Research Department
Federal Reserve
Bank of
San Francisco
7-19-74

Different Script

Financial developments in the first half of 1974 did not follow the accepted script for a period of economic slowdown. Hit by rampant inflation and record credit demand, financial markets behaved as if the nation were in the midst of a full-fledged boom. Money-market rates moved onto an escalator with no apparent terminus, and banks were caught in a maelstrom of seemingly unending business-loan demand. In some respects this was a repeat of the early 1973 experience, but many of the ingredients were quite different indeed.

Much of the credit demand was either inflation-induced or else the result of shortages in supplies, energy and capital facilities. In long-term markets, investors held out for higher and higher yields as an end to the inflation spiral became more illusory, while pressures on short-term markets were even more intense. The monetary authorities maintained a restrictive stance because the first-half decline in real GNP was largely induced by special supply problems rather than by a deficiency in demand. Even so, the narrowly defined money supply rose at more than a 7-percent annual rate, while bank credit expanded at a 14-percent rate, in the West as elsewhere in the nation.

Banks accommodated huge business demands for credit, including demand diverted from the commercial paper and capital markets. But all-time high asset holdings at record rates of return did not necessarily produce record earnings. Many banks saw their profit margins narrow as their own costs for funds rose in tandem with other money market rates and as the spread between their borrowing and lending rates narrowed. Those institutions which were heavily dependent on large CD's, Federal funds and other borrowed funds became particularly vulnerable. In addition, net income declined at some banks because of capital losses on their security portfolios and foreign-currency transactions. With liquidity problems increasing, loan losses rose and potential problem situations multiplied. Overall, it was not an entirely happy period for banks.

Business loans dominant

Total loans increased by $35 billion in the first half of the year, with business loans accounting for over one-half of the total gain. Banks in the San Francisco District recorded a $6-billion increase, with the business loan share coming to over one-third of that regional increase. (All data are seasonally adjusted.) Borrowing by the business sector got off to a fast start in January, slowed in February and then spurted to more than a 40-percent annual growth rate in March and April. The torrid borrowing pace decelerated somewhat in the following months, luckily so because of the trouble the banks had obtaining funds. Higher operating costs, particularly for financing inventories, caused many business firms to draw heavily on their bank lines of credit. Some borrowing also reflected the effects of stockpiling in anticipation of further price increases. At the same

(continued on page 2)

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Research Department
Federal Reserve
Bank of
San Francisco

Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, nor of the Board of Governors of the Federal Reserve System.

time, materials shortages caused escalating loan demand as firms became unable to meet delivery schedules of finished products. Meanwhile, interim construction loans were stretched out as shortages prevented builders from completing projects.

By the second quarter, banks began to get a spill-over from the capital markets, as costlier financing and investor selectivity made long-term offerings more difficult to arrange. This trend accelerated because of the unsettled conditions in the long-term financial markets which followed the Con Edison and the Franklin National situations and the failure of the Herstatt Bank in West Germany. In recent months, many national firms also drew upon their seldom-used lines of credit at regional banks.

Bank loan demand surged further because of the narrowing differential which developed, especially in the period from late March through May, between the prime business-loan rate and the dealer-placed commercial-paper rate. The development of a two-tier paper market contributed to this shift, as many corporations and bank holding companies had trouble selling commercial paper.

The prime rate was very volatile in the first half of 1974. In line with the abortive decline in money-market rates in late January and February, banks lowered their prime rate from 9¾ to 8¾ percent in four steps. Then, as price expectations worsened and money rates began their steep ascent, banks quickly reversed themselves and moved the prime up in 13 steps to a record 11¾ percent at mid-year. (The 12-percent level was reached in early July.) Prime-rate increases apparently failed to exert their usual rationing effect on bank credit demand, partly because they were associated with an unprecedented inflation rate which kept the "real" cost of borrowing low. Despite record rates, business demand for credit seemed insatiable.

Costly search for funds

Throughout the nation, banks encountered increasing difficulties in their search for funds to fuel the massive asset explosion. Private demand deposits rose about $1 billion over year-end 1973. However, this gain was more than offset by a reduction in U.S. Government deposits, which remained at unusually low levels throughout most of the six-month period. Time deposits (other than large CD's) rose more than $16 billion, even more than in the comparable 1973 period, despite a second-quarter slowdown.

Nonetheless, the bulk of deposit funds came from large-denomination CD's, which increased by $21 billion in the January-June period to an $85-billion total. Western banks contributed disproportionately, accounting for about one-fifth of the total increase. Rates for CD's moved in step with other money-

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

market rates, dipping below 8 percent in February and rising to a record 12 percent at the end of June. Despite this cost upsurge, some major Western banks maintained an overall cost advantage on time deposits by continuing to pay a below-ceiling rate of 4.5 percent on passbook savings, which represent a large segment of their total time deposits. Meanwhile, banks increased non-deposit sources of funds, with sharp gains in capital issues and bank-related commercial paper, the latter reaching the highest level since August 1970.

As reserve pressures increased, borrowing at the Federal Reserve Banks also rose, reaching a record level of $3.6 billion in late May when accommodation of Franklin National Bank added to an already heavy demand. In the San Francisco District, a somewhat different borrowing pattern prevailed—relatively heavy but not exceeding some of the 1973 highs. The cost of borrowing at the discount window increased in late April, with an 0.5-percent hike in the rate to a record 8.0 percent. But the heaviest borrowing was in the form of Federal funds, unused member-bank balances on deposit with Federal Reserve Banks. With rising reserve pressures, the cost of these funds rose from a low of 9.0 percent in February to 11.9 percent in June and 13.6 percent in early July.

Troubled outlook

Unease prevailed in money and credit markets as the third quarter began, highlighted by the unsettled conditions in the capital, commercial paper and acceptance markets which followed the Con Edison, Franklin National and Herstatt Bank situations. With the development of two-tier financial markets, some borrowers have been paying premium rates and some have had serious trouble finding accommodation. As a result, borrowers from other markets are turning increasingly to banks to meet their credit needs. These demands have converged upon banks at a time when financing requests were already high, and when the "bite" of monetary policy was already becoming uncomfortable.

Since the demise of price controls in late April, banks have made upward adjustments in mortgage, consumer and small-business loan rates, which for two years had been kept artificially low in relation to other rates. As time goes on, these adjustments should impact favorably on net operating income, and should also help banks in controlling their loan demand.

In addition to higher costs for funds, banks are faced with increasing delinquencies on consumer and mortgage loans, and also with growing liquidity problems of some major customers. A return to more stable capital and money-market conditions will relieve current pressures, but banks nonetheless will have to emphasize loan monitoring and improved liability management during the remainder of the year.

Ruth Wilson

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Research Department
Federal Reserve
Bank of
San Francisco
Alaska • Arizona • California • Hawaii
Idaho • Nevada • Oregon • Utah • Washington

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/3/74	Change from 6/26/74	Change from year ago Dollar	Change from year ago Percent
Loans (gross) adjusted and investments*	83,509	− 75	+8,914	+ 11.95
Loans gross adjusted—	65,456	− 74	+8,590	+ 15.11
Securities loans	1,246	− 41	− 7	− 0.56
Commercial and industrial	23,349	+ 22	+3,163	+ 15.67
Real estate	19,529	+ 75	+2,851	+ 17.09
Consumer instalment	9,369	+ 21	+ 814	+ 9.51
U.S. Treasury securities	4,976	− 98	− 860	− 14.74
Other Securities	13,077	+ 97	+1,184	+ 9.96
Deposits (less cash items)—total*	78,842	− 218	+7,001	+ 9.75
Demand deposits adjusted	21,669	− 83	+ 720	+ 3.44
U.S. Government deposits	1,237	+ 200	+ 231	+ 22.96
Time deposits—total*	54,313	− 525	+5,889	+ 12.16
Savings	17,991	+ 72	− 284	− 1.55
Other time I.P.C.	27,081	− 363	+6,414	+ 31.03
State and political subdivisions	6,385	− 273	− 407	− 5.99
(Large negotiable CD's)	13,920	− 269	+4,284	+ 44.46

Weekly Averages of Daily Figures	Week ended 7/3/74	Week ended 6/26/74	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	50	− 6	146
Borrowings	247	141	174
Net free (+) / Net borrowed (−)	− 197	− 147	− 28
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions Net purchases (+) / Net sales (−)	+1,428	+1,163	+563
Transactions: U.S. securities dealers Net loans (+) / Net borrowings (−)	+ 172	− 167	−278

*Includes items not shown separately.

Information on this and other publications can be obtained by calling or writing the Administrative Services Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco, California 94120. Phone (415) 397-1137.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis