Research Department
Federal Reserve
Bank of
San Francisco

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Business & Financial Letter

Changing Picture?

At first glance, the banking environment in January-June 1977 might seem to resemble the situation in the comparable period of 1976. There was the same early-year stability in interest rates and the same early-spring upsurge in the money supply, followed by (just as last year) a modest tightening of monetary policy and run-up in short-term interest rates. But there were substantial differences as well. In particular, bank credit expanded at a 10½-percent annual rate ($41 billion) during the January-June period—faster than in either half of 1976.

Bank lending was the dominant element in this credit expansion, reflecting both the more robust health of the economy and the improvement in bank liquidity obtained after two years' heavy investment in securities. Meanwhile, on the deposit side, savings flows decelerated somewhat yet still added a substantial $24 billion to banks' sources of funds. Banks generally reported higher earnings, because of a higher volume of loans and a generally favorable spread between the rates they received on their assets and the rates they had to pay for funds.

Business lending mixed

Business lending, after beginning to recover during the second half of 1976, increased further—at a 10-percent annual rate—in the first half of this year. But again, there was little activity at the big money-center banks, especially the New York banks, which are oriented toward large corporate borrowers. Despite a flurry of bank borrowing in the first half of June, large firms continued to rely on the capital market for longer-term financing and on the commercial-paper market for short-term credit needs, reflecting in the latter case the wide rate differential between the banks' prime rate and the commercial-paper rate. For that matter, corporations needed relatively little short-term financing because of their strong earnings, greatly improved liquidity and modest capital-spending plans.

The business-lending pace was much stronger at two other types of banks—the small regional banks and the large money-center banks outside New York. Those banks benefited from the substantial demands of small and "middle market" firms for inventories, receivables and capital equipment, because of an expanding economy and a relative lack of borrowing alternatives for such firms elsewhere. Many of these firms, unlike large national corporations, have little or no access to the capital or commercial-paper markets. Hence, they depend for their funds upon the banks—including the large Western branch-banking systems, which for years have maintained strong customer relationships with many such firms.

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Mortgage, consumer loans soar

Bank mortgage lending continued to outperform business lending, with a 14-percent annual rate of increase during the first half of 1977. This situation reflected both the single-family housing boom and the increased aggressiveness of banks with extra money to lend because of the lack of demand from their large corporate customers. In some areas of the country, especially California, the imbalance between a backlog in housing demand and limited new supplies led to escalating prices, higher mortgage rates, and intensive speculative activity. However, a rising volume of residential construction is now improving the supply situation and helping to stabilize the mortgage market. In addition, mortgage-lending institutions have begun to defuse the speculative boom by restricting mortgages to owner-occupants or imposing higher rates and stringent borrowing conditions on non-occupant borrowers.

The late-winter speed-up in consumer spending sparked an upsurge in bank instalment lending this spring. Auto financing accounted for most of the gain, but other important factors included a rise in home-improvement loans and, in May, an increase in credit-card activity. An interesting new wrinkle in consumer financing meanwhile developed in the form of the home-equity loan—a mortgage loan offered by many West Coast banks for consumer purposes. This type of loan permitted many home owners to take advantage of the inflation-boosted rise in their home values to finance household purchases on advantageous terms. Being collateralized by a junior lien on the borrower's property, the home-equity loan allowed consumers to borrow larger amounts for longer time periods, and at significantly lower rates, than they could under regular instalment loans.

Pricing and income

The price of money rose during the spring months, but the sharp rise which many money-market analysts had anticipated failed to materialize. Most of the action took place between mid-April and late May, when the key Federal-funds rate—the rate paid on overnight loans of unused reserves—rose from about 4.70 percent to 5.45 percent, reflecting the Federal Reserve's pressure on bank reserves in response to April's upsurge in the money supply. Banks thereupon raised their prime rate, but by a lesser amount and with some lag, because of the continued weakness of business-loan demand. The rise in the prime—from 6.25 percent to 6.75 percent—took place in two steps, but several banks subsequently rescinded the second of those increases and lowered their prime to 6.50 percent.

While banks paid more for what they borrowed in the Fed-funds market, they were able to obtain funds at the Federal Reserve discount window at the unchanged rate of 5.25 percent, and this factor helped account for a heavier volume of borrowing at the window. Meanwhile, interest costs for deposit liabilities remained relatively low, reflecting the high proportion

of funds held in the form of savings deposits. However, the composition of deposits began to shift during this period. The second-quarter gain in savings deposits was only one-fourth the size of the first-quarter increase, while the inflow of funds into higher-priced time certificates accelerated.

On balance, many banks were able to benefit from a widening spread between the rates they earned on their funds and the rates they paid for those funds. Still, their income reports apparently benefited even more from the expanded loan volume in those categories bearing high rates of return. In addition, banks continued to recover from the impairment they suffered in the mid-1970's, as they were able to reduce the amounts set aside for loan losses, and also to reduce the charges against income required because of actual loan losses and nonperforming loans (including those that were renegotiated as well as those not accruing interest).

Regional banks generally reported better income gains than large money-center banks, reflecting the briskness of their mortgage and consumer lending as well as the strength of demand from their small and medium-sized business customers. Some large banks, suffering from weak business-loan demand at home, continued to obtain a larger share of income from overseas operations.

Tempered optimism

The uncertainties that surfaced during the first half of 1977 are likely to be evident in the second half of the year as well. Many analysts expect higher money-market rates as the year continues, if only because of a higher level of business activity and borrowing demands. Those borrowing pressures will grow as the Treasury shifts from being a net repayor of debt in the second quarter to a large net borrower in the present quarter, and also as Federal housing agencies continue their activity in the market. In this shifting environment, banks could suffer a reduction in the spread between what they earn and what they pay for funds. In line with past experience, their prime rate may not rise as rapidly as most money-market rates, and meanwhile, their cost of funds might increase with a continuation of the recent slowdown in that relatively low-cost source of funds, savings deposits.

If large corporations continue to be modest borrowers, the recent sharp competition in all categories of business lending would probably intensify. This situation could lead to a further erosion in business-loan pricing and lending terms, including reduced compensating balances and fee requirements, fixed rather than floating loan rates, and narrower rate spreads above the prime for non-prime borrowers. Much of the slack could be filled by the continued strength of mortgage and consumer borrowing, although perhaps not at the booming pace of the first half of the year. Yet overall, banks with their ample liquidity are well able to accommodate increased credit demands, as they continue to search for new financing outlets and to create innovative lending programs.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/6/77	Change from 6/29/77	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	98,656	+ 36	+ 9,514	+ 10.67
Loans (gross, adjusted)—total	75,866	+ 360	+ 8,476	+ 12.58
Security loans	2,419	+ 503	+ 966	+ 66.48
Commercial and industrial	23,697	- 67	+ 1,617	+ 7.32
Real estate	24,201	+ 154	+ 3,835	+ 18.83
Consumer instalment	12,998	+ 16	+ 1,750	+ 15.56
U.S. Treasury securities	9,128	- 528	- 562	- 5.80
Other securities	13,662	+ 204	+ 1,600	+ 13.26
Deposits (less cash items)—total*	97,888	+ 1,778	+ 7,690	+ 8.53
Demand deposits (adjusted)	27,971	+ 898	+ 2,936	+ 11.73
U.S. Government deposits	525	+ 302	+ 153	+ 41.13
Time deposits—total*	67,092	- 128	+ 4,211	+ 6.70
States and political subdivisions	5,703	+ 234	- 435	- 7.09
Savings deposits	31,913	+ 110	+ 5,568	+ 21.13
Other time deposits‡	27,311	- 424	- 436	- 1.57
Large negotiable CD's	10,383	- 416	- 2,110	- 16.89

Weekly Averages of Daily Figures	Week ended 7/6/77	Week ended 6/29/77	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (-)	+ 32	- 54	+ 28
Borrowings	1	4	8
Net free(+)/Net borrowed (-)	+ 31	- 58	+ 20
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (-)	- 725	- 1,302	- 431
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (-)	+ 19	- 402	+ 180

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

**Editorial comments may be addressed to the editor (William Burke) or to the author. . . .
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