Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

Tumultuous Year

Banking and financial activity followed a roller-coaster pattern in 1980. Rapid changes in economic activity, in credit demands, and in inflation expectations all contributed to equally rapid shifts in interest rates during that tumultuous year. Interest rates also reached historical peaks—not once but twice—under the spur of inflation and a policy response designed to curb inflation by limiting money-supply growth.

The growth in financial assets consequently slowed considerably from the earlier pace, although funds generally remained available during most of the year. The bond market, despite a highly erratic growth pattern, financed a record amount of new corporate issues. Banks meanwhile coped well with 1980's volatile environment, posting relatively strong earnings in spite of slower loan growth and higher costs of funds.

The Federal Reserve encountered difficulties in its struggle against severe inflation, reflecting the Fed's problem of being "the only game in town" in the absence of parallel tightening actions from government fiscal policy. Following a change in operating techniques adopted in October 1979, the Fed tried to limit money growth during 1980 by controlling the quantity of bank reserves rather than by tightly pegging the cost of bank reserves (the Federal-funds rate). But market participants had trouble adjusting to this new operating environment, which implied a broader range of interest-rate fluctuations according to changes in business and credit conditions. Indeed, interest rates followed a roller-coaster course, rising to historic highs during the speculative boom of early 1980, falling sharply in the spring period, and then rising to new peak levels in the late fall months.

Volatile credit markets

Total funds raised in 1980's financial markets fell below the previous year's total, according to preliminary estimates, because of the record cost of credit and a recession-induced decline in overall credit demand. Nonetheless, the government sector's share of the total increased substantially during the year. The Federal debt grew at least twice as fast as in 1979, as inflation and recession pressures boosted Federal spending while recession dampened tax revenues, forcing the Treasury to step up the pace of its fund-raising efforts. State and local governments were also more active in debt markets, especially through increased sales of tax-exempt mortgage revenue bonds. Federally-sponsored agency debt, by contrast, grew at a somewhat slower pace than in 1979.

In the private sector, corporate businesses raised roughly the same amount of funds as in 1979, primarily in the long-term end of the market. In fact, corporate long-term debt grew by a record amount in 1980—more than half again as much as in 1979—despite widespread fears about the "disappearance" of the bond market. New cash offerings of corporate equities also grew rapidly during the year. In contrast, the mortgage and consumer-debt markets showed considerable weakness, reflecting the sharp decline in consumer housing and auto demand, as well as the impact of the credit-restraint program and the drying up of savings inflows at mortgage-lending institutions.

Financial growth patterns reflected not only the wide swings in business activity, but also the wide swings in interest rates that led to new record highs at the spring and fall peaks. The yield curve traced by instruments of gradually increasing maturity remained inverted for much of the year—a typical inflation phenomenon—as short-term rates rose above long-term rates during the spring and again during the fall months.

The prime business-loan rate rose from 15¼ percent in January to 20 percent in March, fell

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to 11 percent in August, and then rose again to 21½ percent in December. Similarly, corporate Aaa-rated bond rates rose from 11½ percent in January to 14 percent in March, fell to 11 percent in June, and rose again to over 14 percent in December. Corporate-borrowing patterns shifted strongly in response to these sharp rate fluctuations. Businesses relied heavily on short-term borrowings during the several episodes of sharply rising rates, but they issued massive amounts of long-term debt when rates fell in the spring months, in an effort to "lock in" their cost of funds and reduce their reliance on short-term financing. Mortgage borrowing followed a similar stop-and-go pattern, as rates rose to a record 18 percent in the spring, dropped to 12 percent in the late summer, and then approached the earlier peak around year-end.

Sluggish bank credit
Bank credit increased only 9 percent in 1980—far below the growth of the 1978-79 period—and much of that growth was concentrated in new securities investment rather than new loans. The loan slowdown largely reflected a massive runoff of consumer loans—down more than 5 percent for the year—as consumers avoided taking on new debt even after the midyear termination of the credit-restraint program.

Business loans, in contrast, grew at a relatively healthy 11-percent pace over the year, despite a decline in this category during the spring recession period. Business loans expanded rapidly in the fall, as many banks offered financing to firms that couldn't find funds in the corporate-bond market—and additionally, offered sub-prime loan rates to many firms in an attempt to compete with the commercial-paper market. Banks' real-estate loans increased nearly 8 percent during the year—and in fact increased most rapidly in those several crunch periods when many savings-and-loan associations ran out of funds.

Funds for financing this bank-credit expansion were costly to come by, because of the continuing shift of funds from "core" deposits (demand and passbook-savings deposits) to more expensive sources acquired at market-determined interest rates. The most rapid growth occurred in small-denomination time deposits, which included the popular 6-month and 30-month money-market certificates. Banks also relied heavily on large-denomination ($100,000 and over) time deposits, especially in those several tight-money periods when they actively sought lendable funds.

Stable bank earnings
Bank earnings in 1980 exceeded the 1979 peak, according to preliminary evidence, despite the impact of record interest rates on both sides of banks' balance sheets. Wholesale (commercially oriented) banks experienced a large increase in operating income because, with their substantial floating-rate loan base, prime-rate increases raised the return on a sizable portion of all their assets. But by the same token, they experienced dramatic increases in the cost of funds, because of their heavy reliance on short-term, interest-sensitive liabilities.

Retail (consumer oriented) banks experienced almost the reverse situation. Because of the concentration of their assets in fixed-rate mortgage and consumer loans, they failed to receive higher returns on the bulk of their portfolios when rates increased. But because of the concentration of their deposits in fixed-rate "core" deposits, they generally experienced smaller increases in interest costs—except for those cases where funds shifted out of such deposits into certificates bearing market-determined interest rates.

On balance, increases in banks' operating income generally outpaced increases in their cost of funds. Still, results varied widely for individual banks because of their different responses to 1980's unsettled credit-market conditions. The net interest spread—the difference between the rate of return on assets and the rate needed to cover the cost of funds—narrowed severely for many banks during the early-year crunch, and again dur-

ing the similar period in late fall. Nonetheless, the banking industry generally dealt very well with 1980's highly volatile credit markets.

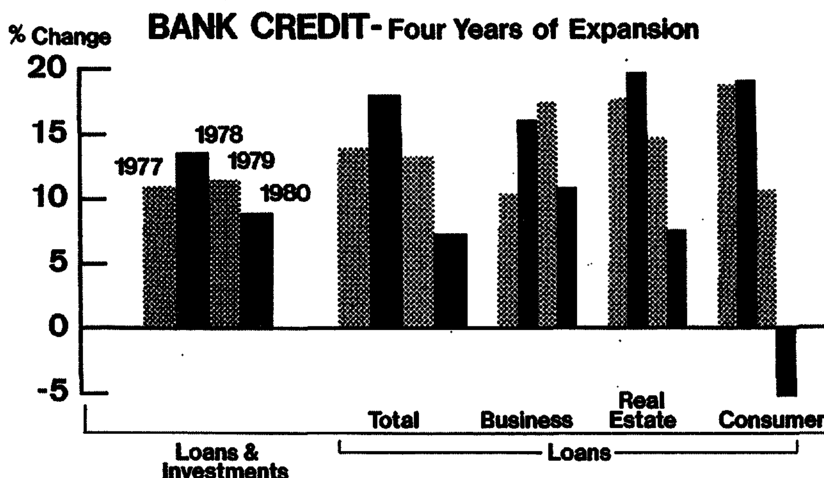
Continued uncertainty

The volatility in credit demands and interest rates that characterized 1980 should be less evident in 1981, because of greater expected stability of business activity and greater familiarity of market participants with Federal Reserve operating procedures. In contrast to last year, the economy will not be subject to the fluctuations associated with the imposition and later termination of a direct credit-restraint program. Still, interest rates may remain high by historical standards, reflecting the continued problem of inflation as well as a tight Federal Reserve policy designed to reduce money growth over time.

Nonetheless, overall credit demand may remain relatively strong, despite high interest rates and a sluggish economic recovery. The Federal government should again be a heavy borrower because of another substantial budget deficit in fiscal 1981—currently estimated at $55 billion. Business borrowing may also remain strong, because in a sluggish economy, most firms won't be able to generate enough funds internally to finance capital investment and inventories. Banks undoubtedly will supply a substantial portion of the needed funds, at least until corporations find more attractive terms in the bond market. On the other hand, high interest rates and weakened income prospects may depress the demand for consumer and mortgage credit, producing little growth in those loan categories during the year.

In this environment, banks should benefit from the acquisition of high-yielding earning assets, but will also have to continue paying high rates for lendable funds. In fact, even core deposits may become more expensive in 1981, as bank customers shift funds out of zero-interest checking accounts to interest-bearing NOW accounts. But overall, banks are relatively optimistic about 1981, because of the experience they gained in dealing with 1980's difficult environment.

Barbara Bennett



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/14/81	Change from 1/7/81	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	147,013	– 453	9,409	6.8
Loans (gross, adjusted) — total#	124,519	– 455	9,603	8.4
Commercial and industrial	37,425	– 294	3,884	11.6
Real estate	50,531	115	6,631	15.1
Loans to individuals	23,883	2	– 431	– 1.8
Securities loans	1,289	– 75	104	8.8
U.S. Treasury securities*	6,762	– 15	– 387	– 5.4
Other securities*	15,732	17	193	1.2
Demand deposits — total#	44,148	–2,437	– 2,059	– 4.5
Demand deposits — adjusted	31,893	– 697	– 1,703	– 5.1
Savings deposits — total	29,238	280	674	2.4
Time deposits — total#	74,194	140	15,217	25.8
Individuals, part. & corp.	64,541	151	14,449	28.8
(Large negotiable CD's)	28,737	– 106	7,259	33.8

Weekly Averages of Daily Figures	Week ended 1/14/81	Week ended 1/7/81	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	n.a.	n.a.	68
Borrowings	10	180	208
Net free reserves (+)/Net borrowed(–)	n.a.	n.a.	– 139

* Excludes trading account securities.
# Includes items not shown separately.

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