Research Department
Federal Reserve
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FRB SF Weekly Letter

Turbulent But Profitable

Banking and financial markets were buffeted in 1979 by inflation, recession fears, increased international tensions, and then by the Federal Reserve's decisive monetary-policy actions of October 6. Funds generally remained available to meet 1979 credit demands, but interest rates were very high and very volatile. Yet the nation's commercial banks posted record profits during the year, attesting to their ability to adjust to rapid economic and financial changes. Those profits reflected a robust 11½-percent expansion in bank credit, as well as a rate of return on assets high enough to maintain a favorable spread over banks' increasingly costly funds.

Policy tightens

Faced with an acceleration of inflation at home and abroad, the Federal Reserve moved forcibly on October 6 to achieve better control over money and credit expansion. Earlier restrictive actions—including several boosts in the discount rate (from 9½ to 11 percent)—had failed to stem the rapid growth of the money supply and of the inflation indexes. Thus the Fed unveiled its "Saturday night special" of October 6: 1) increasing the discount rate on member-bank borrowings a full percentage point, to a record 12 percent; 2) imposing an 8-percent reserve requirement on increases in the aggregate total of certain "managed liabilities," such as large time certificates (CD's) and Eurodollar borrowings, and 3) making a fundamental change in the System's monetary-control procedures to focus on bank reserves, rather than on the Federal-funds rate which governs interbank borrowings.

These actions helped produce a significantly slower growth in the money supply and bank credit in the fourth quarter—and also a greater volatility in money-market rates before market participants accustomed themselves to a new and unfamiliar operating environment. With the fourth-quarter deceleration, the annual growth of the narrow M1 money supply (currency plus bank demand deposits) fell within the 3- to 6-percent target growth range which the Fed had announced earlier in the year. (This figure adjusts for the impact on demand-deposit growth of automatic transfer-from-savings accounts.) Again, with the late-year deceleration, the growth of the broader M2 measure (currency plus all bank deposits except large negotiable CD's) came in only slightly above the upper end of the 5- to 8-percent target range after having been considerably higher earlier in the year.

Financial markets grow

Net funds raised in 1979's financial markets roughly matched the 1978 total, according to preliminary estimates, as private-sector borrowing offset a decline in debt financing by the public sector. Although Treasury debt increased only half as fast as in 1978, foreign holders liquidated substantial amounts of government securities, forcing the Treasury to rely more heavily on domestic purchasers to finance its debt offerings. State-and-local governments showed modest increases in borrowing and spending. In contrast, Federally sponsored agencies boosted their debt by record amounts, primarily in order to provide support for the hard-pressed mortgage-finance industry. In the private sector, corporate long-term debt expanded at about the 1978 pace, but corporate short-term debt rose as firms increased their reliance on bank credit and doubled their sales of open-market paper.

Although funds remained available, they also became more costly. Short-term rates were three percentage points higher at the end than at the beginning of the year, under the impact of accelerating inflation, energy shocks, and a tighter Federal Reserve policy. Rate movements also became very volatile after October 6. Money-market rates began

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climbing at midyear as business activity quickened, then shot upward after the October 6 policy package, and finally eased in November and December as the markets learned how to operate in the new policy environment. October's record rates on large CD's, Federal funds and commercial paper prompted banks to hike their prime business-loan rate to a record 15¾ percent, but they later reduced that rate to 15 percent as their cost of funds began to decline. In contrast, Treasury-bill rates lagged considerably behind other money-market rates.

Long-term corporate bond rates rose modestly in the first half, accelerated during the summer as inflation expectations worsened, and then rose even faster in the fall as fears surfaced about declining credit availability. Throughout the year, the yield curve retained an inverted ("humpbacked") shape, with higher yields on short- and intermediate-term maturities than on long-term issues, as is typical of inflation periods. Prime mortgage rates rose steadily over most of the year, except in states with restrictive usury laws; after October 6 they rose as high as 14 percent in some areas, exerting a dampening impact on housing activity.

Bank credit expands

Commercial-bank credit expanded by $117 billion in 1979—a substantial 11½ percent gain, although somewhat behind the 1978 pace. Loans accounted for 84 percent of the total gain—down from the preceding year's 90-percent share—as banks built up their liquidity by adding to their holdings of Federal agency and tax-exempt securities while maintaining their Treasury securities at the 1978 level. Business demand for bank credit rose over $40 billion, an accelerated 17-percent rate, reflecting strong corporate needs for working capital and for increasingly expensive inventories. However, this strength was concentrated in the first and third quarters of the year. The pace of business borrowing at major money-center banks, particularly in New York, far exceeded that at small banks during most of the year, but was relatively weaker in the fourth quarter.

In contrast to this uneven business-borrowing behavior, bank mortgage lending continued strong throughout 1979. (However, the $32-billion increase lagged behind the phenomenal 1977-78 pace.) The steep late-year rise in mortgage rates could be expected to dampen activity in this area, but it came too late to affect 1979 data because of the long time-lag between mortgage commitments and actual loan take-downs.

The major shift in loan demand last year came from the household sector. Consumer borrowing remained strong until about midyear. Then the pace slackened significantly as consumers, as well as lenders, became more cautious in response to rising consumer-debt ratios, and as declining real income and recession fears brought a decline in consumers' large-ticket purchases.

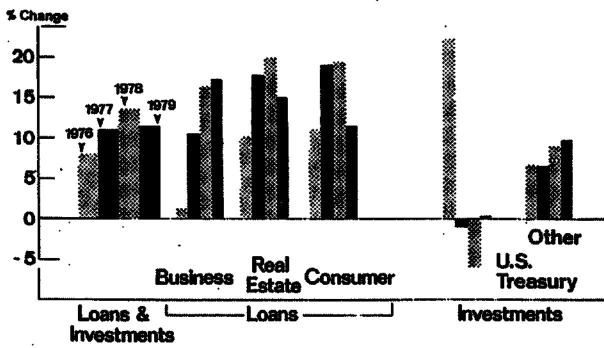
MMC's dominant role

To finance this credit expansion, banks relied heavily on certain types of time deposits and on non-deposit sources of funds. Demand deposits made only a relatively weak contribution.

Money-market certificates (MMC's), with their rates tied to the 6-month Treasury-bill rate, were the most noteworthy source of funds. MMC's quadrupled in volume during the year, offsetting an outflow in fixed-ceiling savings deposits. Moreover, as banks shifted into these new market-rate consumer instruments, they relied considerably less than usual on the normal deposit "stabilizing" function of large-denomination time certificates (CD's). In fact, CD issuance remained practically unchanged in 1979—unlike 1978 and other recent periods of high interest rates—because banks could obtain funds more cheaply through money-market certificates and through non-deposit sources such as Eurodollars.

Rising bank earnings

Bank income apparently reached a new peak in 1979, according to preliminary estimates for the year. Operating earnings increased as banks expanded their volume of earning assets and simultaneously benefited from



Source: Federal Reserve Board of Governors

soaring rates of return on those assets—for example, the prime business-loan rate rose from a midyear level of 11½ percent to a fall peak of 15¾ percent.

Money-center banks in particular benefited from the large expansion in business loans at rates tied to the higher prime rate. Regional banks meanwhile profited from portfolios heavily weighted with high-interest-rate mortgage and consumer loans, even though rates on such loans did not rise as fast as the business prime. These developments helped banks to maintain a favorable spread between their return on assets and their cost of funds. Income statements at many banks also improved because of reductions in the amounts set aside for loan-loss reserves, reflecting their more favorable experience with loan write-offs and write-downs.

However, the cost of bank funds also rose steeply as the year progressed, especially in view of a shift from less costly sources of funds (those subject to fixed deposit-rate ceilings) to more expensive sources acquired at accelerating market rates. Money-market certificates largely replaced the outflow of less-expensive savings deposits, and their cost climbed as Treasury-bill rates rose. Even the "core" savings deposits became more expensive after midyear when the Regulation Q ceiling rate rose from 5 to 5¼ percent. Costs on other liabilities—large CD's, Eurodollars, Federal funds and borrowings from the Fed—all rose to record highs in the fourth quarter. In addition, after October 6 those banks whose "managed liabilities" exceeded their aggregate September base became subject to an 8-percent marginal reserve requirement. But overall, the 1979 profits picture reflected banks' successful weathering of last year's highly volatile interest-rate environment.

Clouded outlook

Both domestic and international uncertainties cloud the 1980 outlook. The full impact of the late-fall monetary-policy moves will become more evident after the normal early-year paydowns of high seasonal December borrowings. However, the business-loan expansion could remain fairly strong as corporations continue to rely on short-term financing instead of costly longer-term funding in the capital markets. Any involuntary inventory accumulation, as the economy slows, also would call for increased bank borrowings—at least in the short-term. On the other hand, many large and some middle-market corporations will continue to use the commercial-paper market as a less costly alternative to bank financing.

In contrast, a reduction in mortgage lending appears assured for the early months of the year, reflecting the recent high mortgage rates which "rationed out" many potential first-time home owners. Moreover, reduced home construction has already become evident because of restricted credit availability. Again, in view of current economic uncertainties, consumers will probably continue to restrict their purchases of large-ticket goods and remain cautious about expanding bank-held debt.

The new 8-percent marginal reserve requirement on managed liabilities should increasingly be written into the cost of credit expansion, because banks will find it more difficult over time to stay within their September base for such liabilities. Meanwhile, a shift in banks' liability structure from managed "purchased" liabilities toward consumer-oriented market-rate instruments should continue, reflecting the popularity of MMC's and the new authorization in January for 2½-year (and longer) certificates tied to yields on Treasury issues of like maturity.

The heavy weighting of bank portfolios by the high-yielding earning assets acquired last year should help banks maintain a favorable interest spread over their average cost of funds, particularly if short-term rates ease somewhat. At the same time, earnings in coming months could be hurt by a slower rate of loan expansion, and possibly by increased loan losses. Under any scenario, banks may have difficulty adjusting to 1980's financial-market uncertainties.

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 1/2/80	Change from 12/26/79	Change from year ago @ Dollar	Change from year ago @ Percent
Loans (gross, adjusted) and investments*	137,846	− 393	+ 16,899	+ 14.00
Loans (gross, adjusted) — total#	115,111	− 218	+ 16,218	+ 16.40
Commercial and industrial	32,529	+ 98	+ 4,404	+ 15.70
Real estate	43,516	+ 243	+ 8,597	+ 24.60
Loans to individuals	24,619	+ 137	+ 4,602	+ 23.60
Securities loans	1,549	− 74	− 353	− 18.60
U.S. Treasury securities*	7,189	− 90	− 566	− 7.30
Other securities*	15,546	− 29	+ 1,303	+ 9.10
Demand deposits — total#	50,387	+4,091	+ 2,348	+ 4.90
Demand deposits — adjusted	35,775	+1,912	+ 3,270	+ 10.10
Savings deposits — total	28,839	+ 331	− 1,602	− 5.30
Time deposits — total#	58,341	− 647	+ 7,084	+ 13.80
Individuals, part. & corp.	49,617	− 548	+ 7,999	+ 19.20
(Large negotiable CD's)	21,668	− 173	+ 1,507	+ 7.50

Weekly Averages of Daily Figures	Week ended 1/2/80	Week ended 12/26/79	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	− 11	29	47
Borrowings	177	64	220
Net free reserves (+)/Net borrowed(−)	− 188	− 35	− 173
Federal Funds — Seven Large Banks			
Net interbank transactions [Purchases (+)/Sales (−)]	+ 619	+1,784	+ 694
Net, U.S. Securities dealer transactions [Loans (+)/Borrowings (−)]	−1,201	− 21	+ 369

* Excludes trading account securities.
# Includes items not shown separately.
@ **Historical data are not strictly comparable due to changes in the reporting panel; however, adjustments have been applied to 1978 data to remove as much as possible the effects of the changes in coverage. In addition, for some items, historical data are not available due to definitional changes.**

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