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Trends in banking and finance

The past six months have witnessed a dramatic reversal in supply-demand conditions in the money and capital markets. As in 1953, 1957 and early 1960 most major types of interest rates—both long and short term—have declined sharply. Lower interest rates partially reflect compensating downward adjustments of credit demands following a period of exceptionally strong borrowing based on both current and anticipated future needs. More important in the longer run, monetary policy since last November has been directed toward less restraint and marked changes have occurred in expectations both for probable future credit needs and probable availability of credit.

Potential borrowers from banks, savings associations, life insurance companies and other lenders are receiving their most sympathetic hearings since mid-1965. No longer hampered competitively by maximum rate regulations, commercial banks have been able to regain almost the entire volume of time certificates of deposit lost during the third and fourth quarters of 1966. Improved availability of time deposits has made it possible for banks to accommodate more readily the still strong demands for loans. Savings and loan associations, meanwhile, attracted record net inflows of share capital in December and January and their willingness and ability to make commitments to builders and potential home buyers have increased. Life insurance companies also have been making new commitments for mortgage loans and to purchase new issues of corporate bonds more readily as the demand for policy loans has subsided and projections of cash inflows for 1967 have been raised.

Some banks and financial institutions are hesitant to resume lending as freely as a year or more ago because of reduced liquidity positions resulting from the exceptionally tight credit markets in the past year or more. These lenders are attempting to rebuild liquidity by increasing holdings of short-term securities and paying off borrowings. But the 1966 experience produced little evidence of serious consequences to well-managed banks or other financial institutions. Evaluations of liquidity positions, moreover, are not measured adequately by balance sheet ratios alone. Projections of cash inflows and outflows comprise a vital part of the picture.

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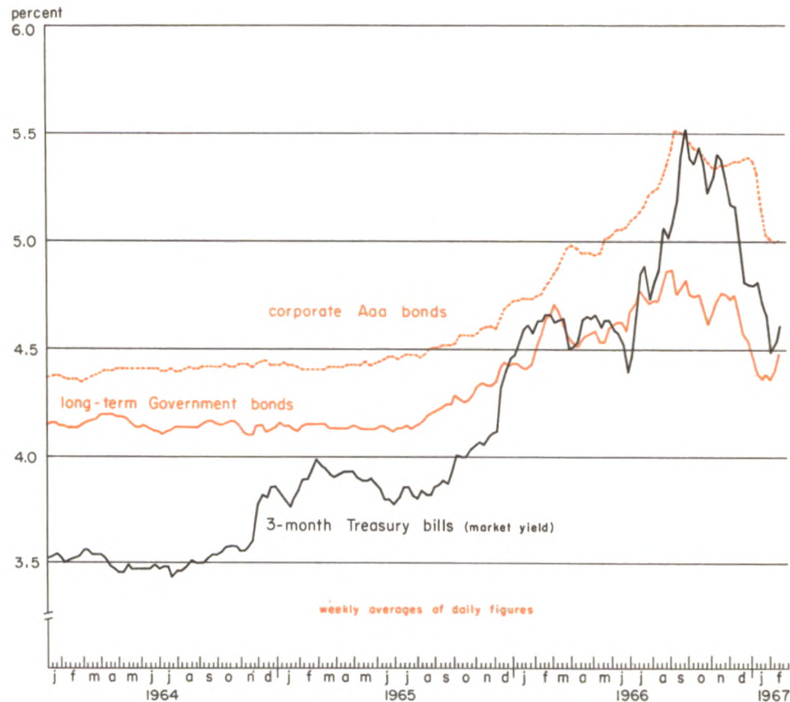
In February some classes of interest rates rose again. Certain money market participants interpreted these movements as the start of a general uptrend. Heavy prospective business borrowings associated with large tax payments due in the spring and the need to finance the projected Government deficit are cited. Forecasts of movements in interest rates and bond prices, however, often have been far off the mark when judged by subsequent events.

Interest rates have declined sharply from the postwar highs reached in the third quarter of 1966



The most important financial development of the past six months has been the replacement of apprehensive uncertainty with a more normal atmosphere. The bulk of the billions of dollars flowing into lenders' hands must be invested in debt instruments constantly. With the danger of sharp increases in interest rates—and accompanying substantial declines in market prices of long-term bonds and mortgages—apparently receding, the vast influx of investible funds can be expected to seek the usual channels, after being disrupted in some sectors by the developments of last year.

Monetary policy changes

In the autumn of 1966 the monetary authorities observed closely the emerging evidence that demand for some types of goods was leveling or declining. Construction activity and output of building materials continued in the downturn of many months duration. Retail sales and output of most consumer durables—autos, appliances and furniture—showed more or less pronounced declines toward year-end. Orders for producers' equipment leveled off and there were indications that defense requirements were rising less rapidly.

Some wholesale prices declined, order lead times were shortening and overtime hours were reduced. Growth in the labor force, installations of new equipment and temporary saturations of some markets all suggested

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that the economy was no longer operating as close to a practical maximum as earlier in the year. As a result, monetary restraints, necessitated by conditions prevailing throughout most of 1966, could now be relaxed. Developments in the first quarter of 1967 indicate that the trend toward easier supply conditions has continued.

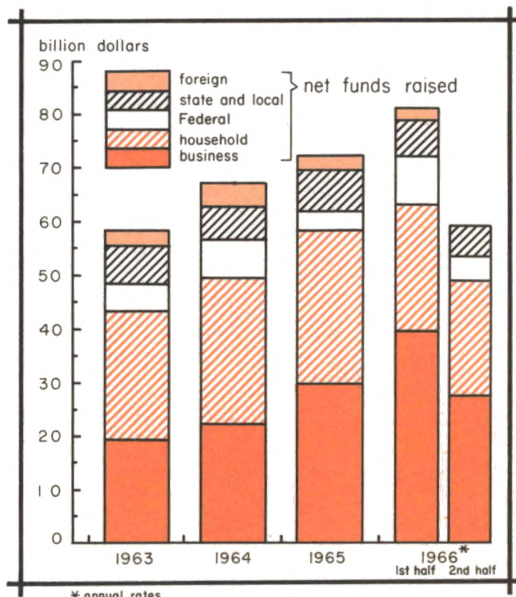
Monetary and credit developments have many facets. An important one is the pattern of interest rates which reflects the prices at which credit supply and demand are equated currently (see chart). Another is free reserves—excess reserves of member banks less borrowings from the Federal Reserve Banks—which reached a negative (borrowings larger than excess reserves) 580 million dollars late last September. In late February average excess reserves exceeded average borrowings. This provides an indication of the relaxation of reserve pressures on member banks of the Federal Reserve System in the interval. Still another measure is total reserves of member banks which declined, allowing for seasonal movements, in most of the fourth quarter before beginning a pronounced upswing. Total reserves reflect the net effects of Federal Reserve actions and other forces upon the supply of bank reserves.

More meaningful to most lenders and borrowers than the measures cited above are quantities such as demand deposits, time deposits and total credit. Demand deposits, seasonally adjusted, were approximately stable in the 131-132 billion dollar range from July through February. Meanwhile, time deposits, which changed little in the August-November period, rose at an average annual rate of almost 16 percent in the December-February period. Total bank deposits, usually a fairly good proxy for total bank credit, rose at an annual rate of about 10 percent in the same period. When interest rates are relatively high but tending to decline, there are powerful incentives for holders of demand deposits in excess of current needs to convert these into time deposits or to purchase other assets with favorable interest yields.

The flow of funds

Bank credit cannot serve as a reliable proxy for total credit granted by all lenders and investors. The flow of funds accounts prepared by the Board of Governors of the Federal Reserve System include quarterly estimates of "net funds raised by the nonfinancial sectors." The proportion of this total supplied by the commercial banks has ranged from less than 10 percent to more than 40 percent in the past decade.

Net funds raised
by all major sectors declined sharply in the second half of 1966



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Total net funds raised was at a record 81 billion dollar annual rate in the first quarter of 1966. By the fourth quarter, this rate had declined to 57 billion dollars, the smallest since early 1963 although still large relative to earlier periods. Apparently, this downtrend was reversed toward year-end and the first quarter of 1967 may witness a substantial gain.

Net funds raised by corporations declined by about half between the second and fourth quarters of 1966 as the growth of both loans and security issues was curtailed. Borrowing by households declined by about one-fourth from the third to the fourth quarters as the increase in both mortgage and consumer debt was reduced. The Federal and state and local governments increased their borrowing in the fourth quarter, but not to the levels reached earlier in the year. Foreigners repaid outstanding borrowings in United States credit markets in the fourth quarter to a limited extent.

Most classes of investors acquired fewer financial assets in 1966 than in 1965. For commercial banks the gain was 18 billion dollars compared with 30 billion in 1965. Savings and loan associations acquired less than 5 billion dollars, the lowest level since 1953, compared with 10 billion in the preceding year. Life insurance company acquisitions of financial assets in 1966 equaled the 1965 gain in contrast to substantial increases in most previous postwar years. Among major nonbank financial institutions, only pension funds reported a larger increase in their holdings in 1966. However, banks and most other financial institutions showed some increase in the rate of growth in their assets late in 1966.

Individuals and nonprofit institutions acquired about 10 percent fewer financial assets in 1966 than in 1965 with a reduction in their holdings of deposit-type savings offset, in large part, by a sharp increase in direct purchases of securities. In the fourth quarter this trend was reversed as deposit savings rose rapidly and security holdings were reduced.

Demands on the capital markets

During 1966 business corporations sold almost 18 billion dollars of long-term securities —up 21 percent from a year earlier and a new record. Net of all retirements and purchases by issuing firms, corporate securities outstanding rose by 11.1 billion dollars last year, more than double the 1965 increase.

State and local governments sold more than 11 billion dollars of long-term securities for new capital last year, also a new high. Outstandings rose only 5.5 billion, however, somewhat less than in 1965. Under more favorable capital market conditions, sales of municipal securities would have been even larger, but in the face of high interest charges and unacceptable bids by underwriters, many planned issues were postponed.

Federal Government securities outstanding rose 6.7 billion dollars in 1966—not a record, but a relatively high total compared with most earlier years. The Government made relatively little use of direct borrowing. Instead, the bulk of the rise in Treasury debt was accounted for by non-guaranteed issues and loan participation certificates. Because these classes of debt are not fully equated in the minds of investors with the usual forms of Federal obligations, somewhat higher interest rates are required. Also, special issues tend to compete more directly with corporate issues.

Heavy demands coupled with restraint on the supply of funds caused most classes of long-term interest rates to rise to the highest levels since the early Twenties last August and September. From less than 4.5 percent

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early in 1966, rates on long-term Treasury bonds rose to a high of almost 5 percent. New issues of top-quality corporate bonds which sold at less than 5 percent in early 1966 required as much as 6 percent last summer. Yields on high-grade municipals rose from 3.5 percent to more than 4 percent in the same interval. (On a pretax equivalent basis these rates on municipals, of course, can be approximately doubled for corporate investors for comparison with rates on taxable issues.)

Mortgage rates also rose in 1966, to the limits imposed by usury statutes in some states. At the peak last autumn, average yields on FHA mortgages exceeded 6.8 percent. Because of various institutional rigidities, mortgage demands for funds do not compete fully with other securities during periods of limited availability. The increase in loans on 1-4 family dwellings declined from 16 billion dollars in 1965 to 12 billion in 1966, and the annual rate of increase had fallen to less than 10 billion dollars in the fourth quarter. Largely for this reason home building declined sharply in 1966. The drop in mortgage financing was most noted in the third and fourth quarters as the large volume of commitments made much earlier was worked off. The importance of the shift in mortgage financing is highlighted by the fact that in 1965 the net increase in total private mortgages amounted to 25.5 billion dollars, 2.2 times the rise in corporate and municipal securities combined. In 1966 this ratio dropped to 1.2.

In the first quarter of 1967, interest rates on Governments, corporates and municipals returned to the levels of early last year. But credit demands remain very strong and will tend to restrain further decreases in yields. The Government deficit is likely to approximate last year's, and the Treasury has resumed the issuance of nonguaranteed securities and participation certificates. State and local government issues have been at a record level thus far in 1967, partly because of the reactivation of issues postponed last year. Corporate demands for funds may not rise appreciably in 1967 since capital expenditure programs are increasing less rapidly and many firms are attempting to reduce inventories. Certain corporations, however, will seek to sell new securities to improve liquidity positions by rebuilding liquid assets and repaying short-term debt.

An accelerated flow of funds to the mortgage markets is now under way, and home building is almost certain to respond although the timing and amplitude of this resurgence remains in doubt. Meanwhile, mortgage rates have declined slightly from last year's peaks but continue substantially higher than in early 1966.

Business loan growth revives

Plant and equipment expenditures of corporations continued to rise throughout 1966, although at a somewhat slower rate in the second half. Inventory accumulations, meanwhile, accelerated to a record rate in the fourth quarter, and additions to trade credit also continued large. But total funds acquired by corporations through security issues and bank loans declined in both the third and fourth quarters. This apparent anomaly is explained by developments in other sectors of business finance.

Depreciation, the most important internal source of business funds, continued to rise for most firms during 1966. Meanwhile, aggregate profits were well maintained and dividend payments were reduced somewhat. As a result, retained earnings continued to rise. Firms able to tap the commercial paper market increased their sales to investors when

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bank loans became less available. But the most dramatic business financial development in the third and fourth quarters of 1966 was the decline in corporate holdings of bank deposits and Government securities. Among major classes of liquid assets held by business firms, only commercial paper continued to rise throughout 1966.

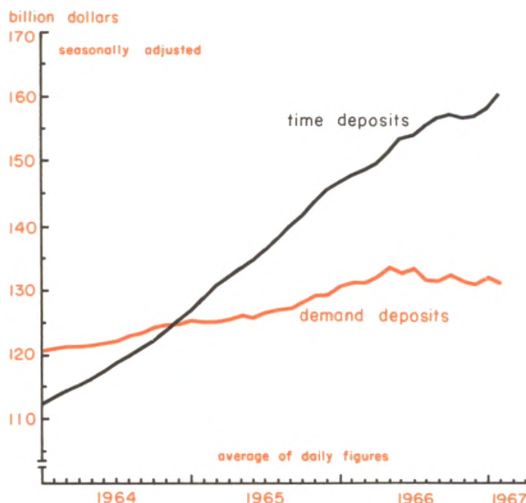
The problem encountered by business financial managers in late 1966 was in part the result of the rise in funds tied up in inventories. As retail sales leveled off, inventories rose above planned levels. A revival in retail sales would relieve quickly current financial stringencies for many firms. Awaiting such a development, manufacturers in important consumer durables lines have reduced production, a development that, in time, will enable these firms to convert surplus inventories into cash.

The decision of the Chase Manhattan Bank to reduce its rate to prime commercial borrowers from 6 to 5.5 percent in January was greeted with some surprise but, nevertheless, was followed promptly by quarter point reductions announced by large banks in other centers, including the Midwest. Nevertheless, the margin between effective rates on new business loans and rates on commercial paper and bonds widened substantially in the early months of 1967. During February new high-grade corporate bonds were sold to yield about 5 percent and shorter maturities of commercial paper sold by major finance companies bore rates as low as 5⅛ and even 5 percent.

In late February business loans of leading banks in the Seventh Federal Reserve District were 15 percent above a year earlier and total loans amounted to 66 percent of total deposits—a high for the postwar period. For all weekly reporting banks, business loans were up 14 percent in the same period and the ratio of total loans to total deposits also was 66 percent. The past decade has revealed several times that supposed ceilings in loan-deposit ratios could be breached. During the early weeks of 1967, it appeared that banks were making progress in rebuilding liquidity and that business loan growth was again proceeding fairly rapidly.

All major industrial nations moved to restrain credit growth in 1966 to dampen inflationary pressures. In most of these countries prices of goods and services had risen substantially more than in the United States. Measures to restrain growth of demand, therefore, were necessary. However, in January and February, most of the central banks of Western Europe (the counterparts of the Federal Reserve System) took steps to ease credit restraint as it appeared that inflationary pressures were easing and margins of unused resources were developing.

Commercial bank time deposit growth resumed in late 1966



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Instalment loans: profitability varies

Profits on instalment loans vary considerably among banks, reflecting largely the substantial range of gross income. Operating expenses vary only moderately.

These observations are based on an analysis of costs and income for the instalment loan function in 186 Seventh Federal Reserve District member banks in 1965.[1] These banks participated in the *functional cost analysis service* which provides comparative information on income, expense and earnings for each of eight banking functions—demand and time deposits; instalment, real estate and other loans; investments; and the trust and safe deposit departments. An analysis of the instalment loan function is presented below.

Instalment loans defined

Instalment loans are usually differentiated from other forms of credit by the monthly repayment feature and the so-called add-on method of computing interest. Typically, an instalment loan is granted for a specific number of months and the outstanding balance is reduced by equal monthly payments. Instalment credit is used principally to finance purchases of consumer durable goods but may be used also for a variety of other purposes, including educational expenses, home improvements or repairs and in some instances consolidation of past-due obligations.

Three kinds of loans were included in the instalment loan function in the functional cost service: direct loans, indirect loans and floor-plan loans. From the borrower's point of view, there is little difference between a direct and an indirect loan. In either case, the monthly payment typically is made directly to the bank. However, loans do differ in origin: direct loans are made directly to borrowers by the bank; indirect loans are purchased by the bank from a third party, usually a retail merchant, appliance dealer or automobile dealer, who sells goods on contract to his customers. The customer's obligation is then to the bank as if he had borrowed from the bank in the first place. The dealer who has already received payment, may or may not have residual liability to "make the paper good" in the event the purchaser of the merchandise fails to make payments as scheduled.

Floor-plan loans, used to finance dealer inventories, are a somewhat different type of credit than the direct or indirect consumer instalment loan. These loans are included in this function because of the strong linkage between these two kinds of financing. It seems to be a common business practice for the bank that provides floor-plan financing to receive the instalment paper generated by the merchant's contract sales.

A typical arrangement is for a bank to provide at a simple interest rate credit needed by an appliance, furniture or auto dealer to purchase goods for display and inventory. The goods serve as collateral for the loan. The outstanding loan balance is reduced as items are sold rather than on a fixed monthly payment basis, and the dealer's loans are

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[1]Other information from the functional cost service has been published in: "Bank Profits—Costs and Returns for Major Functions, 1965," *Business Conditions,* October 1966 and "Bank Earnings, 1965: Banks Set Fast—and Slow—Pace," *Business Conditions,* November 1966.

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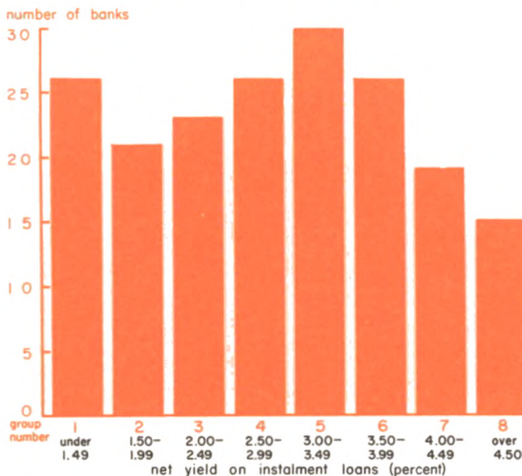
usually replaced on the bank's books by the consumer's instalment paper.

Bank groups: net earnings

For purposes of the analysis presented here, the 186 participating banks were divided into eight groups on the basis of the net yield on instalment loans. Net yield is the earnings less all operating expenses, overhead costs and the cost of money allocated to the instalment loan function, expressed as a percentage of the funds used in the function.

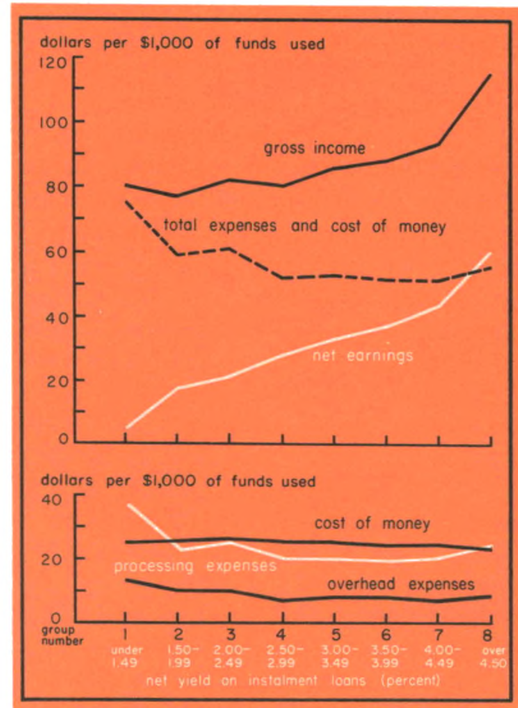
Average net losses on instalment loans are not a current operating expense in the functional cost program. They are, however, one of the very few "below the line" adjustments (losses, recoveries, charge-offs and transfers to and from valuation reserves related to loans and investments) in the report. Loss figures do serve as one measure of the kinds of instalment loans a bank is making. A very high loan-loss ratio coupled with unusually

Distribution of 186 banks in 1965 functional cost service by instalment loan earnings



Increased loan earnings largely the result of higher gross income

reductions in total expenses and cost of money in the low-earning groups due primarily to lower processing expenses



high increases in loans would seem to point to very risky loans. The average loan-loss varied among the groups but, overall, were somewhat larger in the low-earning groups.

The number of banks in each group varied from a low of 15 in the highest-earning group where the net yield on instalment loans exceeded 4.5 percent to a high of 30 banks in group 5 where the earnings range from 3 to 3.49 percent. The statistical data describing the instalment loan operations of these 186 midwestern banks are weighted arithmetic averages.

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Income and expenses

Gross income in the instalment loan function includes all receipts from interest, service charges and penalty charges generated by direct and indirect instalment loans and floor-plan loans.

Gross income varied considerably and appeared to account for about 64 percent of the spread in net earnings on instalment loans between the highest- and lowest-earning bank groups. Gross income is seen to have risen on a nearly parallel path with increases in net earnings among groups 1 to 8 (see chart 2). In the highest net earnings group, instalment loans generated $115 per $1,000 of funds used. The lowest gross income was in group 2 and amounted to $77 per $1,000 of funds used in instalment loans.

Instalment loan income variations are due, in large part, to differences in competitive factors. The level of gross income among banks in any one year can also be partially explained by differences in the method of accounting used. Banks that use a cash method record all the income as earned when a loan is "put on the books" while banks using an accrual method spread the income over the life of the loan. In particular, banks on a cash basis that have a rapidly growing instalment loan business could show very high earnings for a particular year. The accounting methods used by the 186 participating banks varied from group to group and was apparently not a major factor in explaining differences in gross income.

Total instalment loan expenses include: processing costs, overhead expenses and the cost of money. For the low-earnings groups (groups 1 to 4) reductions in total expenses and cost of money appeared to exert a sizable influence on net earnings, but in the higher-earning bank groups increases in gross income were the major factor leading to rising net earnings.

Processing costs are wages, salaries and other expenses incurred in the day-to-day operations of the instalment loan function. Overhead expenses include a portion of the outlays for business development and general administration that benefit the entire bank but are not directly assignable to any one function. Processing expenses showed the greatest range—from a high of $37 to a low of $19 per $1,000 of funds used in the loan function. Differences in processing expenses among the eight groups were relatively small, except between groups 1 and 2 where these costs declined sharply.

Variations in overhead expenses were similar to those for processing expenses but the range was much smaller—between $7 and $13 per $1,000 of funds used.

There were only small differences in the cost of money. In the functional cost program, each funds-using function is assumed to draw upon a common "pool of available funds" and is "charged" the average cost in-

Increases in gross income account for most of the differences in net earnings

Group differences	Change in funds used in the instalment loan function				
	Net earnings	Gross income	Processing expenses	Overhead costs	Cost of money
	(dollars per $1,000)				
1 and 2	13	−3	−14	−3	1
2 and 3	3	5	2	0	0
3 and 4	7	−2	−5	−3	−1
4 and 5	5	6	0	1	0
5 and 6	4	2	−1	0	−1
6 and 7	6	6	1	−1	0
7 and 8	17	21	4	1	−1
Net change*	55	35	−13	−5	−2

*Equal to net differences between highest- and lowest-earning groups.

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Size, earnings and selected ratios of the eight bank groups

Group	Net yield on instalment loans	Instalment loans	Total deposits	Net after-tax earnings	Net portfolio yields	Instalment loans to total assets	Total loans to total assets	Time deposits to total deposits
	(percent)	(million dollars)		(thousand dollars)	(percent)		(percent)	
1	1.49 or less	5	78	544	3.8	8	41	51
2	1.50 to 1.99	9	238	2,323	4.3	12	50	53
3	2.00 to 2.49	5	36	249	4.1	12	47	52
5	2.50 to 2.99	12	108	917	4.1	11	47	53
5	3.00 to 3.49	12	85	768	4.2	12	47	50
6	3.50 to 3.99	7	54	531	4.3	11	46	49
7	4.01 to 4.49	5	32	329	4.4	13	48	50
8	4.50 or more	2	10	113	4.5	13	47	43

curred by the bank in obtaining deposits and net capital funds. (Net capital funds are the total of capital funds and other liabilities less the bank's building and other fixed assets.) The lowest-earning group, group 1, had a net cost of money of $26 per $1,000 of funds used compared to $23 for the highest-earning group, group 8.

Net earnings ranged from $60 per $1,000 of funds used in the highest-earning group down to $5 in the lowest-earning group—a range of $55. As noted above, a large portion of this range appeared to be associated with the differences in gross income.

Bank characteristics

The functional cost service provides considerable information that is useful in identifying characteristics of the instalment loan operations that help to explain the differences in net earnings.

Information developed from the functional cost service indicates that in several bank functions expense control is an important factor affecting overall bank profitability. In the instalment loan function, however, net earnings differences among banks are influenced largely by the bank's ability to generate large gross income per $1,000 of funds used.[2]

Both the size of the instalment loan function and the size of the bank vary among groups, but the data demonstrate a definite tendency for banks with higher net earnings on instalment loans to be smaller in overall deposit size and in the absolute dollar size of the instalment loan function (see table). In the highest-earning group, the volume of instalment loans averaged 2 million dollars and the total deposits of the banks averaged 10 million dollars, both well below the average of any of the other groups. Instalment loan volume was greatest in groups 4 and 5 (11.7 million dollars) and deposits were greatest in group 2—238 million dollars.

Net after-tax earnings for the entire bank also tended to be lower for the groups with relatively high earnings on instalment loans. Net earnings differences reflect the fact that net dollar earnings fluctuate with bank size whereas income per $1,000 of funds is a measure of efficient utilization of resources, not size. Net portfolio yields, by contrast, while varying, tended to rise along with the percentage net earnings on instalment loans.

All of these measures seem to indicate that the smaller banks with corresponding smaller instalment loan volume were able to generate the highest net earnings per $1,000 of funds

[2]See "Banks Set Fast—and Slow—Pace," *Business Conditions,* November, 1966, pages 9-11.

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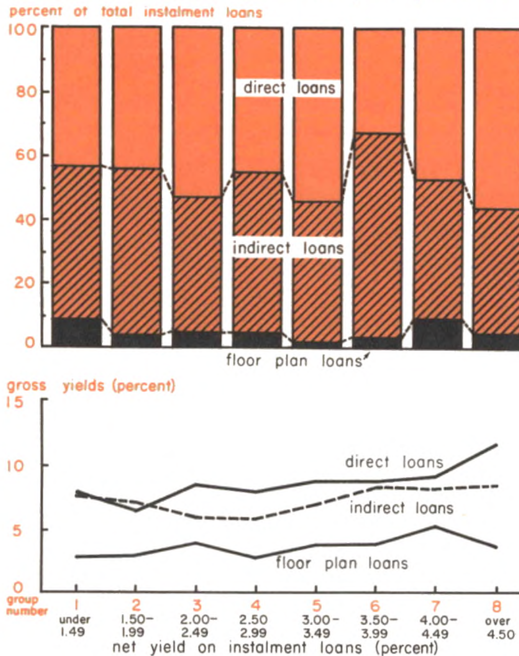
used for instalment loans. The smaller banks that were able to produce relatively high earnings on instalment loans committed relatively more of their total assets to instalment loans than banks in the lower-earning groups. For example, in the highest-earning group, 13 percent of the bank's assets were in instalment loans. This ratio declined along with net earnings in the instalment loan function.

Activity and efficiency measures

The number of loans varied widely among the bank groups but in general tended to be smaller for banks having high net instalment loan earnings. The average size loan, however, was very stable; the range was from $978 in the highest-earning group to $1,173 in group 2—a spread of approximately $195.

Banks with high instalment loan earnings had relatively low operating costs and high volume per person



The small variation in average size of instalment loan apparently reflects the fact that these loans originate largely with the purchase of durable goods—automobile financing accounted for a sizable proportion of total instalment loans.

Group	Number of loans	Average size of loan (dollars)
1	3,021	1,040
2	8,764	1,173
3	4,478	1,045
4	9,900	1,113
5	10,100	1,114
6	5,589	1,092
7	4,358	1,089
8	2,031	978

In the functional cost service, processing and overhead expenses are divided between the cost of making loans and the cost of processing each monthly payment. These two measures of relative operational efficiency indicate that the high-earning banks are more efficient (see chart).[3] The cost of making a loan, which includes all the expenses incurred by the bank up to the time the loan is actually "put on the books" ranged from $27.22 in the lowest-earning group to $13.61 in the highest-earning group. The costs incurred in processing monthly instalment payments are also lower in the higher-earning bank groups—banks in group 1 averaged $2.10 for each monthly payment handled compared with $1.10 in group 8.

Two other indicators—the loan volume per person and the number of loans per person (employe or officer) involved in the instalment loan function—provide some evi-

[3]The functional cost service is not meant to provide a framework for an efficiency study in the usual sense of the term which includes time and motion studies, even though there are a number of very broad efficiency measures included. Many participants, however, might find such activities a useful extension of the services provided by the functional cost materials.

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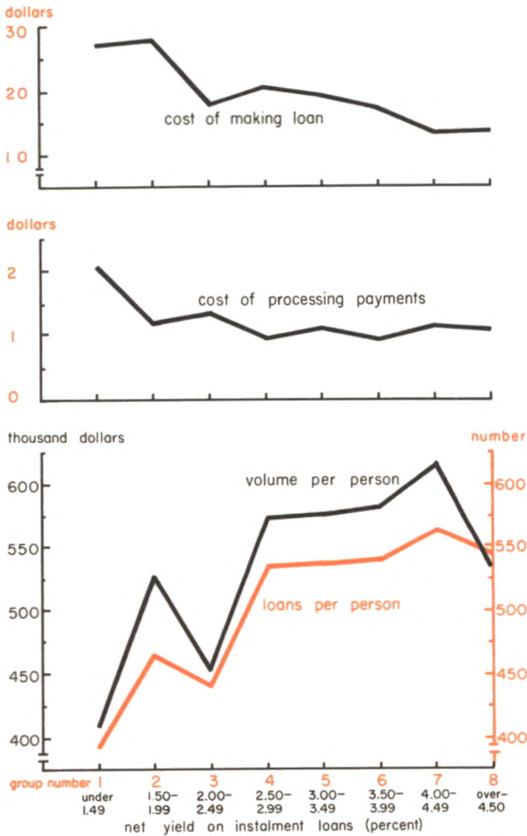
Instalment loan composition varies among banks; direct loans return largest gross yield



dence of the relative efficiency in utilization of personnel. While there was considerable variation among the groups in these two measures, the results indicate that in the high-earning banks each person handled both a larger dollar volume and a larger number of loans. In the case of the dollar loan volume per person, the banks in the lowest-earning group averaged $409,000 per person compared to $536,000 per person in the highest-earning group. Similarly each person in the lowest group handled 392 loans compared with 544 loans in the highest-earning group.

Composition of instalment loans

The proportion of the three kinds of instalment loans held in bank portfolios varies from bank to bank. In the eight bank-earning groups, direct and indirect instalment paper accounted for between 90 and 98 percent, respectively, of the total instalment loan volume. Floor-plan loans ranged between 2 and 10 percent of total volume—most of the groups averaged near 5 percent (see chart).

The mix of direct and indirect loans varied considerably from group to group with the lowest-earning group having relatively less of the direct instalment loans and relatively more of the indirect loans.

In an individual bank, the instalment mix depends on a variety of factors, including the banker's ability to generate direct instalment loans in the immediate banking area. Many bankers prefer to establish credit arrangements with merchants to buy instalment sales contracts that they generate through their instalment sales. Competitive factors, such as the availability and the cost of instalment credit and the aggressiveness of other banks in nearby communities and of nonbank financial institutions—such as sales finance companies—are also important in explaining the observed variations in the mix of direct and indirect instalment loans.

Gross yields on these three types of instalment loans also vary from group to group. Direct loans provide the highest gross return exceeding both indirect and floor-planned loans.[4] In addition, gross yields on the three types of loans tend to rise along with net earn-

[4]Floor-plan loans would be expected to be lower since they are based on a simple interest rate structure compared to the add-on method used for direct and indirect loans.

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ings in the instalment loan function.

Conclusions

Gross income differences seem to be the major factor associated with variations in net earnings of the instalment loan function for banks participating in the 1965 functional cost analysis service. As a "general profile," the high-earning banks tended to be smaller in size and volume of instalment loan operations but relatively more specialized in instalment loans and generated relatively high gross income per $1,000 of funds used for instalment loans. The data on operating costs indicates that the banks with highest net earnings on instalment loans also had low average operating costs in their instalment loan function. However, variations in operating costs were less important in explaining earnings differences than variations in gross income.

Ownership of Federal debt

private holdings decline

The U. S. Government debt rose more than 8 billion dollars during 1966. The entire increase was reflected in investments of governmental institutions, agencies and trust funds, with the latter showing the largest net acquisition. U. S. Government debt held by private investors declined: in this sector, commercial banks, nonfinancial corporations, mutual savings banks and insurance companies all reduced their holdings—more than offsetting the net purchases by individuals.

These shifts in ownership of Government debt followed the pattern of earlier years in the 1961-66 economic expansion. In the period, private demands for credit have risen sharply with associated rapid increases in private debt. Private firms, including banks, have reduced their holdings of Governments in order to increase loans to businesses and individuals. Furthermore, savings flows were diverted to direct investment as interest rates rose, reducing flows to banks and other financial intermediaries that normally place a portion of their funds in Governments.

During the last five years, Federal Reserve Banks and U. S. Government agencies and trust funds added slightly more than 15 billion and 14 billion dollars, respectively, to their holdings of U. S. Government securities. Governments were purchased by the Federal Reserve Banks throughout the period to provide commercial banks with the reserves needed as a basis for the expansion of total bank deposits and credit. Government investment accounts, most of which cannot legally invest in anything except Governments, sharply increased their holdings of Treasury debt in 1966. "Special" securities, which are issued directly to trust accounts, were increased by almost 6 billion dollars. In addition, these accounts made net purchases of public marketable issues of over 1 billion dollars. These larger net acquisitions partly reflect investment of the additional receipts

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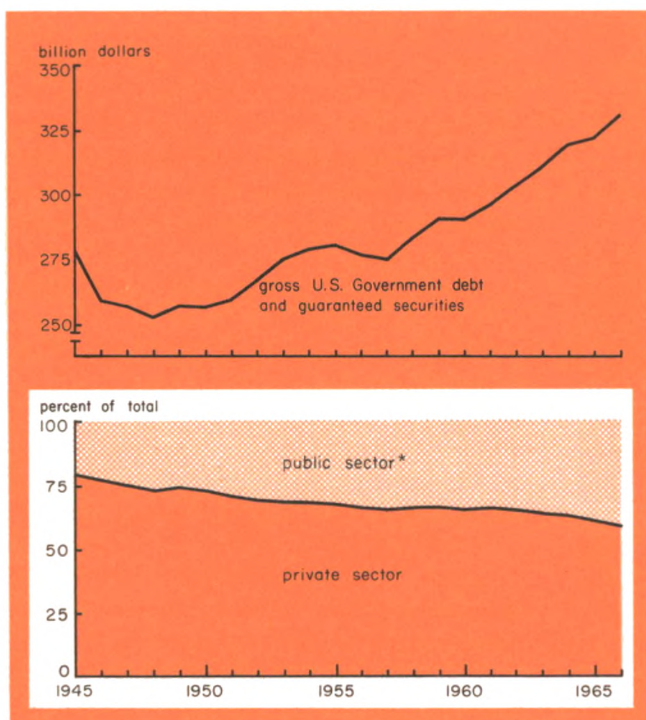
As national debt rises, private investors hold smaller share



*Includes Federal Reserve Banks, Government investment accounts and state and local governments.

SOURCE: Treasury Department. 1966 estimates by Council of Economic Advisers.

resulting from the boost of social security taxes. The Federal Reserve Banks held 13.4 percent of the debt at the end of 1966—up from 9.7 percent five years earlier. During the same period, the proportion owned by Government agencies and trust funds grew from 18.4 to 20.9 percent.

Miscellaneous investors, including savings and loan associations, corporate pension trust funds and international agencies and accounts, added 6 billion dollars to their holdings during the 1961-66 period, increasing their share of the debt from 8.4 to 9.4 percent. Most of this gain occurred between 1961 and 1964; a small decline occurred in 1966, largely because of a decline in holdings of U. S. Government securities by foreign accounts.

State and local governments added about 5 billion dollars to their holdings of Governments and boosted slightly their share of the total debt over the five-year period. Part of these purchases represented investment of employe retirement fund reserves, but the temporary investment of the funds raised in the capital market was also a factor. In 1965, when the share of the national debt owned by state and local governments increased most, these governmental bodies raised almost 8 billion dollars in credit markets.

Individuals, including partnerships and personal trust accounts, hold the largest portion of the debt. Their acquisitions of Governments in recent years were sufficient to increase their share of the national debt from a postwar low of 21.7 percent at the end of 1962 to 22.9 percent at the end of 1966. Individuals acquired, net, about 6 billion dollars of U. S. Government securities in 1965 and 1966; in response to higher interest rates available on Governments, some investors switched from corporate stocks and mortgages to marketable Governments, and others channeled savings directly to credit markets instead of through financial intermediaries.

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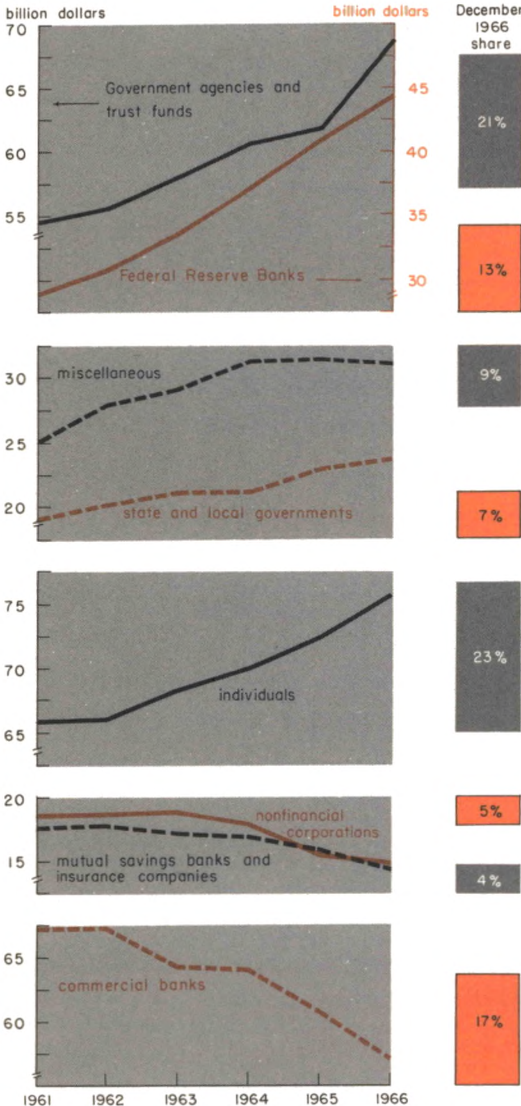
Shifts in debt ownership reflect financing of business expansion



Nonfinancial corporations, mutual savings banks and insurance companies reduced their holdings of U. S. Government securities during the past five years. Prior to 1966, nonfinancial corporations had been switching into higher yielding negotiable CDs, which were specifically tailored to meet their short-term investment needs. During 1966, when interest rates on short-term marketable securities rose above the maximum that banks were permitted to pay on CDs, holdings of Governments by nonfinancial corporations declined very little.

Commercial banks were the major net sellers of Governments; their holdings dropped 15 percent, reducing their share of the debt from 22.7 percent at the end of 1961 to 17.3 percent at the end of 1966. There were large declines in banks' holdings of Governments in 1963 and 1965 concurrent with large net purchases of securities issued by state and local governments and rapid growth in time deposits. The further large liquidation in 1966 was accompanied by only a small increase in holdings of municipals and a much smaller gain in time deposits, reflecting the tighter credit conditions.

Although there have been year-to-year variations, the recent changes in ownership of the Government debt represent a continuation of a long-term trend which began shortly after World War II. The proportion of the debt held by public institutions and agencies has been rising; the share owned by private investors has been declining. Within the private sector, the share held by the commercial banks has shown the greatest decline. As private credit demands and those of state and local governments have strengthened, banks have greatly increased the credit extended to these sectors while reducing their holdings of Governments from their exceptionally large holdings at the end of World War II.

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