Federal Reserve Bank of San Francisco

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Business & Financial Letter

Friendly Lenders

The rollicking pace of the business boom, exemplified by the 14-percent annual rate of increase in the first-quarter GNP, owes a great deal to the recent exertions of the nation's commercial bankers. Moreover, since new credit extensions serve as a leading indicator of business activity, the evidence suggests that the credit-fed boom could continue strong for some time to come.

The Commerce Department's composite index of sensitive financial flows provides some basic evidence. (The series is comprised of changes in business, mortgage, and consumer loans, all of which have been soaring recently, as well as changes in the money stock, which has been growing moderately.) The index advanced 5 percent in 1968, weakened over the next two years, and rose again to the 1968 level in 1971. Then the pace of financial activity accelerated; the index rose 9 percent between the first quarter of 1971 and the first quarter of 1972, and jumped about 20 percent more by the early part of 1973.

Extending loans

Further detailed evidence is provided by the first-quarter changes in the loan portfolios of large commercial banks, compared with year-ago changes. Total loans increased $10.8 billion (4.7 percent) during the January-March period—almost five times as much as during the more "normal" period of early 1972 which followed the sharp fluctuations of the 1969-71 period.

The vast bulk of the first-quarter increase was attributable to an $8.7-billion gain in business loans, which compared with an actual decline in the year-ago period.

Other loan categories also posted very substantial gains during the first quarter. Loans to nonbank financial institutions jumped $1.8 billion, as conglomerate holding companies and thrift institutions paid more frequent visits to their bank lending officers. Real-estate loans advanced $1.5 billion—even faster than in record-breaking 1972. Consumer instalment loans meanwhile increased $0.5 billion, reflecting the boom-level sales of autos and other durables. In striking contrast, each of these categories except mortgage loans rose at only a fraction of the recent pace during January-March 1972.

But to repeat, the unprecedented advance in business loans was the feature element in the first-quarter bank lending boom. The increase in commercial-industrial loans for that single quarter matched the record (1969) full-year increase, and far exceeded the full-year increase recorded for any other year.

The boom was generated by the heavy business demand for funds for capital-goods and inventory spending, augmented early this year by business borrowing to finance international currency transactions. In addition, the Administration's success in limiting increases in the prime rate (and perhaps the fears of imposition of

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credit controls) tended to inflate the demand for bank loans even further.

As the rate advantage shifted, some firms deserted the commercial-paper market and resorted to the banks instead. The rate on prime dealer paper, which normally runs somewhat below the prime rate, rose above the prime in early 1973 and by mid-April was considerably higher (7⅞ vs. 6½ percent). Consequently, dealer-placed paper declined roughly 25 percent during the first quarter, compared with the increase of almost 10 percent in business loans.

Writing guidelines

Some easing of this pressure on the banks may result from last week's adoption of prime-rate guidelines by the Committee on Interest and Dividends, which should permit rates on loans to large firms to move more in line with the market. "By keeping the 'large-business prime rate' consistent with the cost of borrowing from alternative market sources, the recent large diversion of financing from the commercial-paper market would be halted, and tendencies toward excessive and unhealthy expansion of bank credit would be moderated." The Committee added, however, that any increase in the prime should be made in moderate steps, in order to avoid disruptive market effects.

On the other hand, the CID guidelines state that rates charged to small-business and farm borrowers shouldn't rise above recent levels "unless an increase can be fully justified by increases in costs." Similarly, rates on home-mortgage and consumer loans "should remain under special restraint." As for loan volume, "commercial banks are to continue to meet legitimate credit needs of home buyers, consumers, small business, and farmers."

A key feature of the CID guidelines is the adoption of a profit-margin guideline, comparable to that in effect for nonfinancial corporations under Phase III rules. "If increases in interest rates on loans occur, they shall not raise the bank's overall profit margins on domestic operations (excluding revenues from service functions such as trust departments and data processing) above the average of the best two years in the four preceding calendar years."

Financing the expansion

In financing the phenomenal loan expansion within a tightening monetary-policy framework, large banks reduced their Treasury security portfolios by $3.3 billion (11.4 percent) during the January-March period. At the same time, they reduced their holdings of municipals and other bonds by smaller amounts. (In the year-ago period, they sold off $1.3 billion in Treasury securities but more than offset those sales with purchases of other securities, mostly municipal bonds.) This reduction in portfolios was matched only during the 1969 credit crunch; however, the banks in 1973 concentrated their reduction in short-term issues, whereas in that earlier period, they were also forced to liquidate large amounts of longer-dated securities.

Large-bank deposit data similarly indicate the intensity of the scramble for funds to finance the lending boom. Demand deposits declined $8.2 billion during the first quarter, or nine times the decline in the year-ago period; at the same time, savings and consumer-type time deposits increased only $1.8 billion, or far less than half the gain of January-March 1972. Banks thus resorted to more expensive sources of funds—in particular, to negotiable time certificates of $100,000 and over, as they obtained $10.2 billion in such CD money (a 22.7-percent increase) as against an actual decline in the year-ago period. Banks also resorted extensively to non-deposit sources; over the quarter, they averaged $1.5 billion in borrowings from the Federal Reserve, along with $9.5 billion in borrowings of Federal funds (unused reserves of other banks).

The most dramatic impact of the huge loan demand can be seen in the unprecedented search for CD money. As a consequence, CD rates jumped sharply—about two full percentage points since last fall—to 7.25 percent on new 89-day maturities (April). Banks are now forced to confine their issuing activity to 89 days or less, where no rate ceilings exist. (The Federal Reserve retained ceilings on longer maturities when it suspended rate ceilings on the shorter maturities three years ago.) The maturity structure thus has shortened somewhat; with present issuing rates running above the ceilings on 90-day to one-year maturities, banks are issuing short-dated maturities to accommodate the surging loan demand and to replace maturing CD's.

These developments underline the growing reliance of banks on liability management—that is, their increasing dependence on money-market borrowings (especially CD's and Fed funds) rather than on traditional secondary reserves (such as Treasury and municipal bonds). Prior to 1969, liabilities of this type amounted to less than one-half the amount in investment portfolios, but the proportion rose to three-fifths in 1969 and to three-fourths in 1970. After moderating for a while, the trend speeded up again, so that today, the amount outstanding in such liabilities actually exceeds the amount in security reserves.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 4/11/73	Change from 4/4/73	Change from year ago Dollar	Percent
Loans adjusted and investments*	71,592	+447	+8,629	+13.70
Loans adjusted—total*	54,109	+456	+9,653	+21.71
Commercial and industrial	19,729	+302	+3,402	+20.84
Real estate	15,690	+ 83	+2,608	+19.94
Consumer instalment	8,076	+ 20	+1,442	+21.74
U.S. Treasury securities	6,142	—229	— 867	—12.37
Other securities	11,341	+220	— 157	— 1.37
Deposits (less cash items)—total*	70,187	+398	+8,518	+13.81
Demand deposits adjusted	21,927	+716	+1,487	+ 7.27
U.S. Government deposits	503	—649	— 78	—13.43
Time deposits—total*	46,510	+454	+7,036	+17.82
Savings	18,049	— 88	— 63	— 0.35
Other time I.P.C.	19,083	+ 44	+4,512	+30.97
State and political subdivisions	6,833	+530	+1,740	+34.16
(Large negotiable CD's)	8,605	+ 29	+3,691	+75.11

Weekly Averages of Daily Figures	Week ended 4/11/73	Week ended 4/4/73	Comparable year-ago period
Member Bank Reserve Position			
Excess reserves	5	70	34
Borrowings	108	43	0
Net free (+) / Net borrowed (—)	—103	+ 27	+ 34
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions			
Net purchases (+) / Net sales (—)	+657	+325	—531
Transactions: U.S. securities dealers			
Net loans (+) / Net borrowings (—)	+185	+ 85	+389

*Includes items not shown separately.

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