Research Department
Federal Reserve
Bank of
San Francisco

January 15, 1982

FRBSF Weekly Letter

Financial Year

The nation's financial institutions experienced another tumultuous year in 1981, under the impact of financial innovation, recession and still-severe inflation. But at least some progress was evident on the latter front, reflecting the Federal Reserve's two-year-old shift to a tighter policy stance.

The narrow measure of the money supply—currency plus transaction (checking-type) accounts—decelerated sharply in 1981 following modest declines in each of the preceding two years. (This monetary aggregate, known as M1-B in 1981, henceforth will be known simply as M1.) By this measure, the money supply increased about five percent during 1981, roughly in the middle of the Federal Reserve's target growth range of 3½ to 6 percent. (For an analysis of money-growth measures, see the *Weekly Letter* of January 1, 1982.) The broader M2 money-supply measure—primarily currency plus all depository institutions' deposits (except large time certificates) and money-market shares —increased almost 10 percent for the year.

The Federal Reserve's increased success in slowing money-supply growth reflected its greater experience with new operating procedures adopted in October 1979. At that time, the Fed announced that it would no longer peg the cost of bank reserves (the Federal-funds rate) and would instead target the level of reserves in the banking system. Consistent with this policy, the Fed took action on several occasions during 1981 to steer money growth towards the targets announced in February. During the spring months, as money growth began to surge, the Fed sharply restricted the supply of available reserves and meanwhile raised both the discount rate (to 14 percent) and the surcharge on frequent borrowings by large banks (to four percent). Faced with the opposite problem of slow growth in the late summer and fall months, the Fed increased the supply of reserves—and in addition, lowered the discount rate in two steps (to 12 percent), and reduced and finally eliminated the surcharge on frequent borrowings.

Shifting Credit Markets

With borrowing demands relatively heavy in the face of a tightening monetary policy, interest rates remained in the stratosphere throughout most of the year; however, rates did move downward in the late-1981 recession environment. The yield curve traced by instruments of gradually increasing maturity remained inverted for much of the year, with short-term rates remaining above long-term rates. The prime business-loan rate started the year at 21½ percent, and after retreating, climbed again to a 20½-percent secondary peak in the late summer months, before dropping to 16 percent in December. In contrast, corporate AAA bond rates declined during the fall months, but at December's 14-percent average level, were somewhat higher than at the beginning of the year. Real (inflation-adjusted) interest rates soared to record heights in this atmosphere, because of investors' fears of resurgent inflation and Federal government "crowding-out" of other borrowers.

To finance its massive revenue shortfall, the Treasury stepped up the pace of its fund-raising efforts. Federally-sponsored agencies likewise increased their borrowing activities compared with 1980. The Federal Home Loan Bank System, in particular, actively sought funds to support its lending program to a savings-and-loan industry that was battered by poor earnings and outflows of funds throughout the year. Total federally-related financing demands thus jumped from $83 to an estimated $97 billion during 1981. State and local governments, by contrast, became moderately less active in credit markets. Many municipal borrowers could not issue new debt because prevailing high interest

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rates frequently exceeded statutory interest-rate ceilings on their borrowings. Also, local governments sharply curtailed their sales of mortgage-revenue bonds because of new legal restrictions on the sale of such instruments.

Corporate businesses resorted to the credit markets more frequently in 1981 than in 1980, concentrating most of their increased borrowing in the shorter end of the market despite the persistently inverted shape of the yield curve. Firms relied heavily on commercial-bank loans and commercial-paper issues for the short-term working capital that, because of poor earnings growth, could not be generated internally at an adequate pace. Businesses generally postponed long-term bond offerings and stock sales during the year, hoping that overall credit demands would ease and bring down the level of interest rates. The new-issues pace rose significantly, however, during the several periods of declining rates in the late spring and late fall months.

Households stepped up their overall borrowing pace, at least in contrast to 1980, when the spring period's credit-control program caused a sharp reduction in consumer-credit balances. Indeed, short-term consumer debt grew an estimated 10 times faster in 1981 than in 1980. In contrast, home-mortgage debt grew at a somewhat slower pace, as households reduced their purchases of new homes in response to mortgage rates which exceeded 17 percent at the summer peak.

Gain in Bank Credit

Commercial-bank credit increased by eight percent—about the same as in 1980's sluggish atmosphere—although loan portfolios increased at a somewhat more rapid pace than securities-investment portfolios. Business loans, in particular, grew at a fairly healthy (11 percent) pace during the year. But in view of the intense competition from the commercial-paper market and from foreign banks, banks apparently paid dearly in many cases for the business-loan expansion—either by cutting profit margins or by taking on somewhat riskier loans. Banks also increased their real-estate loans almost eight percent over the year, somewhat paradoxically in view of the sharp decline in home-building activity. But much of the real-estate lending was concentrated either in commercial real estate loans or in home-equity loans, which households found to be a more attractive financing source for durable-goods purchases than installment credit. Much of the real-estate lending activity thus could be classified as consumer credit, which would explain the very small one-percent increase in consumer borrowing activity during the year.

Banks faced intense competition for funds to finance 1981's credit expansion, in view of the attractiveness to depositors of money-market mutual funds and thrift-institution NOW accounts. And banks found deposit growth very costly, since most of the growth occurred in deposit categories that paid market-related rates of interest—money-market certificates, small-saver certificates, and large-denomination (over $100,000) certificates of deposit. Over the year, higher-yielding deposit categories rose from 45 percent to more than 55 percent of small time and savings deposits, reflecting shifts of funds into these categories from core deposits (passbook savings and checking accounts). Furthermore, even transaction deposits became more expensive for banks as depositors shifted their funds from the traditional zero-interest checking accounts to NOW accounts paying 5¼-percent interest.

Lackluster Bank Earnings

The banking industry generally turned in a lackluster profits performance for the year, according to preliminary indications, with earnings just about matching the preceding year's level. The continued shift of core deposits to higher-cost categories substantially raised banks' average costs of funds. At the same time, stiff price competition on the lending side made it difficult for banks to recoup these cost increases, and thereby

caused a weakening of net interest margins and profits. Earnings performance varied considerably, however, depending on the sensitivity of each bank's portfolio to increases in the cost of funds and changes in interest rates. Wholesale (commercially-oriented) banks generally avoided deterioration of interest margins by keeping the maturities of both assets and liabilities short. In contrast, many retail (consumer-oriented) banks suffered because of a mismatching of maturities, with the rise in their cost of funds generally outpacing increases in their return on assets. With a heavy concentration of longer-term fixed-rate mortgage and consumer loans, retail banks failed to receive higher returns even as interest rates remained high throughout most of the year. Their profits became further squeezed as their core deposits shifted to expensive money-market and small-saver certificates, thus boosting costs in line with market interest rates.

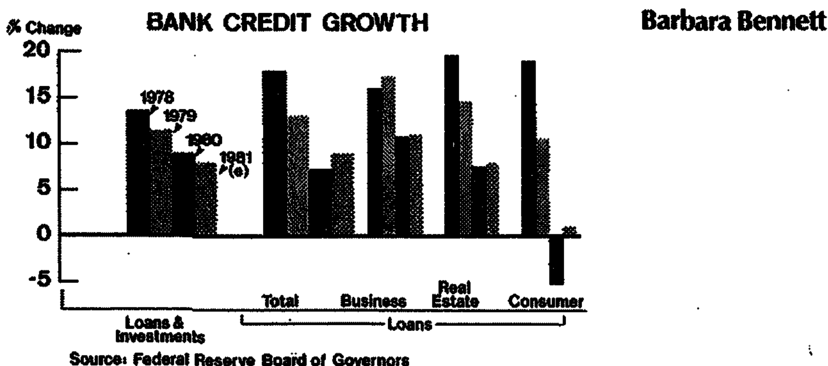
In general, high interest rates remained a problem for the banking industry as well as for its customers during 1981. Banks tried to cope with this environment by curtailing their long-term fixed-rate lending and by limiting their exposure to changes in interest rates. They made substantial progress in this regard, although the continuing shift of deposit funds to high-cost categories took its toll over the year. Nevertheless, the late-fall easing of interest rates brightened year-end earnings prospects for many banks and other depository institutions.

Uncertain '82

The outlook for banks and other financial institutions is uncertain in the recession atmosphere of early 1982. Nonetheless, credit demands should remain strong, especially in view of the Federal government's stepped-up efforts to finance a swelling budget deficit. A sustained easing of interest rates may not be in the cards, therefore—at least until deficit-financing pressures weaken and inflation expectations become less intense.

Commercial banks should be in a position to participate in the anticipated credit expansion. On the lending side, however, banks are likely to face stiff competition from the bond and commercial-paper markets and from foreign banks as well. The business-lending pace, in particular, should strengthen as corporations seek to replenish depleted working capital. Household borrowing also should improve as consumer psychology brightens in the midyear tax-cut atmosphere, and mortgage borrowing should begin to rise out of the depths as real-estate lending rates subside. The cost of financing this loan expansion will remain high, however, as low-cost core deposits continue to shift to higher-cost money-market and small-saver certificates. Banks will also face stiff competition for customers' funds from money-market funds and other (less regulated) nondepository institutions. In this atmosphere, the most successful banks will be those that closely manage their exposure to interest-rate changes and keep close control over their noninterest expenses.

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 12/30/81	Change from 12/23/81	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	156,048	– 180	7,959	5.4
Loans (gross, adjusted) — total#	134,915	– 191	9,547	7.6
Commercial and industrial	41,354	81	3,591	9.5
Real estate	55,734	85	5,233	10.4
Loans to individuals	23,791	161	– 151	– 0.6
Securities loans	2,027	– 231	593	41.4
U.S. Treasury securities*	5,830	– 44	– 1,103	– 15.9
Other securities*	15,303	55	– 481	– 3.0
Demand deposits — total#	43,785	1,328	– 5,515	– 11.2
Demand deposits — adjusted	29,507	700	– 3,918	– 11.7
Savings deposits — total	30,098	152	1,823	6.4
Time deposits — total#	89,782	276	15,003	20.1
Individuals, part. & corp.	80,678	199	15,756	24.3
(Large negotiable CD's)	36,411	317	6,466	21.6

Weekly Averages of Daily Figures	Week ended 12/30/81	Week ended 12/23/81	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	7,569	85	117
Borrowings	14	1	111
Net free reserves (+)/Net borrowed(–)	7,554	84	6

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

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