Research Department
Federal Reserve
Bank of
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Banking Lull

Bank credit expanded at a sluggish pace in 1975 in the face of an obvious turnaround in business activity. In the first half of the year, loans declined by a record amount, reflecting not only the recession-related weakness of borrowing demands but also the rapid pay-down of short-term business credits that had accumulated during the 1973-74 inflationary binge. In the remainder of the year, the moderate pace of the recovery did little to stimulate loan demand. Increased bank investment in securities, mainly Treasury issues, thus accounted for all of the 1975 expansion in bank credit. A sharp reduction in banks' large-denomination CD liabilities paralleled the reduction in lending activity and a massive inflow of savings deposits.

Corporations, municipalities and the Federal Government all borrowed record amounts last year in the financial markets—but not at the banks. This was partly by design, since banks attempted to maintain a wide spread between the rate of return on loans and the cost of bank funds, in order to generate the earnings needed to improve liquidity and capital ratios and to increase loan-loss reserves. A reorientation toward asset quality and sustainable growth, which had begun in the latter half of 1974, was reinforced in 1975 by the mounting severity of loan problems with REITs, W. T. Grant and a myriad of other borrowers, and by the specter of New York City's insolvency.

Loan weakness

Total commercial-bank credit increased $29 billion in 1975—a 4-percent gain compared with the 14 and 9 percent gains of the two preceding years. The weakness of this performance was caused by a net reduction of about $5 billion in total loans, almost entirely in the business-loan category. But this was more than offset by a $34 billion (18 percent) increase in security holdings—a welcome addition to bank liquidity, since purchases were concentrated in short-term Treasury issues. Banks held down their investment in other securities because of a concern over municipal issues which radiated from New York City's financial problems.

Most of the $5-billion business-loan decline occurred in the first half of the year, as corporations used funds raised in the capital market to repay bank debt, and as severe inventory cutbacks reduced short-term credit needs. Later on, an improvement in internal cash flows provided businesses with some of the funds to meet needs associated with the revival in economic activity, limiting the amount of bank credit normally required at this stage of the cycle. Actually, balance-sheet data disguised the weakness of the business-loan sector, because banks towards year-end retained in their own loan portfolios a large volume of bankers acceptances which would normally have been sold to others. But even so, business credit at banks remained high by historical standards, since the pay-

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down for the year was less than 10 percent of the \$54-billion business-loan expansion of the 1973-74 period.

Mortgage-loan growth slowed to about 2 percent—only a fraction of the gains recorded in the two preceding years. For the most part, 1975's real-estate lending centered on the existing stock of single-family homes, as high construction costs and interest rates continued to limit new residential construction. Consumer borrowing, for the second year in a row, also contributed little to the expansion of bank loan portfolios. Instead, as economic uncertainty and high unemployment persisted, individuals made substantial repayments of bank debt. This cautious attitude did not change significantly until Christmas when households again expanded their credit buying.

Wider margins

Banks began to strengthen their inflation-weakened balance sheets in 1975 through a widening of operating margins. By lagging their adjustments in the prime business-loan rate as short-term rates declined, banks were able to keep loan rates at a substantial spread above their costs for funds, such as Federal funds and CD's. Banks lowered the prime from 10½ percent at the beginning of the year to a low of 7 percent in June. When money rates moved sharply higher in the third quarter, banks raised the prime to 8 percent, but they again followed with a lag when rates reversed direction in mid-October. In the mortgage sector, banks raised rates above 9 percent in late spring when mortgage demand strengthened, and kept them near that level through 1975.

The Federal Reserve reduced its discount rate for member-bank borrowing from 7¾ percent at the beginning of the year to 6 percent in May, but that rate remained consistently above the Fed-funds rate except during the July-October period. For this reason, as well as several reductions in reserve requirements and improved liquidity, member-bank borrowing declined from a record \$2-billion daily average in 1974 to only \$196 million in 1975. Later, in January 1976, the Fed lowered the discount rate to 5½ percent, to bring it into line with market rates.

Demand deposits grew about \$6 billion (2 percent), while time deposits expanded by \$26 billion (6 percent), on the strength of a large inflow of deposits into passbook savings. This reflected the consumer's cautious spending attitude as well as the spring tax-cut windfall. The influx of these relatively inexpensive funds, in combination with weak loan demand, permitted a \$10-billion runoff in more costly CD funds, and thus helped reduce the average interest cost on time-deposit liabilities.

Banks also benefited from the opportunity to lengthen deposit maturities after the October reduction, from 3 percent to 1 percent, in reserve requirements on time deposits with maturities over four years. In November, however, an adverse deposit-cost factor emerged when the Fed permitted banks to accept deposits in passbook form (up to $150,000) from partnerships and corporations. By year-end, these new savings deposits exceeded $900 million at large banks alone. To the extent these funds represented transfers from demand-deposit balances, the cost to banks would rise from zero interest to 4½ or 5 percent, the typical passbook rates.

Challenges for 1976

Banks will face challenges in 1976 because of both the legacies of the recent past and a number of developing institutional changes. Problem loans are at the top of the agenda, particularly for REIT's, and many of these will take a long time to solve. Income will be affected not only by actual loan losses, but also by the need to divert funds into loan-loss reserves and to handle the record number of work-out situations where loans are on a non-interest-accrual or reduced-interest basis. Nobody knows how many write-downs banks will have to take on tax-exempt securities, but at the least, they will be locked-in on some securities which have suffered severe price erosion.

Banks are also facing various institutional changes which have materially increased competition from nonbank financial institutions. There is, for example, the widening range of interest-bearing deposits, which is now blurring the distinction between demand and time deposits. Deposit costs, such as those associated with new corporate savings deposits, may expand further if more extensive use of telephone and third-party transfers leads to more shifts from demand balances to savings or time deposits. Banks must also deal with all of the cost ramifications implicit in the initiation of electronic-transfers.

These adverse cost factors are coming at a time when many analysts are forecasting only a modest gain in bank loan demand. Business-sector borrowing may remain low in 1976 because of caution in rebuilding inventories and in spending for plant and equipment, and also because of improved corporate profits and internal cash flows. (Still, a further decline in interest rates with a low prime could trigger some business borrowing for purposes which had been delegated to the "optional" category.) Mortgage demand for single-family housing should continue to expand, but demand for commercial and industrial mortgages may well remain near its present depressed level. The consumer, now strengthened by a rising trend of income and by last year's debt repayment, may continue the more active role in the credit market evident in the closing months of 1975. On balance, then, the consensus view would indicate a moderate level of loan demand in 1976, but with increasing momentum as the year progresses.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/07/76	Change from 12/31/75	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	89,761	– 856	+ 2,418	+ 2.77
Loans (gross, adjusted)—total	66,056	– 1,051	– 2,071	– 3.04
Security loans	1,507	– 235	– 90	– 5.64
Commercial and industrial	23,593	– 438	– 1,346	– 5.40
Real estate	19,687	– 27	– 431	– 2.14
Consumer instalment	10,305	+ 8	+ 332	+ 3.33
U.S. Treasury securities	10,956	+ 178	+ 4,715	+ 75.55
Other securities	12,749	+ 17	– 226	– 1.74
Deposits (less cash items)—total*	91,222	– 197	+ 6,049	+ 7.10
Demand deposits (adjusted)	25,308	+ 46	+ 1,547	+ 6.51
U.S. Government deposits	656	+ 329	+ 209	+ 46.76
Time deposits—total*	63,446	– 213	+ 3,990	+ 6.71
States and political subdivisions	7,726	+ 79	+ 90	+ 1.18
Savings deposits	22,617	+ 304	+ 4,223	+ 22.96
Other time deposits‡	29,557	– 392	– 444	– 1.48
Large negotiable CD's	15,558	– 532	– 1,006	– 6.07

Weekly Averages of Daily Figures	Week ended 1/07/76	Week ended 12/31/75	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	97	119	84
Borrowings	0	24	78
Net free(+)/Net borrowed (–)	+ 97	+ 95	+ 6
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (–)	+ 708	+ 1,339	+ 1,635
Transactions of U.S. security dealers			
Net loans (+)/Net borrowings (–)	+ 703	+ 620	+ 962

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

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