A review by the **Federal Reserve Bank of Chicago**

Business Conditions

May 1970

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THE Trend OF BUSINESS

Impact of the truck strikes

Activity was hampered in many business sectors in April and May by strikes and lockouts in the trucking industry. As a result, the possibility faded that the second quarter would witness a modest uptrend in general activity in real terms following declines in each of the two previous quarters.

The impact of the truckers' work stoppages, dating from early April, was especially severe in the Midwest and was centered in the Chicago area. Many local unions have sought larger increases in wages and benefits than were provided in the blanket agreement negotiated by leaders of the International Brotherhood of Teamsters and a management coalition at the national level.

Among the manufacturing industries affected by the work stoppage are steel, motor vehicles, machinery and equipment, household appliances, and radio-TV. Many retailers and wholesalers, faced with curtailed deliveries of goods from factories and warehouses, have been unable to satisfy customers' desires. In addition, progress was slowed on major construction projects, especially those requiring structural steel.

Striking workers are not eligible for unemployment compensation. But widespread layoffs associated with shortages of parts and supplies, or inability to ship products, were the primary cause of an April jump in unemployment compensation claims in Midwest states to levels two and three times those of a year earlier. Never before has a truckers' strike had such far-reaching effects on general activity. In part, this reflects the steady rise in the proportion of total freight handled on the highways. Some steel plants, for example, now ship well over half of their output by truck.

Dip in durable goods manufacturing in April followed March recovery

Rebound ahead

Studies of the impact of strikes in major industries on total economic activity indicate that, for the most part, losses in sales and output during work stoppages are recouped rapidly when work is resumed. But man-hours spent in involuntary idleness are lost forever; and delays and inefficiencies in production and distribution associated with

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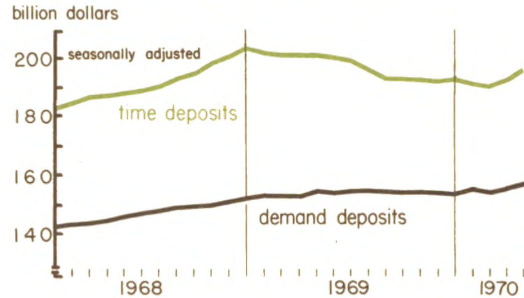
strikes contribute to inflation, regardless of the nature of the final settlement of the dispute.

When strikes have cut off supplies of materials such as steel or copper, users often have been able to maintain operations by depleting inventories, using foreign sources, or by substituting other materials. But when transportation strikes halt movements of goods in and out of plants and work sites, such adjustments often are not feasible. Therefore, the inflationary potential of the truckers' strikes is greater than in other disputes involving similar numbers of workers.

Prior to the truckers' strikes, there were signs that the decline in total output that started in the third quarter of 1969 had lost momentum. Reductions in output and employment had been largely confined to three major sectors: (1) consumer durable goods, especially automobiles; (2) residential construction; and (3) defense. For the most part, inventory adjustments appeared to have been made in these industries. Meanwhile, activity in consumer nondurable goods, producer equipment, nonresidential private construction, the service industries, and nonmilitary government functions has been maintained.

Personal income and employment in non-

Commercial bank deposits rose in March and April, reflecting easing monetary policy



manufacturing activities continued to rise through April. Monetary and fiscal policy have become less restrictive since the start of the year. The uptrend in the general price level has eased slightly as pressures on industrial capacity and labor resources have moderated. But consumers and businessmen appear to have little confidence that relative price stability will be achieved in the near future. These developments suggest that total spending will accelerate in the second half of 1970 and that growth in real output will be reasserted.

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Tight credit and the banks— 1966 and 1969 compared

The early months of 1970 marked a resumption of monetary expansion and easing in credit markets, at least for a portion of the period, after the highly restrictive conditions that had prevailed through most of 1969. Growth in commercial bank deposits, both demand and time, was resumed by March. Interest rates remained high but for an extended interval were below the peak levels of earlier months.

These changes in the financial setting provide an opportunity to evaluate the impact of tight credit last year in comparison with developments three years earlier. The two years of credit stringency, 1966 and 1969, show important similarities but also significant differences.

The basic objective of official action was the same in both years—to hold the growth in aggregate demand to a pace more in line with the expansion of productive capacity, and thereby dampen strong inflationary pressures. The money stock grew in 1966 and again in 1969 but at considerably lower rates than in the preceding years. Net credit extended rose in both years, but borrowers' demands rose even faster. As a result, interest rates increased sharply. Large commercial banks in the financial centers were hampered in competing for funds in both periods by regulatory ceilings on rates paid on time accounts. At most smaller banks in outlying areas, however, time deposits continued to grow both in 1966 and in 1969 but at a slower pace in the latter year.

Major differences in banking developments between the two years reflected the greater magnitude of the inflation problem in 1969, as compared with 1966. Deposit drains at large commercial banks were larger and lasted longer. Many banks reacted by actively seeking funds from nondeposit sources—including sales of loans to holding company affiliates issuing commercial paper—that had not been tapped previously. Finally, 1969 saw no repetition of the "credit crunch" of August 1966, when some bankers feared for a time that sources of liquid funds had substantially dried up.

Developments in 1966

The increase in the Federal Reserve banks' discount rate in December 1965, from 4 to 4.5 percent, was widely assumed to signal the beginning of a more restrictive monetary policy. Nevertheless, sufficient reserves were supplied to the commercial banks by the Federal Reserve System in the first half of 1966 to accommodate heavy credit demands associated with rising expenditures and an accelerated corporate tax payment schedule, albeit at rising interest rates.

Loans and investments of commercial banks rose at a seasonally-adjusted rate of 9 percent in the first half of 1966, and the money stock (currency and demand deposits in the hands of the public) rose at an annual rate of 4.7 percent. Both rates of increase were about as rapid as they had been in 1965.

Monetary policy became increasingly restrictive in the late spring and summer of 1966. Bank loans continued to rise in the second half of 1966 but at a much slower pace than earlier in the year. Bank invest-

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ments declined as Treasury securities were liquidated. The money stock declined slightly after April but showed essentially no change through the remainder of the year.

Federal Reserve actions in the third quarter were related, in part, to the problems of thrift institutions—savings and loan associations (S&Ls) and mutual savings banks—forced to meet savings withdrawals. Savings drains occurred mostly because of the inability of the thrift institutions to pay rates of interest to their savers that matched yields obtainable on market investments. This inability to compete in the savings market in turn was traceable to the predominance of low-yielding, long-term mortgage loans, most made earlier when interest rates were lower, in the institutions' asset holdings.

In July 1966, following the June interest-crediting period, the S&Ls reported a net outflow of share capital of about $1.5 billion, by far the largest quarterly drain on record. Further massive withdrawals could have had serious consequences, both for the S&Ls and for the housing market, the principal outlet for S&L funds.

Part of the savings lost by S&Ls was deposited in commercial bank time accounts. This transfer of funds undoubtedly would have assumed greater proportions if the ceiling rates payable on bank time accounts under Regulation Q had been increased by the Federal Reserve Board. But maximum rates payable on time accounts were not raised in line with high market interest rates. In fact, rates on multiple maturity time deposits were reduced in July from 5.5 percent to 5 percent on deposits maturing in 90 days or more and to 4 percent on maturities in the 30-90 day range.

Legislation enacted September 21, 1966 specifically authorized the Federal Reserve to prescribe time deposit interest rate limitations related to size of deposit. The Board immediately reduced the maximum rate payable on single maturity time deposits of less than $100,000 from 5.5 to 5 percent. Also, reserve requirements on time deposits in excess of $5 million at individual banks were increased from 4 percent to 6 percent.

Unable to compete effectively for funds in the savings and money markets, some banks curtailed loan expansion. Moreover, large banks faced the prospect of sizable net outflows of funds in late August. A substantial volume of large denomination certificates of deposit (CDs) were approaching maturity, and yields on commercial paper and Treasury bills were above the 5.5 percent maximum rate banks could pay to depositors.

Heavy credit demands by both the federal government and the corporate sector were expected at about the time of the anticipated CD runoff. Large banks could refuse to accommodate these credit demands only at the risk of alienating some of their best customers. At the same time, banks' access to funds from nondeposit sources was severely limited. Eurodollar borrowings were already being extensively used by banks with branches abroad. Moreover, financing any exceptional expansion of business loans was regarded as an inappropriate use of Federal Reserve advances under Regulation A; and many banks, therefore, were reluctant to borrow at the discount window.

Under these circumstances, it appeared that the principal means open to banks seeking additional funds was the sale of securities from their portfolios. The prospect of banks becoming large volume sellers of Treasury and state and local securities led to bond price declines. Disorderly conditions developed briefly in the bond market in late August, an occurrence later described as the "credit crunch."

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To alleviate accumulating pressures in financial markets, the Federal Reserve System took two types of action. First, the open market desk late in August 1966 supplied additional reserves to the banking system. Then, on September 1, the Federal Reserve bank presidents in a letter to member banks offered to provide needed credit at the discount window to banks willing to adjust reserve positions by more restrictive loan policies. Although the announcement apparently was misinterpreted by some banks, it may have served to curtail the amount of distress selling of securities.

The efforts of the Federal Reserve were reinforced by the expectation that fiscal measures would soon be adopted to backstop monetary policy in the effort to contain inflationary pressures and by evidence that the business upsurge was losing momentum. A sustained recovery started in the bond market and the credit crunch, largely a psychological phenomenon, was over.

Most interest rates began to level off or decline in September and October 1966. In November, the Federal Reserve authorities, satisfied that inflationary pressures were subsiding, relaxed their policy of monetary restraint and supplied additional reserves to the banking system. As market interest rates declined, banks were again able to compete for funds in the money market.

Restraint renewed in 1969

After a brief and mild economic downturn in the first half of 1967, expansion in business activity resumed. Bank credit expanded at an annual rate of more than 10 percent, but demands for credit grew rapidly and pushed interest rates higher in the second half of 1967. Rates averaged even higher in 1968. In early 1969, yields on most financial instruments were above the peaks reached during the 1966 period of credit stringency.

Federal tax rates were raised in mid-1968 and expenditure growth was checked. This fiscal action came only after extended Congressional deliberation. By the time it took effect, concern had become widespread that "overkill" was in prospect. The Federal Reserve provided a generous supply of reserves in the ensuing months, in part to cushion the sharply repressive effects expected of the tax increase. By late in the year, however, it had become clear that the combination of fiscal restraint and moderately expansive monetary action was not proving effective in dampening excess demands for goods and services.

Federal Reserve policy again turned restrictive. Interest rates on money market instruments were near Regulation Q ceilings for large CDs, even though these had been raised in April 1968. The impact of renewed restraint, therefore, was immediate. Some large banks noted a net outflow of time deposits as early as December 1968. The net drain of time deposits persisted throughout 1969, with large CDs dropping more than $13 billion from the $24 billion peak reached in November 1968. Expansion of bank credit slowed sharply in 1969, with the second half showing only a slight increase.

Regulation Q ceilings were held at existing levels in 1969. As an additional restrictive measure, the Federal Reserve Board increased reserve requirements on demand deposits by 0.5 point in mid-April. Major banks raised their prime loan rates to 8.5 percent in early June. Interest rates on all financial instruments rose to record highs.

Rising interest rates and severe pressure on bank reserve positions persisted throughout 1969. Bond prices fell, but no crisis atmosphere reminiscent of the 1966 credit crunch developed at any time during the year.

Large banks showed great flexibility in de-

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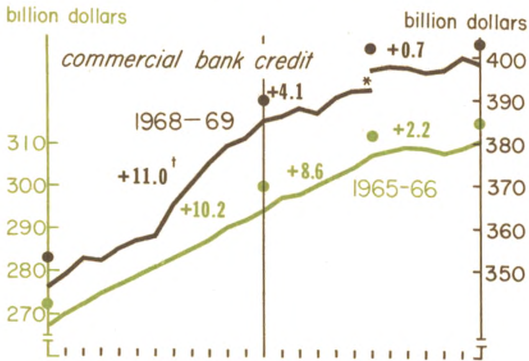
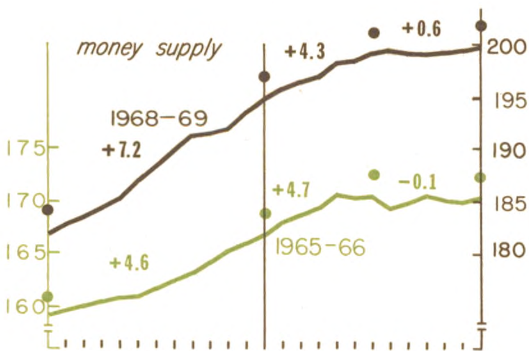
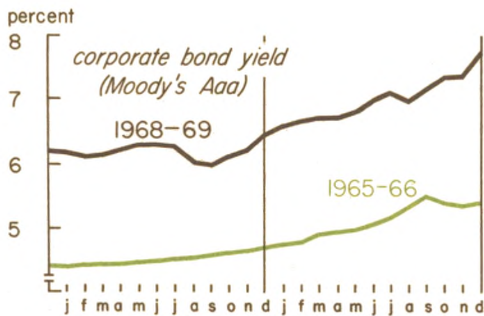
Restraint slowed growth of bank credit and money as interest rates rose







*Change in series.

†Annual percentage rates of change in seasonally-adjusted data for periods between dots.

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veloping nondeposit sources of funds to offset the drain of time deposits in 1969. These sources included more extensive use of Eurodollars, sales of securities and loans under repurchase agreements, and the sale of commercial paper by bank holding companies.

Eurodollar borrowings increased sharply in the first half of 1969. When the year began, U. S. banks had more than 350 foreign branches—nearly double the number operating three years earlier. Additional branches greatly expanded the potential of the Eurodollar market as a source of bank funds. Liabilities to foreign branches at U. S. banks rose $6 billion in the first half of 1969, compared with an $8 billion decline in CDs.

Sales of assets under repurchase agreements and increased borrowings from the Federal Reserve banks provided further supplements to deposits. Large banks also acquired funds from smaller banks through the purchase of federal funds.

Formation of one-bank holding companies was accelerated by the desire to acquire funds through the issuance of commercial paper, a market instrument with an interest yield not subject to Regulation Q ceilings. Holding company paper could be sold at competitive market rates. Funds obtained were used by holding companies to buy loans, either outright or under resale agreements, from affiliated banks. A substantial portion of the proceeds from the CD runoffs at affiliated banks was retained in this manner.

Although loans sold outright were removed from the books of the selling banks, most continued to be held by bank affiliates. According to reports from the large banks in the nation's leading cities, bank affiliates acquired almost $5 billion of loans from their bank subsidiaries in 1969. Without adjustment for loans sold, the reported slowdown in bank credit last year exaggerates the severity of restraint on bank lending at the time.

In a series of steps, the Federal Reserve Board moved to restrain bank use of nondeposit funds. Effective July 25, Regulations D (covering reserves of member banks) and Q (ceiling rates on commercial bank time accounts) were amended to include funds raised through sales of loans and securities under repurchase agreement (other than U. S. and agency issues) in the definition of deposits. Other amendments and interpretations imposed reserve requirements on Eurodollars above the amounts in use in a specified base period. The effect of these actions was to place some nondeposit sources of funds under deposit interest ceilings or make them more expensive to users.

As the growth of nondeposit sources of funds was slowed in these ways, total bank credit showed only moderate further growth in the second half of 1969, even after adjustment for loans sold. Partly for this reason, a proposal made earlier by the Federal Reserve Board to extend the definition of deposits to cover holding company commercial paper was not implemented.

Impact on district banks

Comparison of changes in major assets and liabilities of Seventh District banks in 1966 and 1969 reveals differences between the two periods of restraint and between banks of different sizes. In general, as the accompanying chart shows, loan expansion was similar in the two years. However, deposit outflows and liquidation of U. S. securities were larger and the acquisition of funds from nondeposit sources was much more significant in 1969 than in 1966.

Deposits of the district's largest banks (those with more than $500 million in deposits and that report detailed condition statements weekly) increased $350 million,

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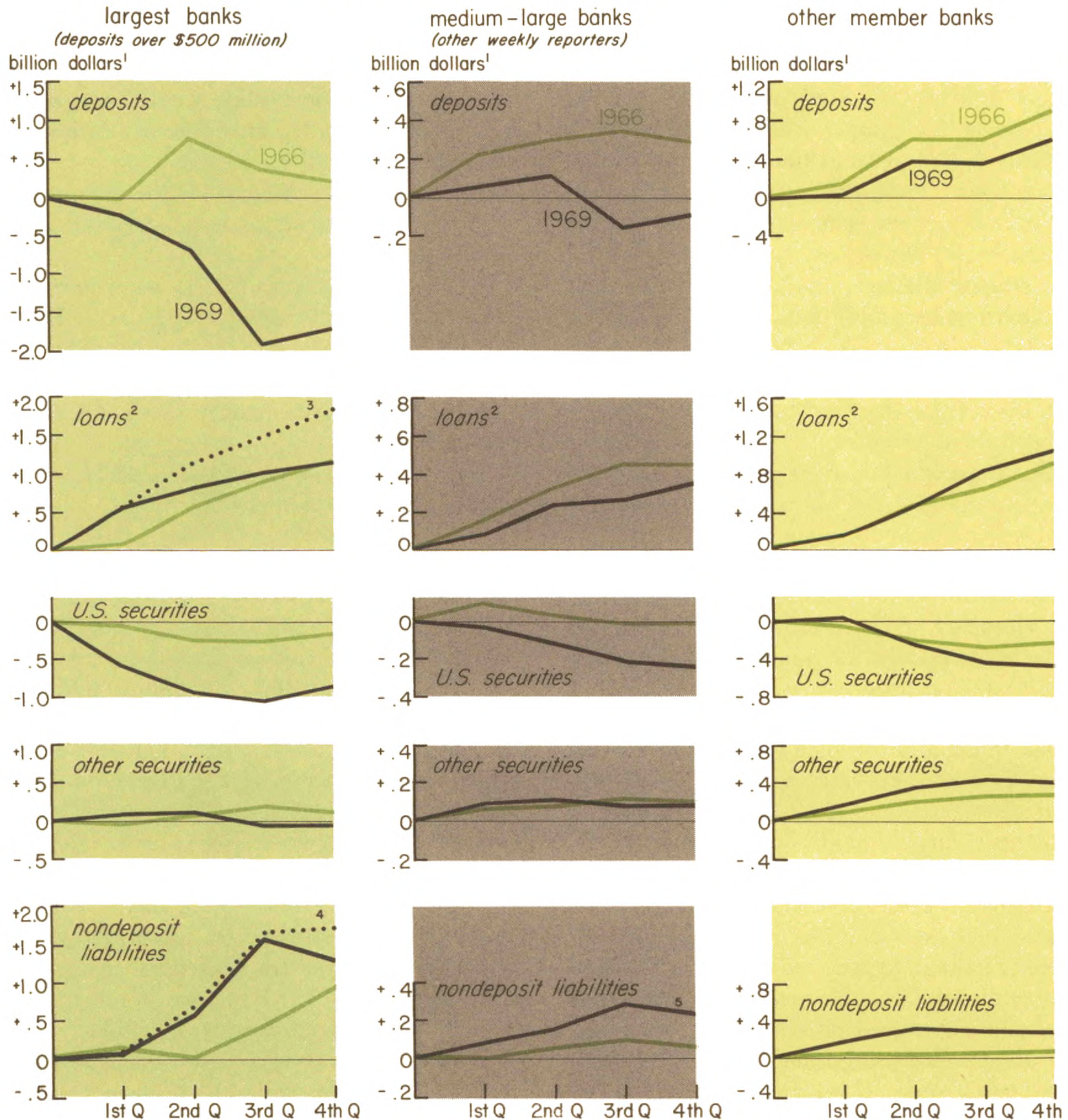
The impact of monetary restraint was greater in 1969 than in 1966, especially at the large banks.



[1]Cumulative change from fourth quarter of previous year.

[2]Includes federal funds sold.

[3]Includes loans sold outright to affiliates and foreign branches.

[4]Includes commercial paper issued by holding company affiliates.

[5]Includes small amount of commercial paper not shown separately.

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or at an annual rate of about 3 percent in the first three quarters of 1966. Time deposits rose moderately in the first half, while demand deposits changed little. By midyear, however, these banks had begun to experience difficulty in rolling over maturing CDs, as secondary market rates on such instruments rose above maximum rates payable on new issues. From the end of August through November, their time deposits dropped almost $400 million.

Despite relatively slow growth in the usual sources of loanable funds, outstanding loans at large district banks continued to rise in the third quarter of 1966. The $900 million gain in loans from the fourth quarter of 1965 to the third quarter of 1966 amounted to an annual growth rate of 9 percent. Continued expansion of loans at large banks was financed primarily through sales of U. S. Government securities, Eurodollar borrowings, and federal funds transactions.

Holdings of U. S. Government securities at the large district banks declined about $300 million, from a beginning level of $2.8 billion, in the first three quarters of 1966. The liquidation probably would have been much greater but for the heavy credit demands of the federal government. Some of the district's largest banks are primary U. S. security dealers that help underwrite Treasury financing. In addition, many banks were reluctant to sell securities in a falling market, and others had already reduced their holdings to minimum amounts needed as collateral for public deposits and borrowings. Holdings of other securities continued to grow in 1966 but much more slowly than earlier in the decade of the 1960s.

Funds raised through nondeposit sources —borrowings, federal funds, and Eurodollars —increased by more than $400 million during the third quarter of 1966 and continued to rise sharply further in the fourth quarter, despite easing of monetary restraint near year-end.

During 1969, by contrast, total deposits at the largest district banks declined $1.7 billion, or 8 percent. The decline would have been even larger but for an unusually large increase in demand deposits at year-end. Net deposit declines reflected, for the most part, the year-long runoff of large denomination negotiable CDs.

Loan growth appeared to be somewhat slower than in the 1966 experience. Total loans on the books of the large district banks increased 7 percent from the fourth quarter 1968 to the fourth quarter 1969. Adjusted for sales to affiliates, however, loans of these banks actually rose at a faster pace in 1969 than in the 1966 period of restraint.

The large banks sold or redeemed substantially greater amounts of U. S. Government securities in 1969 than in 1966. Holdings of such securities declined 23 percent in 1969, nearly twice the rate of decline in the first three quarters of 1966. The banks' holdings at the start of 1969 were larger than in 1966; and in addition, a smaller volume of new U. S. issues appeared in 1969 than in 1966. Federal budget deficits in fiscal years 1967 and 1968 had required large security sales by the Treasury, and the Federal Reserve System supplied the reserves necessary to permit banks to take the Treasury issues into their portfolios. The shift in the federal budget to surplus in fiscal 1969 facilitated larger net sales of government securities by banks.

Large district banks also reduced their holdings of municipal, U. S. agency, and corporate securities during 1969. The net decline was only 1 percent, but it reflected substantial liquidation in the second half of the year.

The main offset to the deposit drain during

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1969 was increased use of nondeposit sources of funds. During the first three quarters of the year, net funds raised through Eurodollar borrowing, interbank borrowing, and loan sales amounted to more than $1.5 billion at the large district banks. In the final quarter of 1969, outstanding Eurodollar borrowings declined moderately as the regulatory changes implemented during the third quarter made such funds increasingly costly. Meanwhile, the net outflow of time deposits had almost ceased and demand deposits were rising seasonally. Total loans sold by the largest banks, mainly to affiliated holding companies, rose $230 million in the final quarter to a level of $700 million; and these sales continued to relieve the pressure on the lending banks.

The impact of restraint on the smaller banks was also apparent in 1969. Deposits also declined at banks with deposits in the $100 million to $500 million range, mainly in the third quarter. Growth in deposits continued last year at district member banks in the less-than-$100-million size range but at a pace much below the average of recent years, even somewhat below 1966. Loans at these smaller banks increased by 10 percent in 1969, slightly less than the annual growth rate during the first three quarters of 1966.

Total security holdings of the small district banks changed little in 1969, but the composition of portfolios changed markedly. A $480 million decline in holdings of government securities was largely offset by the acquisition of $400 million of other securities. A shift of similar proportions had occurred during 1966.

Total earning assets expanded at about the same rate in 1966 at banks with greater than $100 million in total deposits, as well as at smaller banks. In 1969, however, even the extensive use of nondeposit funds by the largest banks was not sufficient to offset heavy time deposit outflows, and the smallest banks were able to increase their earning assets at a more rapid pace than the larger banks.

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The following publications on finance are available from the bank's research department:

• **Midwest Banking in the Sixties: A decade of growth and change,** a 193-page booklet dealing with the major trends in banking over the past decade as evidenced by changes in organizational structure, assets and liabilities, services, and earnings of the commercial banks in the Seventh Federal Reserve District. *Available for $1.00, make your check payable to the Federal Reserve Bank of Chicago.*

• **Banking Briefs,** a one-page biweekly release that reports some of the highlights gleaned from the continuous flow of information received from commercial banks in the Seventh Federal Reserve District. *Free of charge.*

• **Farm Borrowing in the Midwest,** a 45-page booklet based on information from surveys conducted by the Federal Reserve System and the Farm Credit Administration. *Free of charge.*

• **Changing Styles in Business Finance,** an 11-page reprint from the November issue of *Business Conditions,* analyses the decline in business liquidity and describes new techniques of raising funds in the money and capital markets. *Free of charge.*

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