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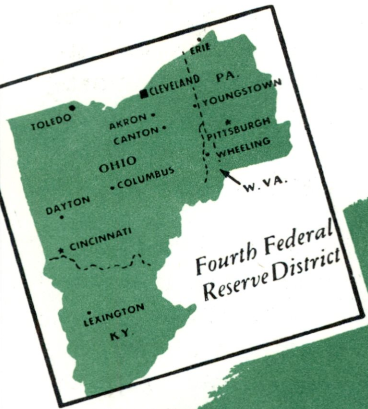

Business Trends

Prepared in the Research Department of the
FEDERAL RESERVE BANK OF CLEVELAND
Serving the Fourth Federal Reserve District

MEASURING MONETARY EASE

Alongside the many business indicators which reflect the course of productive economic activity, such as the gross national product, the index of industrial production, employment and unemployment, inventories, etc., the behavior of various "financial barometers" warrants more than cursory consideration at regular intervals. In some instances, the financial barometers do not present as graphic a picture as do the business indicators. But by no means should they be "sent to the bench" when the roll is called. For the financial barometers render an important service in that they reflect not only the course of business activity in general, but also the combined impact of changes in demand-supply situations and shifts in monetary policy.

It is widely understood in a general way that as the economy slackened in 1960 the Federal Reserve System moved from a restrictive monetary policy, first toward a lessening of credit restraint, and then to monetary ease.

Using at alternate times the various tools of monetary policy--i.e., open market operations, changes in reserve requirements of member banks, and changes in the discount rate--the Federal Reserve System was able in 1960 to shore up the credit base of the banking system, and by so doing helped to bring about money and credit conditions consistent with monetary ease.

The combination of monetary ease by the Federal Reserve System (which is directed toward combating the recession) with the slackened pace of business has influenced in recent months the supply of and the demand for funds in the economy. Thus, the interaction of monetary ease and business conditions has been reflected in both banking statistics and credit conditions. Let us read the record in order to see what has happened to the major financial barometers, remembering that the data will reflect changes in business conditions as well as monetary policy.

Banking Statistics. In response to the easing actions throughout most of 1960 and so far in 1961, the volume of bank reserves, after falling to $18.0 billion in March 1960, began to move up, rising almost continuously month by month until in February of this year they amounted to $19.0 billion, on a daily average basis. Such an addition to the credit base of the commercial banking system has brought about at least two developments.

First, the increase in bank reserves has helped member banks to reduce their indebtedness to the Federal Reserve Banks, from $906 million in December 1959 to $140 million in February 1960, on a daily average basis. In addition, enlarged bank reserves have helped to increase the average daily volume of excess reserves - the difference between the total amount of reserves member banks main-

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tain and what they are required to keep - from $408 million in April 1960 to about $710 million in Febrary 1961. The combination of reduced borrowing by member banks and increased excess reserves has resulted in an expansion of the unused lending capacity of the banking system. That is, free reserves - the amount by which total excess reserves of member banks are in excess of total borrowings - were at approximately $570 million in February, on a daily average basis, after being a minus figure (net borrowed reserves) in the early months of 1960.

A second by-product of the recent expansion in the volume of member bank reserves has been the impetus to bank credit, i.e., loans and investments. Total credit extended by member banks moved up substantially in 1960, increasing more than $8 billion, with all of the rise coming in the second half of the year, thus offsetting a decline in the first half. Most of the rise in the second half of 1960 was in holdings of securities, reflecting a gradual weakening of loan demand, a concomitant of both the slowdown in business activity and a shift in borrowing habits. It is still too early to ascertain the course of bank credit in 1961, especially since seasonal factors work so as to dampen the demand for bank credit in the early months of any year.

Credit Conditions. The movement of interest rates is an indication of the influence of (1) general business conditions on the demands for funds and (2) monetary policy actions on the supply of funds available. Interest rates in general drifted down in 1960. Most of the decline occurred relatively early, as rates tended to stabilize toward the end of the year, a condition which carried over into 1961. A partial explanation of the general trend in interest rates would be the monetary actions of the Federal Reserve System (including changes in the discount rate). At the same time, however, reflecting the slowdown in business activity, the demands for funds in the economy dropped sharply in 1960, as compared with 1959, thus lessening the pressures on the available supply of funds. The reduced demands were evident in most categories of credit, although the bulk of the reduction took the form of less Federal Government borrowing and a smaller amount of mortgage credit. (In fact, the Federal Government during 1960 was, on net balance, a supplier of funds rather than a borrower.)

In the money market, the rate on three-month U. S. Government bills, which is a sensitive indicator of short-term borrowing costs, has followed the over-all pattern of interest rates described above. The average rate on such securities dropped from 4.35 percent in January 1960 to 2.40 percent in February 1961. As would be expected, the downtrend in the bill rate helped to bring about similar declines in the interest rates on other short-term open market credit instruments, e.g., commercial paper and bankers' acceptances.

In the long-term end of the open market, interest rates on both U. S. Government securities and corporate securities also declined, although less markedly. The average rate on U. S. Government long-term securities, i.e., issues maturing or callable in 10 years or more, eased down from 4.37 percent in January 1960 to 3.81 percent in February 1961; the average rate on high-quality corporate bonds (Aaa) declined from 4.61 percent in January 1960 to 4.27 percent in February 1961.

The data thus show quite clearly that the costs of credit in the open market have responded, as would be expected, to the interaction of an enlarged supply of and reduced demands for available funds. In the banking system, the one-half percent reduction in August of last year of the rate charged high quality business borrowers, i.e., the prime lending rate, also reflected such conditions. In the course of these developments, as has been widely recognized, long-term interest rates have not fallen relatively as much as short-term rates over the same period of time. In addition, both short-term and long-term interest rates have declined less than in other recent periods of economic downturn.

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