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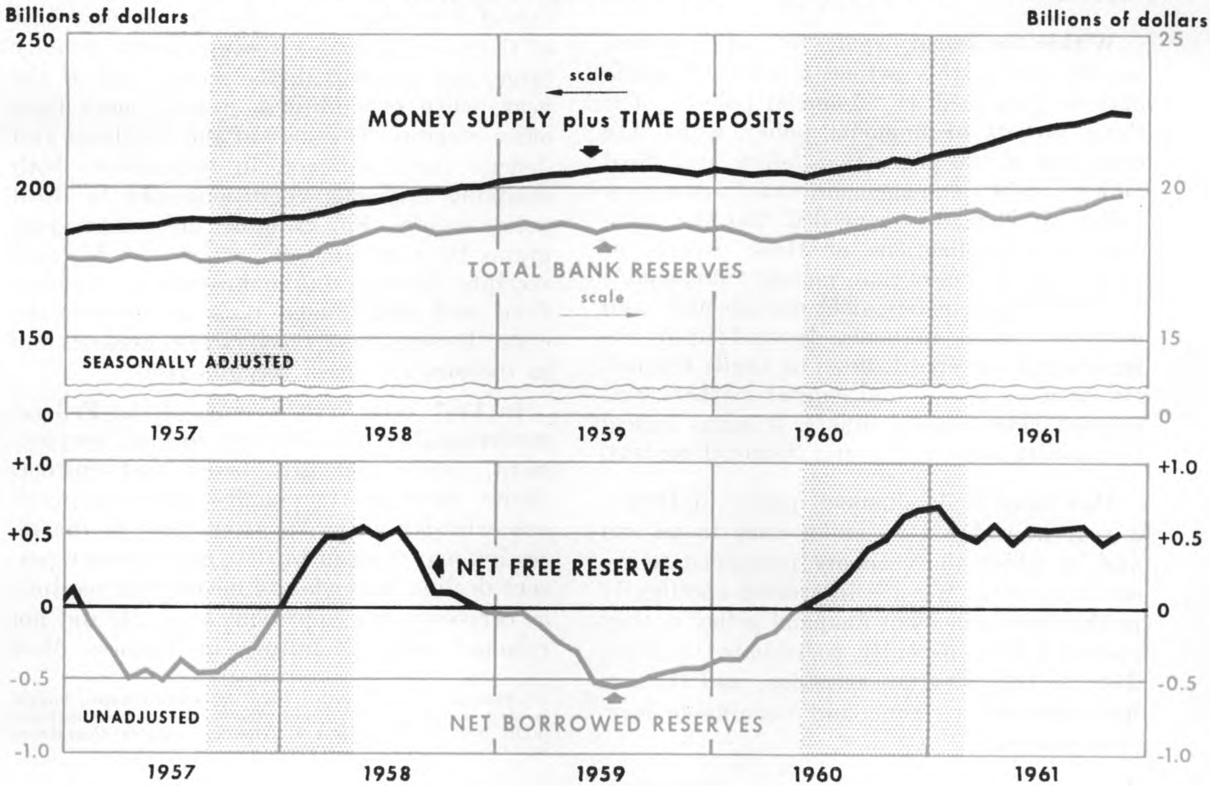
IN THIS ISSUE

MEASURING EFFECTS OF MONETARY POLICY



NOTE: Data are monthly averages of daily figures, except Money Supply plus Time Deposits, which are month-end figures.

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Focus On Financial Policy In 1961

THE U. S. ECONOMY, or any private-enterprise economy for that matter, would have difficulty in functioning effectively without at least a minimum contribution from the public sector of the economy. In this connection, our public sector is committed, through the Employment Act of 1946, to pursue policies which are consistent with promoting economic growth, maximum employment, and price stability. Thus, it is widely regarded that public policy in general should move against the tide of cyclical fluctuations in business activity, in order to help stimulate the economy during periods of recession and to help prevent excesses during periods of expansion.

Within the broad expanse of public policy, we discuss in this article a segment which may be identified as "financial policy". The three aspects of financial policy which are discussed in the pages that follow are: fiscal policy, debt management, and monetary policy. It is readily conceded that the influence and implications of these aspects of policy may be more than merely "financial". Yet, since fiscal policy, debt management, and monetary policy influence demand-supply relationships for credit, flows of funds through the nation's money and capital markets, and interest rates, among others, it seems logical to consider such policy in a financial context.

Our focus is on financial policy in 1961—a year in which a recession came to an end and in which the economy proceeded to recover smartly. We are interested specifically in the three aspects of financial policy as they operated in apparently coordinated fashion, first, to help end the recession, and then to help promote a strong and sustainable business recovery.

Fiscal Policy in 1961

Fiscal policy refers to the way in which the Federal government, through decisions affecting tax programs and appropriations for expenditures, shapes its income and spending to influence the nation's business activity. For example, when used to help counteract a recession, fiscal policy usually attempts to supply more funds to the economy through Government spending than are absorbed in the form of tax receipts. One measure of fiscal policy is the Federal cash budget—a record of government receipts and payments.(1)

In any calendar year, the cash budget is expected to show a surplus in the first half of the year, when tax receipts are seasonally large, and a deficit in the second half of the year, when expenditures usually more than offset receipts. The sizes of the surpluses and deficits vary, however, in response to both changing economic conditions and to fiscal policy actions. For example, present tax programs tie a substantial portion of total cash receipts directly to the incomes of business firms and individuals; thus, as incomes decline, Federal cash receipts also decline, and as incomes rise, cash receipts rise.

In 1961, total cash receipts of the Federal government, which include income, employment, estate and gift taxes, and customs duties, declined fractionally from the previous calendar year. An after-effect of the recession may be seen in the year-to-year 6-percent decline in corporate income tax receipts, as corporate tax collections typically did not rebound with the upturn in business. Most

(1) The cash budget, rather than the administrative budget, is used in this article, because the former is more inclusive in its content. Statistics are from the Treasury Department and the Bureau of the Budget.

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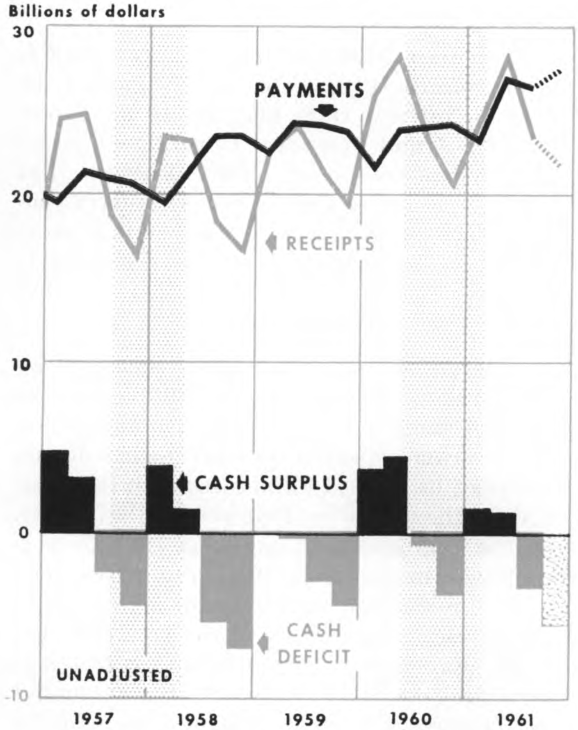
FEDERAL CASH RECEIPTS AND PAYMENTS



other tax receipts did not decline on a year-to-year basis, however, because of the relative stability of income and spending during the recession and recovery.

Total cash receipts exceeded cash spending in the first half of 1961, so that the cash budget showed a surplus of $2.6 billion. (See the accompanying chart, which illustrates the Federal cash budget on a quarterly basis. The shaded panels represent periods of recession.) It is important to note, however, that the seasonal surplus was smaller than is usually realized.(2) It was less than one-third as large as in the first half of 1960, and was also smaller than that of the first half of 1958, another period of recession and recovery. Thus, the surplus in the first half of 1961 had less of a contractive effect on the economy than it usually does, or than it did in the similar period of 1958.

In the second half of 1961, the cash budget was in deficit status by more than $9 billion. In this case, the deficit was larger than in the same period of 1960, and, in fact, was larger than is usually realized. The deficit thus had more of an expansionary effect on the economy than is usual during the second half of a year.

The direct actions of fiscal policy in 1961 were most evident in government expenditures. Cash spending rose sharply, with the total for the year about 10 percent more than in the previous year. Although part of the increased spending was the result of the international situation, which necessitated greater expenditures for defense and foreign aid, cash payments also rose in connection with domestic programs to help counteract the recession and to help bolster the recovery. Such programs included a speed-up in highway construction payments, and an increase in the amount of social security payments, unemployment benefits, agricultural subsidies, and spending for public health and urban renewal.

For the year on balance, fiscal policy actions supplied about $6.4 billion more to the economy than were taken out in cash receipts. Over and above the contribution to the economy by government spending in general, the excess of payments over receipts helped stimulate over-all economic activity. Fiscal policy was thus on balance an important factor in the business recovery of 1961.

Management of the Federal Debt in 1961

Debt management consists of the actions taken to influence the ownership, interest cost, and maturity structure of the Federal debt. One objective of debt management is the achievement of a balanced maturity structure. An appropriate balance between short- and longer-term issues is desirable for two reasons: (1) it ensures a safe outlet for in-

(2) On a seasonally adjusted basis, for example, the cash budget showed a deficit of $4.0 billion in the first half of the year.

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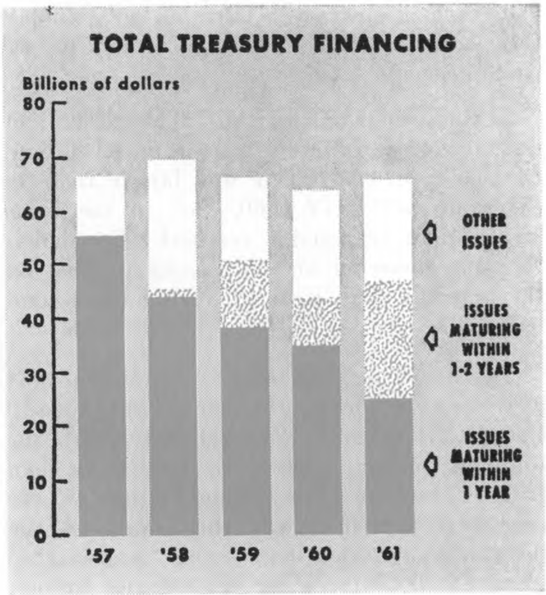

vestors with available long-term funds, and (2) it helps to counteract the constant shortening of the average maturity of the Federal debt which occurs with the passage of time. In addition, a concentration of debt maturing within one or two years would mean that the Treasury must undertake a larger number of financing operations, which would involve to some extent additional interference with money and capital markets. Moreover, more frequent financing also might have to be accomplished without regard to prevailing interest rates.

It is widely recognized, however, that during a recession and early in a period of recovery it may be in the best interests of the economy for the Treasury to finance maturing debt and new cash needs of the Government mainly through short-term issues. This is done "in order not to pre-empt an undue amount of the new savings needed to support an expansion of the economy",[3] i.e., the long-term funds that otherwise might be channelled into private economic activity. Short-term financing by the debt managers also helps to bolster the liquidity of the economy in periods of recession; this is important in the sense that additional liquidity may act to stimulate spending.

Short-term financing during a recession is often considered desirable even though a decline in interest rates may create an opportunity to fund long-term Government issues at lower interest costs. Many observers feel that interest costs should be a secondary consideration in debt management — that costs should be weighed in terms of the possible economic effects of the absorption of long-term funds, for example.

A large portion of the gross financing by the Treasury Department in 1961 was in the form of short-term issues. Nearly $66 billion in Government securities were issued during the year, or only $1 billion less than the average for the preceding four years (1957-1960). Of the total amount financed in 1961, 37 percent was in securities maturing within one year—the smallest proportion of highly-liquid issues released in recent years.[4] In contrast, if all new issues maturing *within a two-year period* are combined, such securities accounted for 71 percent of total Treasury financing in 1961, as compared with 68 percent in 1960 and with 65 percent in 1958.

Thus, the contribution of debt management toward aiding the business recovery in 1961 was to increase the amount of short-term Government securities in the economy. This increase in near-money assets added to the general liquidity of the private sectors (particularly among commercial banks) without absorbing long-term investment funds, which could be channelled into private economic activity.

Insofar as meeting other goals of debt management, in 1961 the average maturity of the Federal debt was held steady, and the propor-

(3) From "Debt Management and Advance Refunding", U. S. Treasury Department, September 1960, p. 2.

(4) The decline in the proportion of issues maturing within one year was due in part to the decreasing use of Treasury certificates of indebtedness as instruments of Federal borrowing. Currently, debt managers seem to prefer to borrow through short-term Treasury notes, which carry maturities of one to five years, in contrast to the maximum one-year length of Treasury certificates. Data on the Federal debt are from the Treasury Department.

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tion of gross financing involving maturities of ten years or more was within one-half of one percent of the proportion financed in both 1960 and 1958. Interest costs on the total Federal debt in 1961 were below 1960 costs because of the lower level of interest rates during the past year. Finally, an important side-effect of the relatively large amount of short-term Treasury financing was that the increase in the supply of such securities helped offset downward pressure on short-term interest rates in general.[5]

Monetary Policy in 1961

The third aspect of financial policy—monetary policy—involves the actions taken by the Federal Reserve System to influence the flow of credit and money which is necessary to foster growth and price stability in the economy. Although Federal Reserve actions are directed through the commercial banking system, such actions are felt ultimately in the financial activity of the entire economy.

The Federal Reserve System affects the volume of reserves held by the commercial banking system. The amount of reserves the banks hold will determine, in turn, their ability to satisfy demands for money and credit. Thus, by affecting the volume and composition of bank reserves through a number of different actions—open market operations, discount policy, and changes in reserve requirements—the Federal Reserve System is able to influence the availability and cost of bank credit. Credit which is extended by the banks in the form of loans and investments is singularly important because it serves as the support for the deposits which are the nation's money supply. The Federal Reserve System is always interested in having an adequate supply of money in the economy. Thus, if an increase in the money supply is deemed desirable, the System will move to supply additional reserves to the banking system. Let us consider the record of the past year or so to see what the Federal Reserve has done in such a situation.

Following the peak of the most recent business cycle (May 1960), various market factors would have reduced bank reserves substantially unless offsetting actions were taken.[6] Chief among such factors was the large outflow of gold that occurred late in 1960. Intensifying this absorption of reserves were a seasonal increase in the amount of currency in circulation and a decrease in the volume of float. The Federal Reserve System uses open market operations in U. S. Government securities to offset the impact of market factors. (By purchasing securities, the System supplies additional reserves to member banks.) It is evident from the accompanying chart that the System purchased large amounts of Government securities to help offset the market factors in the latter part of 1960.

Taking the period on the chart from the peak of the most recent business cycle through the end of 1961, market factors, taken together, absorbed $3.3 billion of bank reserves, with most of the change taking place in the last half of 1960 and 1961. The cumulative change in Federal Reserve holdings of Government securities during the same period (June 1960 to the end of 1961) was not as large, amounting to $3.1 billion. The difference was more than balanced, however, by the result of a series of changes in reserve requirements that were made in the second half of 1960, and which are not shown on the chart. By putting central reserve city banks in the lower-requirement class of reserve city banks in late 1960 and by allowing banks to count *all* of their vault cash as part of their legal reserves, the Federal Reserve System released nearly $2 billion net in usable reserves. As a result, between June 1960 and the end of 1961, the combination of open market operations and changes in reserve requirements more than offset the total effect of

(5) It might be noted that an important factor influencing the relatively large-scale short-term financing in 1961 was the absence of inflationary pressures.

(6) The major market factors which absorb bank reserves are an increase in currency in circulation, a flow of gold out of the country, a decrease in float, an increase in Treasury cash holdings and in Treasury deposits at the Federal Reserve banks, and a decline in Treasury currency outstanding.

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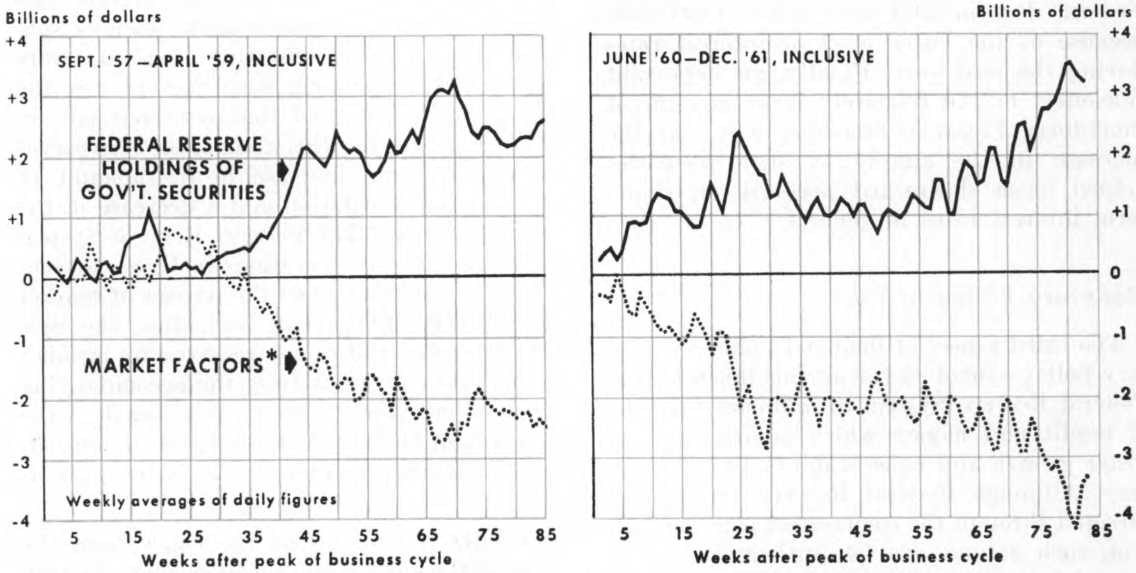
OPEN MARKET OPERATIONS vs. MARKET FACTORS

Cumulative changes following peak of business cycle through recovery period



* Include changes in gold stock and foreign accounts, Treasury operations, float, currency in circulation, and other deposits and accounts at the Federal Reserve banks.

NOTE: (+) or (—) indicates effect on free reserves.

all market factors, indicating that on balance the Federal Reserve supplied reserves to the banking system.

The effects of Federal Reserve actions during the period between June 1960 and the end of 1961 are shown on the chart on the cover of this issue. The chart shows, first, that the Federal Reserve System acted to increase total bank reserves early in the recent recession (shaded area in 1960-61) so that a net amount of about $800 million, on a seasonally adjusted basis, was added from peak to trough. This increase was 25 percent more than in the previous recession (shaded area in 1957-58). Moreover, total bank reserves continued to rise in the recovery months of 1961, in response to Federal Reserve actions. From February through November, total reserves increased by about $700 million—an amount in excess of the rise during the two previous recovery periods.

One purpose for increasing bank reserves is to increase the money supply (demand deposits and currency in circulation) and thus to facilitate economic expansion. In the recent recession, however, the rise in total reserves did not result initially in a large net increase in the amount of demand deposits and currency. Such a development is not unusual in recessions; in 1957-58, for example, the growth in the money supply was even less. The change in the money supply in 1960-61 was relatively small, even though net free reserves — the difference between excess reserves and borrowings of member banks — hovered within the $400-600 million range between September 1960 and February 1961.

While the money supply showed only a small net change in the past recession, the

(7) There are a number of explanations for the increase in time deposits during periods of recession: (1) money is not used as frequently during recessions and may be held in less-volatile time deposits; (2) the interest paid on time deposits attracts idle and otherwise nonearning funds; and (3) time deposits are becoming increasingly liquid, due partly to the recent introduction of negotiable time certificates of deposit.

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money supply plus time deposits, as shown in the cover chart, rose about 50 percent more than in the two previous recessions.[7] The rise in the money supply, thus defined, continued through the recovery period (including an increase in demand deposits and currency), exceeding the gain in the previous recovery period by 45 percent.

In short, a contribution of monetary policy in 1961 was to add substantially to available bank reserves; this in turn engendered an increase in bank credit and an increase in the money supply plus time deposits. Over and above the fact that the actions of monetary policy were taken earlier in the most recent recession than in 1957-58, the Federal Reserve System has continued to maintain free reserves at a relatively high level throughout the recovery.

* * *

It seems clear from the foregoing that in 1961 all three aspects of financial policy — fiscal policy, debt management, and monetary policy—were important influences in helping to combat the recession and to bolster the recovery. Moreover, the basic policies that contributed importantly to the economy in the recession have continued for a longer time after the trough of the cycle than was the case in previous recovery periods. This apparent coordination among financial policies was important because it is widely recognized that no one aspect of such policy by itself is capable of completely counteracting the business cycle.

The role of financial policy in 1961 was assisted by the use of a number of different methods and techniques. This was especially noticeable in debt management, for example, where a greater recognition of the effectiveness of Federal debt management as a counter-cyclical weapon was combined with marketing procedures such as advance refundings, cash refundings, and the sale of "strips" of Treasury bills. With reference to monetary policy, the Federal Reserve System broadened open market operations to include intermediate and long-term Government securities and allowed, in 1959 and 1960, vault cash to be counted as a part of bank reserves.

It should be pointed out, however, that financial policy in 1961 was influenced by factors outside the economy. Chief among the external factors was the deficit status of the nation's balance of payments. Partly because of relatively wide differentials in interest rates between the United States and countries in Europe and Asia, this nation experienced a large outflow of short-term capital and gold in the second half of 1960. To slow down the outflow, it became important for financial policy to help prevent short-term interest rates from declining to very low levels in the United States, while at the same time helping to produce a domestic environment conducive to economic expansion.

The need to harmonize between domestic and external objectives led monetary policy to attempt to maintain short-term interest rates in 1961 at higher levels than in previous recession and early-recovery periods. This was a reason for the conducting of open market operations, beginning early in 1961, in all maturities of U. S. Government securities. Moreover, the balance of payments situation apparently influenced debt management policy toward a greater reliance on short-term issues to finance the Federal debt in 1961. The larger supply of such issues in the money market tended to prevent short-term rates from declining to lower levels. The balance of payments situation was a factor to be considered in fiscal policy in the past year, not only because Government spending abroad is an important item in our international accounts, but also because foreign confidence in the dollar is apparently tied to a large extent to developments in the Federal budget.

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Banking Box Score In 1961

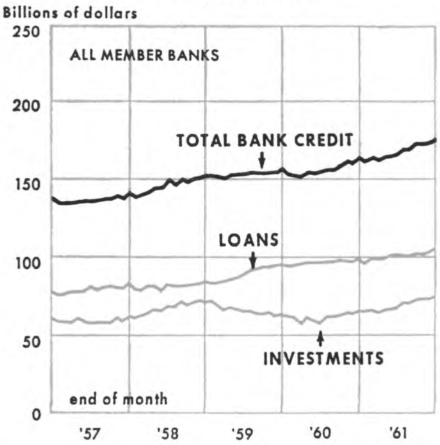
During the year ended last month, commercial banking developments were influenced importantly by the recovery in business activity, which spanned the last ten months of 1961, and a policy of relative ease maintained throughout the year by the Federal Reserve System. Thus, as the central bank provided additional reserves to the banking system to help support an increase in bank credit, the banks looked to the recovery to stimulate an expansion in their portfolios of higher-yielding assets.

A tally of bank credit developments in 1961 reveals that member banks of the Federal Reserve System expanded their portfolios of earning assets, i.e., loans and investments, by 9 percent. Such an expansion compared with that of 8 percent during 1958, which also was a year of business recovery, and 5 percent during 1960. The accretion in bank credit in 1961, however, was not distributed evenly between loans and investments; also, the expansion in earning assets was not balanced evenly throughout the year. Consequently, approximately 79 percent of the total rise in earning assets in 1961 was registered during the second half of the year, with 56 percent of the expansion over the entire year accounted for by enlarged holdings of investments. Both of these developments can be discerned from an examination of the chart below.

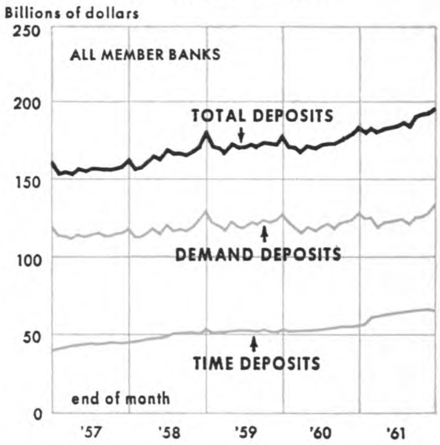
Moderate Loan Expansion

Demands for bank loans remained relatively subdued throughout most of 1961 despite the business recovery. This is reflected in the fact that additions to bank loan portfolios during the year amounted to 6 percent, which, although comparing favorably with the additions in 1958, fell short of the gains posted in both 1959 and 1960.

BANK CREDIT



BANK DEPOSITS



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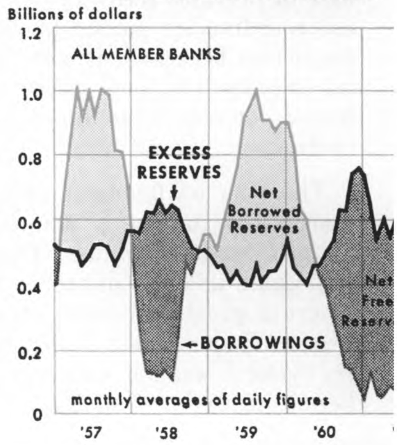

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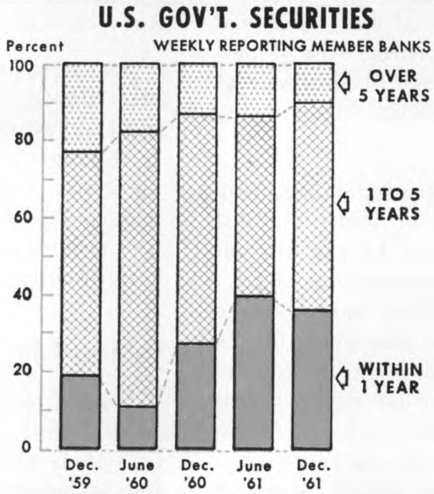

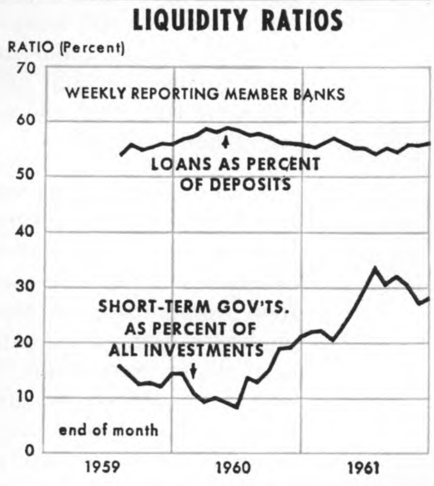

Business loans. The failure of bank lending to expand perhaps more vigorously in 1961 seems to be attributable largely to the sluggishness in demands for loans by commercial and industrial borrowers, especially in view of the fact that such loans constitute the largest single category of total bank loans. (See the accompanying chart.) Data available from member banks in the nation's leading cities which report weekly to the Federal Reserve banks indicate that loans to business borrowers advanced only 3 percent during 1961, following a 6 percent increase in 1960.[1]

An examination of business financial practices during 1961 reveals a number of factors which may help to explain the lack of spark in the demand for business loans. First, an absence of strong demand for working capital loans was due in part to an apparent preference of business firms for other sources of short-term funds, e.g., commercial paper and bankers' acceptances, which is explained to some extent by an ability to obtain such funds at somewhat lower costs. Second, long-term funds raised by business firms in the capital market, through the sale of additional securities, provided a substantial nonbank supply of funds in 1961. For the year as a whole, the sale of corporate securities amounted to approximately $13 billion, an amount only slightly below the all-time high reached in 1957. Such financing provided corporations with additional cash assets which allowed them to either take down their indebtedness to banks, or to postpone new short-term borrowing. Another factor which helps to explain the absence of strong demand for business loans at banks was the internal cash flow generated by depreciation allowances and retained profits, which satisfied in part the working capital needs of many potential business borrowers. Still another factor would be that business loan demand usually remains slack even after a recovery period is clearly underway. In 1958, for example, even though the upturn in business activity began in April, commercial and industrial loans of reporting banks did not register an appreciable increase until the fourth quarter of the year; and, despite the fourth quarter improvement, business loans at the close of that year were 2.5 percent below the year-earlier figure.

Nevertheless, during the final quarter of 1961 the amount of business loans outstanding at reporting banks began to reflect the seasonal rise in demands for working capital

(1) Commercial and industrial loans of weekly reporting member banks account for about three-fourths of those of all member banks.

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as well as the influence of the business recovery. Consequently, commercial and industrial loans at weekly reporting banks rose 3 percent during the final quarter of the year at the same time that the economy was showing significant strength.

Data available from weekly reporting member banks on other types of loans in 1961 indicate mixed developments in the various categories. (See the accompanying chart.) *Real estate loans* at reporting banks scored moderate gains during the past year, as the market for real estate financing in general was characterized by somewhat easier credit terms and a relatively larger supply of funds. In spite of these conditions, however, a 7 percent expansion in real estate loans at weekly reporting member banks in 1961 was less than the sharp advances registered in both 1958 and 1959, although it was in excess of that in 1960.

Other loans (mainly consumer loans) at reporting banks were up 9 percent for the year as a whole, which compared with an increase of 4 percent in 1958. During the first half of 1961, consumer loans outstanding at these banks moved up fairly well. In the third quarter, however, a downturn occurred in the volume outstanding as repayments on previously incurred indebtedness exceeded the amount of new loans. This situation was then reversed in the fourth quarter, as consumer borrowing again increased on balance, reflecting the upturn in retail sales and the purchases of consumer durables.

Loans to nonbank financial institutions by weekly reporting banks moved up during 1961. For the year as a whole such loans were up 3 percent. The relatively moderate gain in loans outstanding to nonbank financial institutions was due primarily to reduced demands for such credit by sales and consumer finance companies. The reduction in the utilization of bank credit by finance companies in 1961, in turn, reflected the lack of vigorous demand for consumer credit in general, as well as the use of commercial paper by finance companies to satisfy in part short-term capital requirements.

Security loans made by reporting banks, after fluctuating within a narrow range during the first quarter of 1961, moved up sharply during the remainder of the year, scoring an increase of 24 percent for the year as a whole. The increase was stimulated in part by the increased activity in all securities markets during the last half of the year.

Enlarged Investment Portfolios

With a moderate increase in loan portfolios during 1961, member banks attempted to sustain their earnings by acquiring larger holdings of securities. That this was accomplished to an appreciable extent is evidenced by the fact that member banks' investment portfolios were expanded 12 percent during the year. Approximately 65 percent of the additional securities acquired by member banks in 1961 were those of the U. S. Treasury, with the balance consisting primarily of obligations of state and local governments.[2] In addition to the expansion in investments, banks also responded to changing conditions in money and capital markets by making substantial adjustments in the maturity distribution of investment portfolios.

Investment liquidity. As indicated above, banks made substantial adjustments in 1961 in the maturity distribution of investment portfolios, with the emphasis quite clearly on shortening portfolios and the bolstering of bank liquidity. Information regarding the maturity distribution of Treasury securities is made available regularly by weekly report-

(2) U. S. Treasury issues held by member banks are comprised of bills and certificates of indebtedness, both of which have a duration of one year or less; notes, which bear a maturity ranging from one to five years; and bonds, which carry a maturity usually in excess of five years. Taken together, these four classes of Treasury obligations account for roughly 75 percent of the total security holdings of member banks. Investment portfolios also include state and municipal bonds and a small number of securities issued by federal agencies and private corporations. An increasing interest in state and municipal bonds by commercial bank managements is believed to be due to the tax-exempt status of the interest earned on most of these obligations and the serial maturity feature under which nearly all state and municipal bonds are issued. Serial maturity provisions permit portfolio managers to select obligations with maturity ranges which are most appropriate for the cash needs of their banks.

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ing member banks to the twelve Federal Reserve banks.

During the first nine months of last year, reporting banks increased substantially holdings of short-term Treasury issues, i.e., those securities which are due to mature within one year or less. Holdings of such securities advanced from approximately 27 percent of total Treasury holdings at the end of 1960, to 30 percent of the total by the first quarter of 1961, to 39 percent by midyear and to 42 percent by the end of the third quarter. Furthermore, at the end of the third quarter, of these short-term obligations nearly 45 percent were Treasury bills, which have the shortest original duration of all Treasury issues.

A number of factors may help to explain the rapid rise in the liquidity of reporting banks' investments during the initial three quarters of 1961. First, the increase in short-term holdings may have reflected anticipation by bank management of an upswing in loan demand, as a concomitant of the recovery in business activity, during the last half of 1961. Had a substantial increase in loan demand materialized, a portion of earning assets could have been shifted, if necessary, from investment portfolios to loan portfolios. By maintaining a larger proportion of investment portfolios in short-term, highly-liquid securities, a risk of encountering capital losses in such shifting might have been averted. Another factor prompting the bolstering of liquidity by banks may have been an interest in attempting to reacquire some of the liquidity expended in the accelerated loan expansion of 1959. In addition, there tended to be less inducement for banks to move toward longer-term securities in 1961, due to the relatively narrow differential in yields between long- and short-term obligations. Still another factor reflected the fact that, since in any business recovery there is some uncertainty concerning the future course of security prices, bank portfolio managers may have been interested generally in maintaining a considerable amount of liquidity in investment portfolios. Finally, the ability to move into short-term issues was facilitated by a relatively large amount of short-term securities made available in 1961 through Treasury financing operations.

By the end of the third quarter, as shown in the chart, the increased liquidity of weekly reporting member banks was quite evident in the level to which the ratio of short-term Treasury securities to total investments had risen. (Another measure of bank liquidity shown in the chart is that of the ratio of loans to deposits. In view of the slackness in loan demand in 1961, the decline in loan-deposit ratio, which signifies an improvement in bank liquidity, should not be surprising.)

Late-year developments. During the fourth quarter, in contrast to earlier developments, reporting banks began to reduce holdings of short-term issues. Subsequently, by the end of 1961 such securities accounted for 38 percent of total Treasury holdings, which was somewhat less than at the end of the third quarter.

Part of the relative decline in short-term holdings of reporting banks during the fourth quarter may have been due to the failure of loan demand to turn up as *sharply* as banks had anticipated originally. Furthermore, due to the moderate expansion in loan demand toward the end of the year, banks began to shift to higher - yielding, intermediate - term securities to bolster their earnings. (Holdings of intermediate-term issues rose 13 percent during the fourth quarter.) The issuance by the Treasury of intermediate-term securities during the fourth quarter may also have influenced the recasting of member banks' investment policy.

Deposit Growth Continues

The primary source of funds for commercial banks consists of the demand and time deposits held by such institutions. The primacy of such deposits in bank operations is revealed in the fact that demand and time deposits are equivalent to approximately 90 percent of total bank assets. It is apparent, therefore, that any significant expansion of

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bank credit depends heavily upon the continued growth of both demand and time deposits. Furthermore, the composition of bank assets—types of loans and types of investments — is influenced by the types of deposits, i.e., time or demand, as well as the identity of the holders of accounts, e.g., individual or business, which banks acquire. In the way of a very general illustration, an increase in demand deposits, after compliance with reserve requirements, might be placed mainly in short-term, highly-liquid earning assets, or in nonearning cash assets. On the other hand, an increase in time deposits might warrant an expansion of either intermediate-term loans or longer-term investments due to the stability usually associated with time deposits.

Demand deposits. During 1961, total deposits of all member banks increased 7 percent, as compared with an 11-percent expansion in 1958. Demand deposits, however, provided 43 percent of the addition to total deposits, whereas in 1958 demand deposits accounted for 52 percent of the total gain. The growth in demand deposits in 1961 was confined to the final six months of the year.

Time deposits. On the other hand, time deposits of all member banks increased approximately 19 percent in both 1961 and 1958. By the end of 1961, time deposits accounted for 33 percent of total deposits, as compared with the year-earlier figure of 30 percent. The increase in time deposits in 1961 consisted primarily of savings deposits; however, during the year many of the banks in large cities also attempted to attract, or, in some cases, regain, corporate funds by offering negotiable time certificates of deposit. Due in part to this innovation, the increase in time deposits at central reserve and reserve city banks was much larger than in previous years; in fact, it was the first year since 1958 that a gain in time deposits at these banks exceeded the increase at country banks.

In view of the expansion in total deposits, and the moderate increase in bank loans during 1961, as indicated earlier, the loan-to-deposit ratio of all member banks on balance declined during 1961, signifying some increase in liquidity. Actually, the ratio, after moving down during the first nine months, turned up slightly during the fourth quarter. In the way of a general comment, it is surprising to some observers that, in view of the significant growth in time deposits, banks indicated a relatively strong preference for additional liquidity in investment portfolios during most of 1961.

Reserve Position

In response to Federal Reserve policy the reserve position of member banks, by and large, remained easy. For example, on a month-to-month basis, using averages of daily figures, member banks were able to maintain excess reserves ranging between $500 million and $700 million throughout 1961. This situation, taken in conjunction with the relatively low levels of member bank borrowing from the Federal Reserve banks during the year, produced a net free reserve position — the difference between excess reserves and borrowings—which ranged between $400 million and $700 million throughout the year.

Continuation of a relatively high and stable level of net free reserves throughout 1961 was in marked contrast to 1958, when net free reserves fell below $100 million less than six months after the upturn in business activity in that year.

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