Research Department
Federal Reserve
Bank of
San Francisco

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Banks' Respite

Most of the financial action was in the capital markets—not at the banks—during the first half of 1975. Despite an accommodative monetary policy and rapid second-quarter money growth, total bank credit expanded at a relatively slow 3.4-percent annual rate during this period. (At Western banks, bank credit grew at only a 2.5-percent rate.) The banking environment was affected not only by a recession-caused weakening of loan demand, but also by recurrent pressures generated in the financial markets—pressures which included a record volume of debt offerings, special problems in municipal financing, and the Treasury's massive deficit-financing needs. The sharp decline in interest rates during this period might have been even greater if it weren't for these special factors.

Banks mostly sat on the sidelines during the first half of 1975, while corporations used part of the record $23 billion that they raised in capital-market funds to help repay the massive short-term bank debt acquired in the two previous years. Moreover, banks experienced diminished demands for new short-term credit as inventory liquidation accelerated, and also experienced a curtailment of mortgage-and consumer-loan demand as unemployment rose and consumer real incomes declined.

Following the normal cyclical pattern, banks invested more heavily in securities when loan pressures weakened. They invested mainly in U.S. Treasury issues, shunning municipals because of a reduced need for tax-exempt income and because of specific problems of some municipal issuers, especially New York City.

Banks utilized the respite from loan pressure to repair the inroads made on their liquidity and capital ratios during the 1973-74 period of record loan demand. They gave more and more attention to provisions for loan-loss reserves and to work-out situations for problem loans, including those loans not accruing interest. They intensified their efforts, first begun around mid-1974, toward slower growth and increased quality of assets. In addition, banks in all size groups continued to deemphasize liability-management practices, reducing their reliance on volatile deposit liabilities as an accelerating inflow of passbook savings and consumer time deposits provided a welcome source of alternative funds.

Loan decline

Total commercial-bank loans declined at a 5½-percent annual rate (seasonally adjusted) in the first half of 1975, with almost all of this reduction concentrated in the second quarter. Business loans accounted for one-half of the total $14-billion reduction—providing a mirror image to the situation in the year-earlier period, when sharply rising business borrowing accounted for one-half of a $38-billion upsurge in total loans.

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The past half-year's $7-billion reduction in business loans should be considered in the perspective of the massive $27-billion increases recorded in each of the two preceding years. A significant proportion of the bank credit extended to corporations during that earlier period, especially in 1974, represented a spillover from the commercial-paper and capital markets, because these markets were not only expensive but were also closed at times to all but prime borrowers. Thus, recent bank-loan repayments were largely a recycling of short-term corporate debt into longer-maturity obligations. This repayment trend was accentuated in the second quarter when a record liquidation of business inventories sharply reduced the need for inventory financing.

Households, like business firms, consolidated their debt obligations and drastically restricted new commitments in the face of an uncertain economic environment. With the new housing market moribund, the mortgage lending pace increased at only about a 2½-percent annual rate during the first half of 1975, compared with a 14-percent rate of increase in the year-ago period. (Still, banks' continued concern over the future course of interest rates became apparent in early spring, when a flurry of mortgage-appraisal requests at Western banks brought an almost immediate increase in mortgage rates to over 9 percent.) Meanwhile, with the auto and appliance markets stagnant, the consumer-instalment lending pace declined at about a 6½-percent rate in both the first and second quarters.

Rate decline

Paralleling but not matching the first-quarter plunge in money-market rates, banks reduced their prime business-loan rate in 12 separate steps from 10½ percent at the end of December to 7½ percent at the end of March. Nonetheless, they maintained an unusually wide spread between the prime and the rates on sources of funds such as Federal funds and large certificates of deposit. The interest-rate decline later slowed and eventually reversed direction; the prime stood at 7 percent at midyear, and then rose to 7¼ percent in mid-July under the spur of rising money rates.

The easing in loan demand relieved banks from the costly search for new funds which had been their dominant concern during most of the two preceding years. A $6-billion runoff in CD funds thus ensued, mainly in the second quarter. In contrast, total time deposits (other than CD's) increased by $24 billion, as the rate on time deposits suddenly became very attractive as rates on Treasury bills and other market instru-

ments declined. The shift was encouraged by the Federal Reserve's move last December, lowering reserve requirements on savings and longer-maturity time deposits.

Demand deposits increased at a much slower pace than time deposits in early 1975. But demand deposits rose at nearly a 12-percent annual rate during the spring quarter, reflecting the impact on the banking system of Federal anti-recession measures—tax rebates, lower tax withholdings, and the special supplemental payments to social-security recipients.

New commitments?

Banks are entering the economic-recovery period in relatively good shape to take on new commitments. The massive run-off of business inventories virtually guarantees some rebuilding of stocks in coming months, and this should soon be reflected in bank-loan demand for inventory financing. On the other hand, the improved liquidity of many business firms should enable them to limit their reliance on bank financing, at least in the near term. Again, banks themselves may continue their present policy of selectivity in making loan commitments. (Despite the current weakness of loan demand, many banks are not seeking new customers or out-of-area customers.) This cautious attitude may make credit availability a continuing problem for less credit-worthy business firms, especially those that have been unable to refinance short-term debt in the capital market.

In other lending categories, a modest increase in demand may be all that can be expected. In view of the slow revival of residential construction, mortgage lending by banks may increase rather slowly, and in view of the wary attitude of consumers toward purchases of autos and other big-ticket items, consumer-loan growth may also lag.

Despite the modest outlook for loan demand, banks could face a tightening interest-rate situation in coming months. The recent sharp turnaround in short-term rates brought the first prime-rate increase of the past year, as well as a narrowing of the spread between the prime and the cost of bank funds. The very favorable margin which produced record income statements in the first half of 1975 may not be maintained if money rates continue to move upward. This could create special problems for those banks that are still adding large amounts to loan-loss reserves, and also for those major Western banks that recently boosted their interest expense by going from 4½ percent to the 5-percent ceiling rate on passbook savings.

Ruth Wilson

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/09/75	Change from 7/02/75	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	86,534	+ 1,179	+ 2,743	+ 3.27
Loans (gross, adjusted)—total	65,534	+ 1,108	– 228	– 0.35
Security loans	2,136	+ 1,045	+ 1,019	+ 91.23
Commercial and industrial	23,429	+ 49	– 49	– 0.21
Real estate	19,576	– 3	– 11	– 0.06
Consumer instalment	9,850	– 15	+ 398	+ 4.21
U.S. Treasury securities	8,576	+ 19	+ 3,746	+ 77.56
Other securities	12,415	+ 52	– 775	– 5.88
Deposits (less cash items)—total*	85,736	– 118	+ 6,487	+ 8.19
Demand deposits (adjusted)	23,962	+ 112	+ 1,314	+ 5.80
U.S. Government deposits	338	+ 64	– 274	– 44.77
Time deposits—total*	59,993	– 177	+ 5,654	+ 10.41
States and political subdivisions	6,510	– 136	+ 211	+ 3.35
Savings deposits	20,551	+ 62	+ 2,521	+ 13.98
Other time deposits‡	29,044	– 50	+ 1,771	+ 6.49
Large negotiable CD's	15,892	– 113	+ 1,882	+ 13.43

Weekly Averages of Daily Figures	Week ended 7/09/75	Week ended 7/02/75	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	38	88	107
Borrowings	16	264	139
Net free (+) / Net borrowed (–)	22	– 176	– 32
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+) / Net sales (–)	+ 1,693.6	+ 859.3	+ 2,070.9
Transactions of U.S. security dealers			
Net loans (+) / Net borrowings (–)	+ 838.0	+ 354.7	+ 170.5

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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