Research Department
Federal Reserve
Bank of
San Francisco

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Business & Financial Letter

Banking 1976—Funds Available

The atypical behavior of interest rates and financial markets in the current recovery period strongly affected commercial-bank balance sheets in 1976. Total credit—loans and investments—increased by 6.4 percent at the nation's banks, reflecting the modest pace of the recovery. Despite a second-half upturn, loans accounted for only one-half of the credit expansion. Mortgage and consumer loan demand strengthened, but the long expected upsurge in business borrowing failed to materialize.

With loans relatively sluggish, banks added further to their holdings of Treasury securities, moving into longer maturities in an effort to improve income—and later in the year, they also reentered the previously distressed municipal market. Meanwhile, $40 billion in savings funds inundated the banks as money-market rates dropped substantially below the 5-percent ceiling rate paid on savings deposits, in early 1976 and again near year-end. This heavy inflow of funds made it possible for banks to reduce their issuance of large certificates of deposit by a record $19 billion.

Sluggish business loans

By year-end 1976, bank loans were only 5 percent above their March 1975 cyclical trough. In contrast, at comparable points of earlier cyclical recoveries, loan volume was anywhere from 14 to 21 percent larger than at the recession low. The key factor was 1976's weakness in business-loan demand, particularly at large banks where lending is heavily weighted toward national and multinational corporations. Contributing to this weakness was the sluggishness in business plant-equipment spending. More importantly, corporations took advantage of the declining trend of market rates to restructure their debt, borrowing heavily in the bond market and using much of the proceeds to repay bank debt. Improved corporate liquidity, cash flows and profits meanwhile tended to limit business demand for short-term bank credit. This was particularly evident in the first quarter, when a significant rebuilding of inventories occurred without a parallel increase in bank borrowing.

Booming mortgages

With the business sector weak, mortgage lending contributed the largest share of the $25-billion expansion in total loans. Banks accelerated their financing of single-family homes as the year progressed, particularly in many areas of the West. Consumer instalment loans also grew in the latter part of the year, as individuals became less cautious spenders and less reluctant to incur bank debt. For some major banks, meanwhile, an increase in foreign loans overshadowed their domestic lending.

Borrowings in other financial markets also reached record volume during the year. In financing a $60-plus billion Federal deficit (calendar 1976), the Treasury altered its pattern of borrowing and raised $50

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billion in coupon issues. Thus, by adding relatively little to Treasury-bill supplies, it relieved pressure on short-term rates and contributed to a more normal ascending yield curve. State and local governments borrowed record amounts; indeed, as the year-earlier fear of widespread defaults dissipated, the market became more receptive and municipal yields declined sharply from 1975's record highs.

Declining rates

These developments occurred against a backdrop of a declining rate of inflation, a moderately accommodative monetary policy and a moderate business recovery. With investable funds in ample supply, long-term interest rates came under pressure, and in December reached the lowest point of the past several years. Short-term rates remained relatively flat during the early part of 1976, rose steeply in May and June, and then also declined to a cyclical low at year-end. The prime business-loan rate lagged the decline in money rates, as banks attempted to maintain or widen the favorable "spread" (net differential) between their return on earning assets and their cost of funds. Despite relatively weak loan demand, banks felt compelled to maintain profit margins large enough to cover continuing high loan-loss reserve requirements and to offset non-accrual loans (i.e., loans on which interest was not being paid). Many also acted cautiously because of a belief that rate reductions would not spur loan demand from the business sector. But as the year progressed, many banks became more aggressive and began making concessions, on both price and non-price lending terms.

Monetary policy was directed in 1976 toward "encouraging continued economic expansion while restraining inflationary pressure." The Federal Reserve achieved these 1976 targets within reasonable tolerances. The narrowly defined money-supply—M_1, or currency plus demand deposits—increased at a 5.4-percent rate (fourth-quarter to fourth-quarter), while M_2—M_1 plus savings and time deposits except CD's—expanded at a 10.9 percent rate. M_2's faster growth rate reflected the significant shift of funds from demand balances to savings deposits by corporations and domestic governmental units, as well as the favorable differential between savings-deposit rates and the rates on other money-market instruments, which led to the massive inflow of interest-sensitive funds into bank savings accounts.

Improved earnings

Bank earnings generally were better than the poor 1975 performance, although results again varied widely among individual institutions. Many retail-oriented banks reported sharply higher income because of strengthened consumer demand for mortgages and instalment loans. Large wholesale banks, on the other hand, suffered from the second straight year of weak business-loan demand. Still, loan revenue generally increased because of the favorable spread which

banks maintained between their return on earning assets and their cost of funds, reflecting the downward stickiness in both business-loan and mortgage rates.

Earnings also benefited from banks' tighter control over expenses. The greatly reduced volume of large CD's lowered deposit interest costs, but in the other direction, interest paid on savings deposits was higher than on other instruments during at least part of the year. Net profits suffered in some cases because of greater provision for loan-loss reserves, and because of the continued high volume of actual loan losses and of non-accrual loans—although most banks made significant progress in working out their various problem situations.

Stronger '77?

Banks are well-positioned to benefit from the moderate economic expansion generally forecast for 1977. Improved liquidity and capital positions should permit banks to concentrate more on building up their earning assets and profits. The substantial additions made to loan-loss reserves over the past three years should mean less diversion to reserves in 1977.

With economic activity increasing, loan volume should expand significantly and bring an improvement in operating revenue, even in the event of a narrowing of net interest differentials. Record savings flows should provide ample funds to meet the strong demand expected for single-family mortgages as well as some turnaround in demand for multifamily mortgages. The proposed tax rebate and lower tax rates should stimulate consumer spending and willingness to add to instalment indebtedness. Sustained consumer spending could then trigger increased borrowing for inventories and even the long-expected increase in business borrowing for capital expenditures. For that matter, banks can expect at least a temporary surge in business borrowing this spring to meet enlarged corporate income-tax payments resulting from the short-fall in 1976 payments.

There are, however, some negative factors in the 1977 picture. Interest costs on deposit liabilities will increase as more and more deposits become interest-bearing, with individuals, corporations, and governmental units increasingly shifting funds from demand to time-and-savings accounts. Banks will have to absorb new costs stemming from the many innovative programs and electronic services offered as a result of increasingly competitive financial markets. The inauspicious events of early 1977—a sharp rise in interest rates and extreme weather conditions throughout much of the country—have already created fears about renewed inflation and a slowdown in the economic expansion. If this should result in delays in inventory financing or capital spending, the long-awaited resurgence in the business sector's loan demand would once again be pushed into the future.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/19/77	Change from 1/12/77	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	92,765	– 1,935	+ 4,394	+ 4.97
Loans (gross, adjusted)—total	70,211	– 443	+ 5,002	+ 7.67
Security loans	1,497	– 297	+ 627	+ 72.07
Commercial and industrial	22,876	+ 32	– 621	– 2.64
Real estate	21,707	+ 140	+ 2,027	+ 10.30
Consumer instalment	12,294	– 15	+ 1,623	+ 15.21
U.S. Treasury securities	9,611	– 1,130	– 945	– 8.95
Other securities	12,943	– 362	+ 337	+ 2.67
Deposits (less cash items)—total*	93,177	– 1,808	+ 3,978	+ 4.46
Demand deposits (adjusted)	26,309	– 1,356	+ 2,185	+ 9.06
U.S. Government deposits	593	+ 187	– 159	– 21.14
Time deposits—total*	64,985	– 244	+ 2,135	+ 3.40
States and political subdivisions	5,948	+ 31	– 1,671	– 21.93
Savings deposits	30,873	+ 130	+ 7,390	+ 31.47
Other time deposits‡	25,904	– 234	– 2,837	– 9.87
Large negotiable CD's	9,945	– 477	– 4,136	– 29.37

Weekly Averages of Daily Figures	Week ended 1/19/77	Week ended 1/12/77	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	– 52	+ 82	+ 82
Borrowings	2	1	6
Net free(+)/Net borrowed (–)	– 54	+ 81	+ 76
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (–)	+ 1,263	+ 1,244	+ 1,601
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (–)	+ 351	+ 1,054	+ 558

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

Editorial comments may be addressed to the editor (William Burke) or to the author. . . . Information on this and other publications can be obtained by calling or writing the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 544-2184.