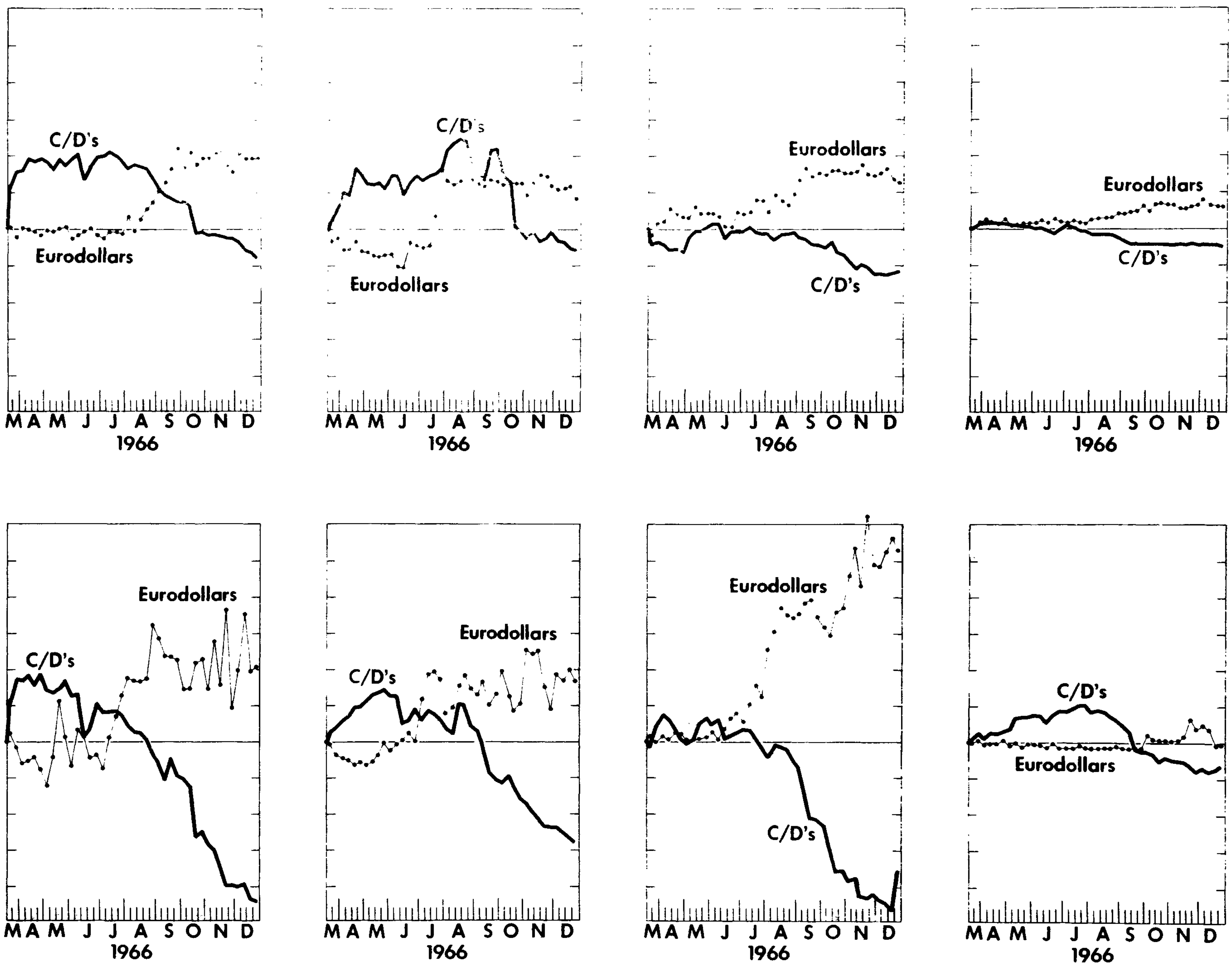
C/D's began. Consequently, the basic reserve position of these institutions improved sharply, though temporarily, in August and early September.

Virtually all of the major money market banks used Eurodollar borrowings as an offset to C/D losses (see Chart III). Individual banks varied in their approach to the Eurodollar market, however. A few banks began to seek these funds after a downward trend in their C/D liabilities had become clearly visible or at the same time as C/D losses commenced. On the other hand, some borrowed Eurodollars considerably in advance of C/D runoffs. Some banks built up liabilities to foreign branches gradually over the period of C/D outflows, compensating for losses of funds as they occurred. Other money market institutions borrowed heavily initially, then allowed these foreign liabilities to remain on a plateau until the latter part of the year, when the greater part of interest-sensitive C/D funds had been withdrawn. Most of the eight banks' cumulative borrowings of Eurodollars corresponded roughly to cumulative C/D losses. At two institutions, however, Eurodollar borrowings were quite heavy relative to C/D runoffs.

Although little is known about the maturities of Eurodollars borrowed by the City banks, it may be reasonable to assume that some portion of the aggregate amount represented overnight or call money, while a relatively larger amount represented funds acquired by the foreign branches on longer-term contracts. Maturities may have varied widely from bank to bank, however, since some branches overseas characteristically seek short-term Eurodollar deposits while others seek somewhat longer maturities.

CHART III

CUMULATIVE CHANGE IN NEGOTIABLE CERTIFICATES OF DEPOSIT AND EURODOLLARS AT EIGHT INDIVIDUAL NEW YORK CITY BANKS, MARCH 16 TO DECEMBER 28, 1966.



Note: Vertical scale is identical for all eight banks.

Source: Federal Reserve Bank of New York.

In order to increase the availability of Eurodollars for its domestic lending operations, one New York City institution in April 1966 began to sell negotiable certificates of deposit at its London office at yields slightly lower than those available for comparable maturities of regular Eurodollars. At the same time, the bank organized a secondary market for Eurodollars C/D's. Within a short time, the majority of other money market banks with branches in London had begun to sell these instruments.

The major purpose of the C/D sales abroad by the money market banks was to acquire more funds through the Eurodollar market. By offering the C/D's in relatively small denominations (the minimum of $25,000 compared with a regular Eurodollar deposit minimum of $250,000 and a New York negotiable C/D minimum of $100,000), the banks set their sights on the funds of small investors who had not previously participated in the Eurodollar market. In addition, however, the City banks hoped to benefit by acquiring Eurodollars at a reduced cost and by improving their ability to retain funds that might otherwise be lost through the redemption of domestic C/D's by foreign holders in the event of interest rate increases here or abroad. C/D's sold in London are not subject to any rate limitation such as that imposed by Regulation Q. The creation of the Eurodollar C/D market did not add significantly to the supply of Eurodollar deposits in foreign branches of the major money market banks. It is, however, illustrative of the resourcefulness of these institutions in attempting to locate new sources of funds for lending.

Although needs for new loanable funds were intense during 1966, the New York money market banks' sustained liquidation of U.S. Government securities ceased after the first quarter. Portfolio adjustments were used to tide the banks over periods of seasonal increase in loan demand, but net sales at these times tended to offset by purchases when acute pressures eased. The use of the U.S. Government securities portfolio as a temporary adjustment mechanism after the first quarter of 1966 contrasted sharply with its use as a more or less permanent source of funds earlier in the business expansion. During 1965, net sales of U.S. Governments had been a major source of new loanable funds for the City banks, second only to the issuance of negotiable C/D's, and in the first quarter of 1966 the liquidation of these investments had provided another $1.1 billion.

The reduced role of portfolio adjustments in the City banks' program to meet accelerating loan demands was primarily a reflection of the low level of holdings. By March 1966, the combined U.S. Government securities portfolio of the eight money market banks had been reduced to its lowest level of the entire postwar period as a result of the sustained liquidation which had commenced late in 1961. At this level, the bulk of securities remaining in portfolio may have been pledged against public deposits and, hence, not saleable. Another factor tending to discourage securities sales by the City banks in the summer of 1966 was that the sharp increase in market yields raised the cost, in terms of capital losses, of liquidating coupon issues.

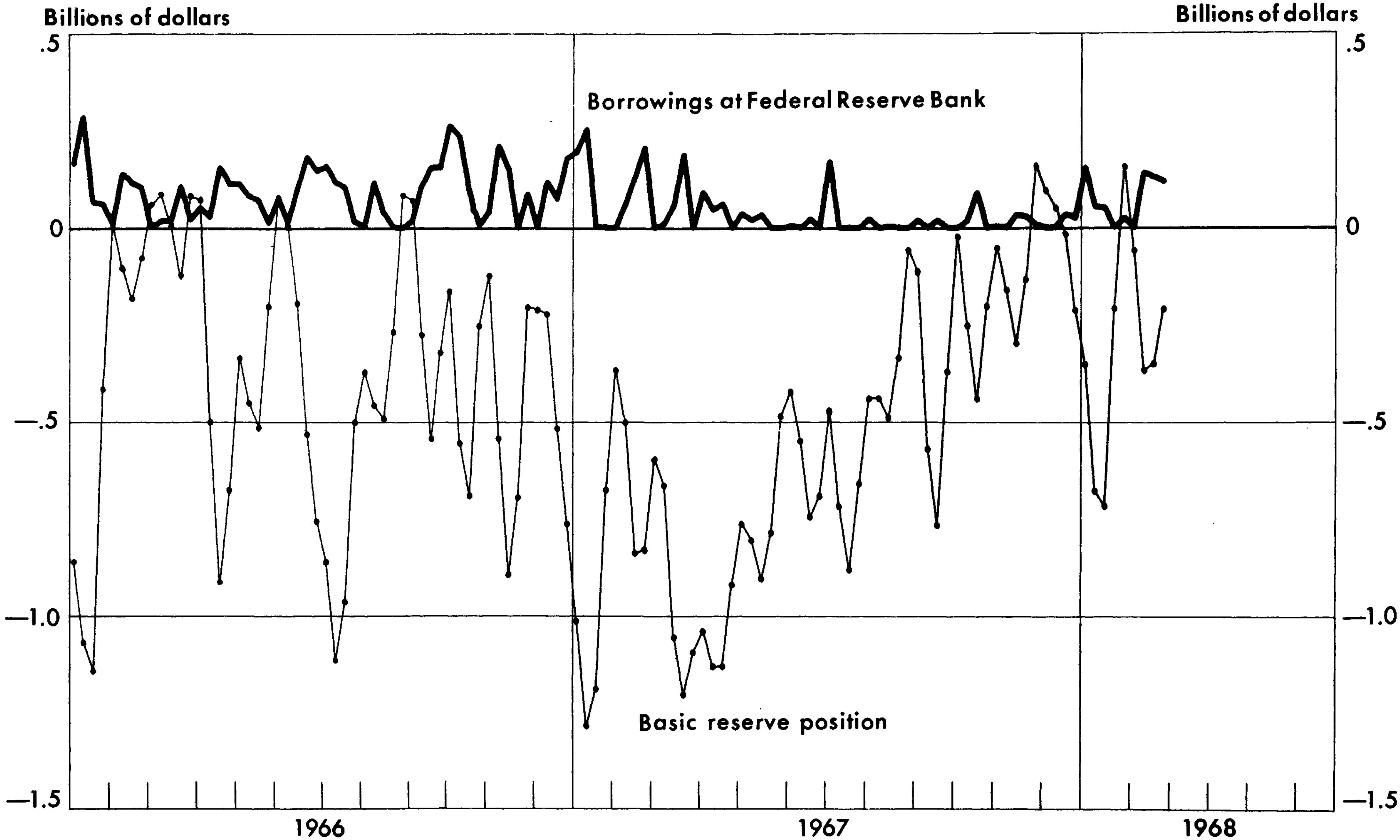
After September 1, moreover, the liquidation of investments by banks ran directly counter to the expressed wishes of Federal Reserve System policy makers. Through public statements, periodic counseling of individual member banks, and the administration of the discount window, System officials left no doubt that they looked with disfavor upon further reductions in bank holdings of tax-exempt securities, especially when accompanied by a sustained rate of expansion in business loans. Member banks engaging in large-scale liquidation of such securities, thus tended to invite closer scrutiny when requesting discount accommodation at the Reserve Banks. This possibility of increased surveillance was not a significant restraint on liquidation, however, because of the relatively limited use of discount facilities made by the City banks during 1966. In fact, these institutions sold off tax-exempt securities at a steady pace throughout 1966, gaining about $0.5 billion from this source through June and a like amount over the latter half of the year. These sales, occurring during a period of heavy net new borrowing by state and local governments, were a significant factor in the sharp rise in yields on tax-exempt bonds to a thirty-four year high by August 1966.

Use of the discount window

The major New York City banks were generally in a position of deep basic reserve deficit during 1966 (see Chart IV). At times during the first eight months of the year, their reserve positions underwent some sharp, temporary improvement as a result of inflows of C/D funds,

Chart IV

BASIC RESERVE POSITION AND BORROWINGS AT THE FEDERAL RESERVE BANK EIGHT MAJOR NEW YORK CITY BANKS, 1966-68



Note: Data are daily average levels for weeks ended on Wednesday. Figures for basic reserve position are two-week moving averages.

Source: Federal Reserve Bank of New York.

liquidations of securities, and substantial borrowing of Eurodollars as during the summer months in advance of the heavy C/D runoffs. During the latter part of the year, however, the basic reserve deficit deepened to unusually high levels under the impact of the drastic decline in C/D liabilities after mid-August. As a result, the daily average basic reserve deficiency of the eight banks rose to nearly $500 million in the fourth quarter of 1966 from roughly $350 million during the first three quarters of the year.

While their needs for funds to cover reserve requirements were consistently heavy during 1966, the New York money market banks made relatively little use of borrowing facilities at the Federal Reserve Bank. As shown in Chart IV, substantial increases in the basic reserve deficiency prompted only moderately increased use of the discount window. Moreover, whatever borrowing these institutions did at the Federal Reserve during 1966 was invariably the traditional overnight or short-term type of accommodation. None of the eight money market banks took advantage of the privilege of extended discounting offered in the System's September 1 letter to member banks, despite the increase in their basic reserve deficits during the fall of the year.

The City banks' hesitancy to approach the Federal Reserve Bank for assistance, except at times of extreme emergency, partly reflected the unwillingness of these institutions to have their lending and portfolio adjustment practices the object of official scrutiny. It also reflected the much heavier use made of the Federal funds market by the money market banks in recent years. During the early 1960's, the City banks had begun to borrow Federal funds from other banks for the purpose of relending, particularly to Government securities dealers, as well as for the purpose of making day-to-day adjustments in their reserve positions. As the function of the Federal funds market broadened, the rate for Federal funds rose in relation to the discount rate, and had generally exceeded the latter since 1964. During 1966, however, the margin by which the effective rate for Federal funds exceeded the discount rate widened to nearly a full percentage point by mid-November from about 10 basis points throughout 1965 (Chart II). This sharp increase in the differential reflected the City banks' determined efforts to operate without assistance from the Federal Reserve Bank as well as their continuing use of Federal funds for dealer and other lending operations. In 1966, to an even greater extent than formerly, the City banks were permanent debtors in the Federal funds market, automatically renewing overnight loans and borrowing for periods of more than the usual one day.

Attempts by the City banks to curtail lending

Between December 1965, at the time of the increase in the discount rate, and August 1966, the large New York City banks raised their prime lending rate to business borrowers in four steps from 4 1/2 per cent to 6 per cent. These increases were largely dictated by the need to maintain profitable operations in the face of the rapid rise in the cost of loanable funds to the banks. Although the prime rate increases, and particularly those occurring in June and August, were also intended to discourage loan applications from business borrowers, they had apparently little effect on total loan demand.

Early in 1966, many of the large City banks adopted programs amounting, in effect, to voluntary credit restraint. These programs, aimed generally at moderating the pace of business loan expansion through the exercise of greater selectivity in reviewing loan requests, were not implemented with any great vigor until the summer, when the gap between credit demands and the supply of bank funds for new lending widened significantly. Under these programs, the City banks denied loan requests which were clearly for speculative or hoarding purposes, turned down requests for term loans or formal loan commitments, and discouraged applications for loans from new customers. They also attempted to reduce loan amounts and lines of credit. Moreover, the banks reported that they made fewer loans at the prime rate and also raised compensatory balance requirements.

At the same time, however, the money market banks seemed very hesitant to turn down loan requests from old customers, or from new customers whose business they had long solicited. For competitive reasons, as well, some banks apparently went back on their original intentions not to issue formal loan commitments for a fee, even with the knowledge that the presence of a large volume of outstanding commitments would seriously limit their flexibility in time of emergency.

Despite the banks' efforts and procedures to restrain credit expansion, and the successive increases in the prime loan rate, net increases in business loans of the eight money market banks in the second and third quarter of 1966 exceeded by roughly two-fifths the amount of increase in the corresponding quarters of 1965. Not until the fourth quarter of the year did business lending fall off. In that period, the net increase in business loans declined sharply to a less-than-seasonal $0.4 billion from $1.1 billion in the fourth quarter of 1965. This rather drastic change in the pattern of business lending, however, probably reflected a slowdown in corporate demands as much as denials or scaling down of credit requests by the City banks.

During the fourth quarter of 1966, two factors which had contributed significantly to the vigorous loan demand earlier in the year were no longer present. Expectations of further increases in interest rates had largely disappeared, and corporations, whose liquidity needs were still large, had shifted part of their credit demands back to the capital markets in response to a reversal of the upward trend in bond yields. These favorable developments, in turn, had been prompted by a number of factors tending to stabilize the credit markets in the fall of 1966. Early in September, President Johnson announced a fiscal program to combat inflation and the U.S. Treasury indicated that it would curtail certain types of Government agency financing over the balance of the year. Prospects for peace in Vietnam seemed to be improving, moreover, and hopes were high for an income tax increase after the November elections. By the end of November, the markets began to detect signs of a relaxation of credit restraint and, indeed, the record of policy directives issued by the Federal Open Market Committee shows that the New York Reserve Bank was instructed on November 22 to conduct open market operations "with a view to attaining somewhat easier conditions in the money market..."