

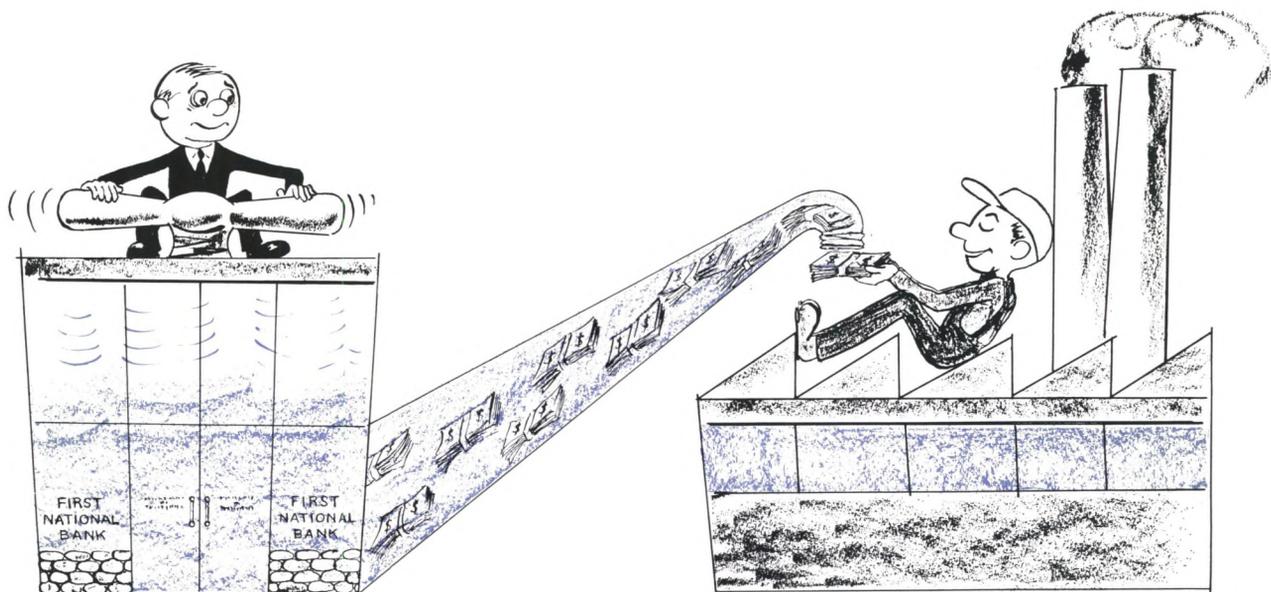
# MONTHLY REVIEW



**Banks become less liquid as the demand for money and credit outweighs the supply.**

**FEDERAL RESERVE BANK OF RICHMOND**

**AUGUST 1966**



# CHANGES IN BANK LIQUIDITY

The record breaking length and breadth of the current business expansion with its steadily growing competition for credit has stimulated an increasing amount of interest in the liquidity position of the banking system. Not since World War II has there been so much comment on the subject in the financial press and among bankers. Most of the dialogue has been concerned with two aspects of liquidity—methods of measurement and standards of adequacy. The recent development of new money market instruments and new attitudes toward portfolio management has added uncertainties to an area of bank management in which there have always been many unanswered questions.

Unfortunately, the term bank liquidity has no single specific definition, and spokesmen referring to it frequently have in mind related, but not identical concepts. One may be thinking, for example, of the “moneyness” of bank assets, or the ease and certainty with which they can be converted into cash, when he speaks of liquidity. Another may have in mind the ability of the bank to meet demands for cash, whether by liquidating assets or by borrowing. And a third may think of liquidity as the extent to which a bank can meet new loan demand, through adjustments of assets or liabilities or perhaps the capital accounts.

All of these concepts have one thing in common. All of them refer to the ability of a bank to supply funds, in some manner, without appreciable delay.

But the methods by which the funds are supplied may vary so much from one concept to another that the various uses of the term liquidity are hardly comparable. This lack of precision in terminology is not new, however. Bankers have always varied in their estimates of the importance of bank liquidity, how to measure it, and exactly what it is.

**Measuring Liquidity** Historically, discussion of bank liquidity centered first around the “real bills doctrine,” and later came to involve “shiftability” and “anticipated income.” According to the oldest of these concepts, the real bills doctrine, each bank should insure its liquidity by concentrating on the extension of short-term, self-liquidating business loans. Such loans, due to their self-liquidating feature, would always be collectible, the reasoning ran, and could be collected without appreciable delay as a result of their short maturities. The ideal loan of this sort would be an inventory loan to a retailer, who would liquidate the loan through the sale of the inventory.

Critics of this doctrine pointed out that for a bank to be able to raise funds quickly, the important feature in an asset was not the property of self-liquidation, but of shiftability. To be liquid, an asset should be readily salable to other financial institutions, so it could be discounted for cash if the need should arise. As far as loans were concerned, the difference in views was for some time academic, since

only short-term self-liquidating loans were generally acceptable for rediscounting. But the emphasis on shiftability removed some of the stress on loans as a source of liquidity, and called attention to the investment side of the asset portfolio. And as secondary markets for securities developed, the importance of shiftability increased.

The shiftability concept, like the real bills doctrine, was not universally accepted. Some bankers and economists argued that, while both self-liquidating and shiftable assets were desirable, a bank in the final analysis must rely on the anticipated income of its borrowers for its liquidity. Only if anticipated income of the community at large enables it to make its payments promptly will the economy function smoothly enough for the banks to remain liquid. Any loss of confidence in anticipated income would interrupt the flow of payments, so that self-liquidating loans could not be liquidated, and shiftable assets could not be shifted. This view implied that except at prohibitively high cost, individual bank liquidity depended ultimately on general economic stability.

Today, the limitations of each of these views taken separately is widely recognized, but perhaps because they all contain valuable elements their influence on current thinking about bank liquidity is strongly evident. Most notably, all of these concepts view liquidity as related to the structure of the asset portfolio, and liabilities are seen as a claim against liquidity and a reason for its maintenance. And although these relationships have changed sharply in recent years, the most widely used formulas for measuring liquidity are still based on this view.

There are many liquidity ratios and other formulas used occasionally, but the two best known are the liquid asset-liability ratio and the loan-deposit ratio. The predominance of these two ratios is probably due to a tendency to view liquidity either as the ability of a bank to meet immediate demands for cash or to meet requests for new loans. The liquid asset-liability ratio shows the relationship between liquid assets (the means of cash payments) and liabilities (the immediate sources of demand for cash) while the loan-deposit ratio links the volume of loans outstanding with the volume of deposits, which represent potential demands on liquid assets.

Neither of these ratios takes into consideration the role of liabilities, and especially of time deposits, as a source of liquidity. Before the advent of the negotiable certificate of deposit and the development of a secondary market for CD's, banks played an essentially passive part in deposit growth. It was difficult for them to take positive action to acquire a given amount of deposits. But the ability to sell

CD's places an important new device for the acquisition of liquid assets in their hands, and raises questions about the meaning of the traditional measures of liquidity.

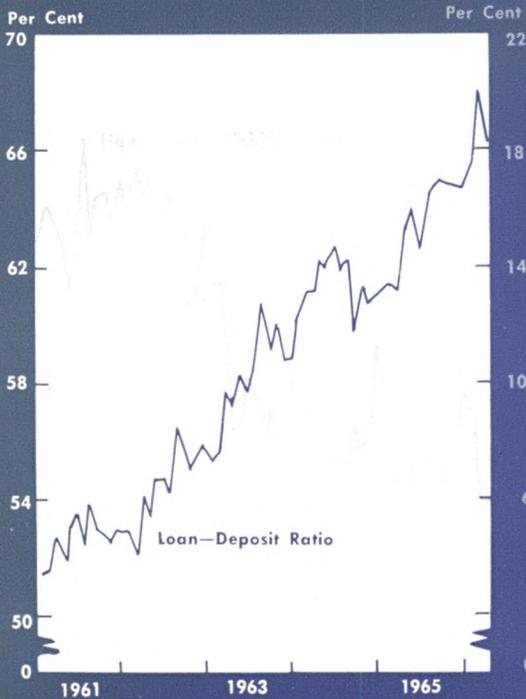
**Liquid Asset-Liability Ratio** The liquid asset-liability ratio is usually computed today as the sum of vault cash, balances with domestic banks, loans to brokers and dealers, and short-term Government securities, minus borrowings, as a percentage of total deposits less cash items in process of collection and reserves on deposit with the District Federal Reserve Bank. The ratio tends to change with varying degrees of monetary tightness or ease. When credit is tight, as evidenced by high or rising interest rates, holdings of liquid assets as a percentage of liabilities decline. And when credit is more easily available, the proportion of assets held in highly liquid form increases.

Cyclical changes in bank asset structure take place primarily as a result of swings in the demand for bank credit, the availability of bank reserves, and the resultant changes in interest rates. When the demand for bank credit increases, many banks are able to choose from among a wider array of potential borrowers and expand their loan portfolios on a favorable basis. At the same time, unless total reserves increase proportionately, banks reduce their holdings of Governments and other liquid assets to acquire the funds for loan expansion. When credit is easier, larger portions of assets are kept in liquid form, since acceptable loan opportunities may be more difficult to find, and the bank may be reluctant to invest in long-term bonds if rates are expected to rise again.

**Loan-Deposit Ratio** For many years the ratio of gross loans to total deposits has been used to indicate the extent to which a bank will be able to meet additional loan demand. But loan-deposit ratio standards have changed over the years. Before 1930, when banks relied heavily on short-term self-liquidating loans for liquidity purposes, loan-deposit ratios in periods of heavy loan demand ran much higher than they have at any time since. Then, during the 1930's loan demand sagged and the ratios fell. Most banks found themselves in the most highly liquid position they had ever been in, by any measure. World War II brought a sharp increase in loan demand, but loan-deposit ratios remained low and liquidity high as a result of heavy purchases of newly issued Government securities by banks. Large holdings of Governments held loan-deposit ratios low at most banks for several years after the war, but as loan demand rose, Governments were liquidated and

## LIQUIDITY RATIOS

FIFTH DISTRICT WEEKLY REPORTING MEMBER BANKS



loan-deposit ratios also rose, and have continued to rise since then.

In general, the liquid asset-liability and loan-deposit ratios move in opposite directions, as shown in the chart. Increases in loans outstanding raise the loan-deposit ratio, but since they usually increase liabilities in the form of demand deposits, they tend to lower the liquid asset-liability ratio. Liquid assets also may be reduced at the same time if reserves to support the additional liabilities are acquired from the sale of short-term Government securities. When loan demand slackens and loans and liabilities are reduced, the proportion of Governments to other assets tends to rise, reversing the process. Thus the series tends to diverge in periods of business expansion, and converge in recession.

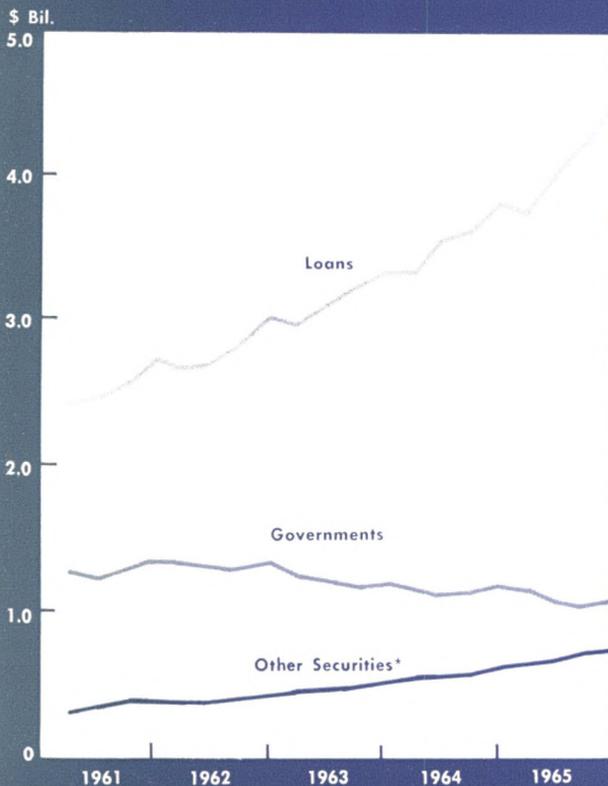
**Recent Experience** Measured by either liquid asset-liability ratios or loan-deposit ratios, bank liquidity is now at the lowest level in many years. The chart shows the average of liquid asset-liability ratios at Fifth District weekly reporting banks falling from over 18% in 1961 to 6% early this year, and the average loan-deposit ratio at those banks rising from 52% to 68%. The average loan-deposit ratio at U. S. weekly reporting banks jumped during the period from 55% to 67%, with even greater increases at some of the larger banks. These movements represent extensions of trends dating back to the immediate post-war years. The trends have been accentuated somewhat over the past five years with the extremely rapid growth of loan demand and changes in bank asset management and money market participation. The pace of change has been especially rapid since the beginning of 1965. Last year, total deposits at all commercial banks increased about 6%, but loans rose 15%.

The liquid asset-liability ratio fell at many banks as the ratio of Government securities to deposits declined. Most commercial banks have steadily reduced their holdings of Governments since World War II to provide reserves for loan expansion. Short-term Governments, in particular, have been liquidated. At U. S. weekly reporting banks they fell 11% in 1965, and at Fifth District weekly reporting banks, 3%. Meanwhile, deposits have risen rapidly. Demand deposits have held their own, but time and savings deposits have expanded at an unprecedented rate since 1960. The chart shows that at Fifth District weekly reporting banks, time deposits have expanded sevenfold and savings deposits have more than doubled over the past five years.

**Symptoms of Prosperity** The increase in bank deposits, the even faster rise in loans, and the liqui-

## EARNING ASSETS

FIFTH DISTRICT WEEKLY REPORTING BANKS



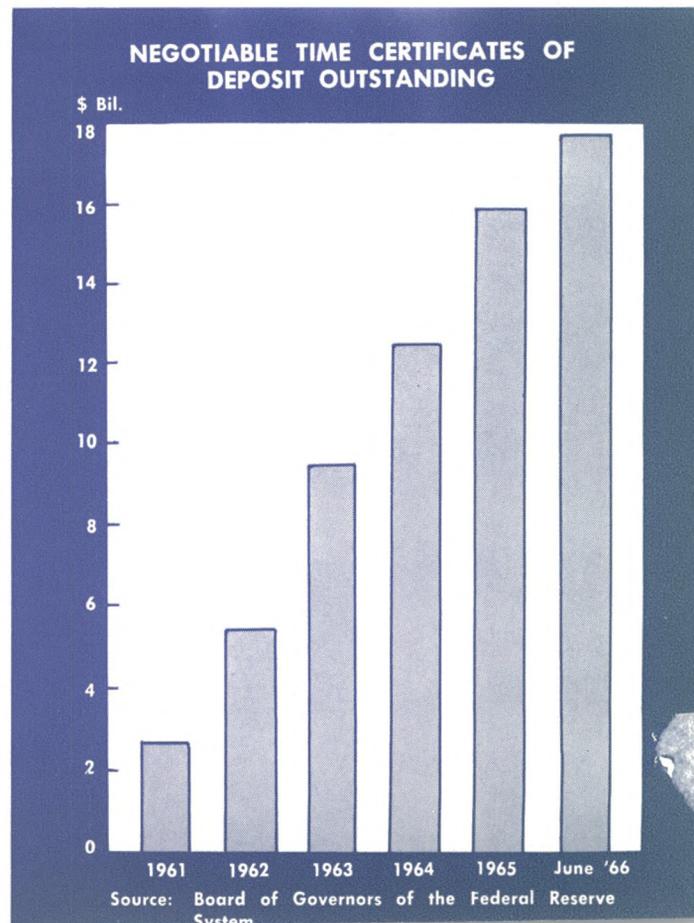
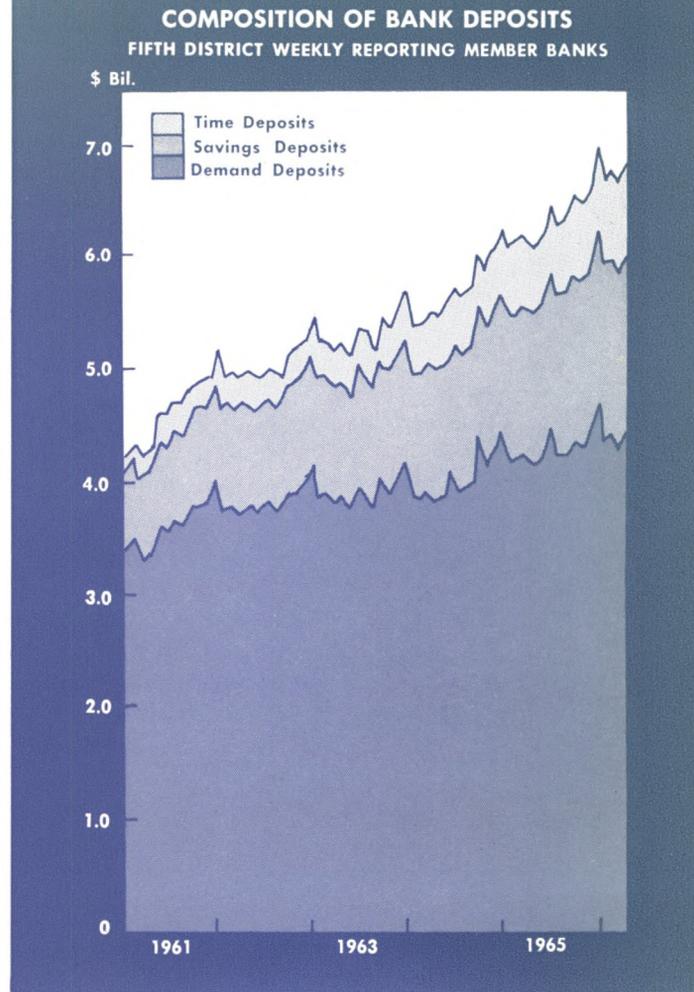
\*Chiefly municipals.

datation of short-term investments are all symptomatic of a sustained period of peacetime prosperity. Whenever business investment and consumer spending have continued to grow over an extended period of time, the expansion of bank lending has been accompanied by declining liquidity, and after a point, banks have been forced to ration credit in some manner. Thus the recent changes in the traditional liquidity measures are to be expected.

Banks must always balance liquidity against earnings. Highly liquid assets usually have low yields or none at all, and high yield assets are not often very liquid. In periods of prosperity, the danger of a reduction in deposits becomes much smaller for most banks, and so their immediate need for liquidity declines. At the same time, banks become more confident, and more aggressive in seeking out high-yielding loans and investments. Government securities, particularly short-term, are sold and replaced with higher yield loans or municipals. The present prosperity has lasted an exceptionally long time—over five years—and banks have had time to carry this process much farther than in other post-war cycles. Partly because of this, many banks are now more fully loaned up than they have been for decades.

**New Sources of Liquidity** It is typical for banks to become less liquid when prosperity brings rapid loan expansion, but the recent changes in bank liquidity differ from those of similar periods in the past in at least one important respect. Never before have deposit liabilities played a similar role in loan expansion. As a result of the use of negotiable CD's, banks have been able to expand loans beyond the limits which would have been possible through the liquidation of securities, while paradoxically remaining liquid in the sense of being able to meet demands for cash. For the individual bank, there is no apparent limit on the reserves it could raise in short order through the issuance of CD's. The only real threat to its liquidity position lies in the restriction of the market for CD's through regulatory action—or the failure to take action. The maximum rate of interest payable on CD's is fixed by Regulation Q, issued by the Board of Governors. If that rate should be set below the market rate for similar funds, or should be held constant while market pressures push other similar rates above it, time deposits as a source of reserves would quickly dry up.

Beginning in 1961, banks marketed negotiable CD's in a rapidly increasing volume. Today, there are more than \$18 billion of negotiable CD's in denominations of \$100,000 and over outstanding. The sale of these instruments provided reserves for loan ex-



pansion not only by mobilizing deposits but also by shifting funds from demand deposits, with reserve requirements of 12 or 16½% to time deposits, with requirements of 4 or 5%. The total amount of bank reserves of course was not altered, but it was rearranged in a way that permitted a great deal of credit expansion.

The use of CD's has not been confined to large money market banks. The smaller banks have made little attempt to tap the money market with negotiable CD's, but they have taken advantage of increases in rates permitted on time deposits to compete with nonbank institutions such as savings and loan associations for savings deposits. They have issued savings certificates in relatively small denominations with yields which at times have been higher than those available at the nonbank institutions, and have offered very favorable rates up to the 4% ceiling on passbook savings deposits. Their competition has been increasingly successful.

Use of the liability side of the balance sheet for liquidity purposes has not been limited to the issuance of CD's. Banks have borrowed from each other through the Federal funds market much more extensively in the past few years. Since a Federal funds transaction is essentially an overnight loan from one bank to another, Federal funds normally are used for emergency liquidity rather than as a basis for loan expansion; but some banks have recently stayed in the Federal funds market on a continuous basis for considerable periods of time. Their heavy participation in the market is undoubtedly related to loan expansion.

For a time, it appeared that short-term negotiable unsecured notes might become an important source of bank reserves. In spite of restrictions in some states and a very limited secondary market, the volume rose rapidly when they were introduced less than two years ago. But the Board of Governors has now redefined deposits to include such notes, and the volume outstanding recently fell to less than \$170 million. These notes are no longer a significant source of liquidity for most banks.

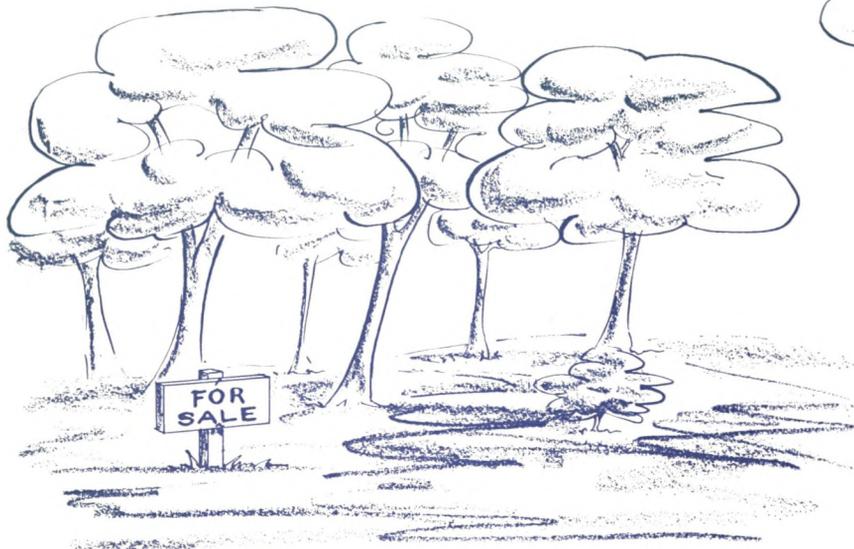
**Adjustment Problems** Individual commercial banks have been very successful in raising reserves for loan expansion by increasing their liabilities. Over the past five years, more than 77 per cent of the growth in bank deposits has been in time and savings deposits, reflecting the aggressiveness with which they have been sought. The new instruments through which banks have attracted funds have strengthened their ability to compete with other financial institutions. They have also added a great

deal of flexibility to the money markets. But the new emphasis on buying reserves has brought with it some difficulties, both for individual banks and for the regulatory authorities.

The negotiable certificate of deposit has caused problems for some banks. In a number of recent bank failures, the indiscriminate use of CD's played a significant role. Hundreds of sound banks have used certificates very successfully to acquire funds for loan expansion, but for many marginal banks, funds secured in this manner have been very costly. Some have marketed CD's through money brokers, paying the broker's fee in addition to a relatively high interest rate for funds with which to expand their loan portfolios. Other banks have been forced by aggressive competitors into costly interest rate races, just to keep from losing deposits. Certificates of deposit marketed on a national scale have forced many small country banks to compete with large city banks for time deposits which otherwise might have come their way as a matter of course.

The large scale use of CD's has also complicated the task of the monetary authorities in carrying out policy. Interest rate ceilings set under Regulation Q have become, unintentionally, a tool of monetary policy. The relationship between maximum rates on time deposits and other interest rates has become highly significant for many banks. A ceiling rate which sharply limited the marketability of new CD's could cause widespread liquidity problems in a tight money market.

**Expected Results** Many bankers are concerned about the high level of their loan-deposit ratios or the low level of their liquid assets, and they are cutting back on loans and long-term investments. But there are some who feel that banks are much more liquid than the traditional measures indicate. They argue that their ability to raise reserves through the purchase of deposits and Federal funds and through the issuance of notes reduces greatly the need to hold liquid assets. And perhaps it does—as long as the number of banks attempting to acquire liquidity in this way is not too large. But if all banks try to tap the money market at the same time, or try to buy Federal funds at the same time, obviously it won't work. The new techniques do not create new reserves for the banking system as a whole. They are merely devices for mobilizing existing reserves and those supplied by the Federal Reserve System. In the present context, Federal Reserve policy is the ultimate determinant of the level of liquidity in the banking system.



## THE SUPPLY OF MORTGAGE FUNDS

The movement of the American people resembles the game of musical chairs. About 20% of the total population moves to a different residence every year, frequently selling one house and buying or building another. Since a tremendous volume of mortgage funds is required to finance these real estate transactions, a change in mortgage rates and terms is an event affecting the pocketbooks of thousands of people.

For several months the supply of some types of credit in the American economy has been insufficient to meet the burgeoning demand, and one area in which shortages have been felt is the mortgage market. This article will examine briefly the structure of mortgage debt, the principal sources of funds, and the effects of restrictive monetary policy on the flow of funds into mortgages.

**Mortgage Debt** Mortgage debt has grown faster than any other major type of public or private debt in the postwar period, increasing at approximately 12.1% per year since 1946. The volume of mortgage debt outstanding surpassed the Federal debt in 1965, and at \$349 billion in the first quarter of this year exceeded the Federal debt by almost \$30 billion. Mortgage indebtedness accounted for about 70% of the total indebtedness of individuals in 1965.

About 94% of total mortgage debt consists of loans on nonfarm property, with mortgages on farm property constituting only about 6%. Although nonfarm mortgage debt, in turn, consists primarily of loans on 1-4 family houses, mortgages on other residential and on commercial properties have accounted for a rising proportion in the last six years, and amounted to about 34% of the nonfarm total in 1965.

### Federal Participation in the Mortgage Market

For many years the Federal Government has played an important role in the housing and mortgage markets. In 1934, Congress established the Federal Housing Administration (FHA) to insure loans for modernization, repair, construction or purchase of residential property. The same law authorized the Federal Savings and Loan Insurance Corporation to insure deposits of savings and loan associations. In 1944, another Federal program, launched by the so-called GI bill, provided for Veterans Administration guarantees of loans made by private lenders to veterans for the purchase or improvement of a home, farm, or business. These Federal insurance and guarantee programs have had a pervasive effect on mortgage markets. In 1965, 38% of total nonfarm residential mortgage debt carried Federal insurance or guarantees.

The Federal Government has also become active in providing a type of secondary market for FHA and VA mortgages through the Federal National Mortgage Association, frequently referred to as Fannie Mae. In 1938, the Reconstruction Finance Corporation was directed to establish Fannie Mae to purchase FHA-insured mortgages, and ten years later coverage was extended to include purchases of VA-guaranteed loans. In the ensuing years, the activity of Fannie Mae has imparted a significant degree of liquidity to the mortgage instrument.

A holder of a Federally underwritten mortgage may convert the mortgage to cash by selling it to Fannie Mae at the rates and terms specified by the agency. Conversely, if a mortgage lender needs an

(Continued on page 10)

The Baltimore Standard Metropolitan Statistical Area stretches across the city's boundaries to embrace Baltimore, Anne Arundel, Carroll, and Howard Counties. It centers around one of the nation's largest industrial, financial, and shipping centers, and blends imperceptibly into the great Megalopolis of the Northeast. The metropolitan population in 1965 numbered approximately 1,900,000.

Basic to the area's economy is a large and highly diversified complex of both heavy and light industry. More than 2,000 industrial establishments, representing 21 major manufacturing groups, are located in the area. The principal industries are primary and fabricated metals, transportation equipment, machinery, chemicals, electrical equipment, and food products. Investment in new industrial plants and additions to existing plants over the past decade are estimated at \$1.5 billion. Value added by manufacturing in the area last year amounted to \$2.3 billion. Baltimore is headquarters for many of the state's banking organizations. There are 31 commercial banks with assets totaling over two billion dollars in the metropolitan area. Baltimore is also the home of a branch of the Federal Reserve Bank of Richmond.

Of growing importance to the area's economy is the historic Port of Baltimore which ranks second among the nation's Atlantic Coast ports in value of foreign commerce. The value of the port's foreign trade in 1965 totaled nearly \$1.4 billion, up from \$1.2 billion in 1960. Vessel arrivals in 1965 numbered 4,997.

The Baltimore area has long been one of the most highly developed in the nation. As indicated by recent annual growth rates in various sectors of the economy, however, the area continues to grow and enhance its position as a leading center of economic activity.

SELECTED STATISTICS  
WITH RECENT AVERAGE ANNUAL GROWTH RATES

	Annual Growth Rate in the Period Indicated	Baltimore SMSA (Most Recent Year)
	Baltimore	
Population (1960-1965)	1.4	1,852,100
Civilian labor force (1960-1965)	1.1	763,400
Wage and salary employment (1960-1965)	1.5	665,000
Manufacturing	-0.9	190,700
Nonmanufacturing	2.8	474,300
Self-employed and other workers (1960-1965)	-1.0	68,900
Unemployed (1960-1965)	-6.1	29,500
Number of manufacturing establishments (1958-1963)	-0.8	2,027
Value added by manufacturing (1958-1963)	3.6	\$2,341,934,000
Value of retail sales (1958-1963)	3.3	\$2,184,465,000
Value of wholesale sales (1958-1963)	3.3	\$3,149,930,000
Receipts of services establishments (1958-1963)	7.0	\$ 441,173,000
Total privately owned deposits in commercial banks (1960-1964)	3.8	\$2,429,671,400
Demand deposits	2.0	\$ 955,918,900
Time deposits	6.0	\$1,121,639,700

Sources: U. S. Department of Commerce, Bureau of the Census; Maryland Department of Employment Security; Chamber of Commerce of Metropolitan Baltimore; Board of Governors of the Federal Reserve System.



# BALTIMORE



outlet for funds, he can buy mortgages from the agency. Typically, Fannie Mae is called upon to acquire mortgages during periods of credit stringency and to supply mortgages during periods of credit ease. It exercises some control over the volume of its purchases and sales by changing the rates and terms under which it will buy and sell.

**Sources of Mortgage Funds** The bulk of all mortgage funds is supplied by four types of financial institutions: savings and loan associations, mutual savings banks, commercial banks, and life insurance companies. These four lenders acquired almost 77% of the \$30 billion increase in mortgage debt outstanding in 1965.

Savings and loan associations are the most specialized of these institutions. Their investments are restricted by law and tradition primarily to residential mortgages, which for a number of years have constituted about 85% of their total assets. Savings and loan associations deal directly with the borrower and do not work through correspondents, such as mortgage bankers. Their trade areas are usually confined to fairly small geographic regions, and Federally chartered associations generally may not lend outside a radius of 100 miles. Savings and loan associations operate primarily in the conventional mortgage market. In 1965, for example, Federally underwritten mortgages accounted for only 10% of their total mortgage holdings.

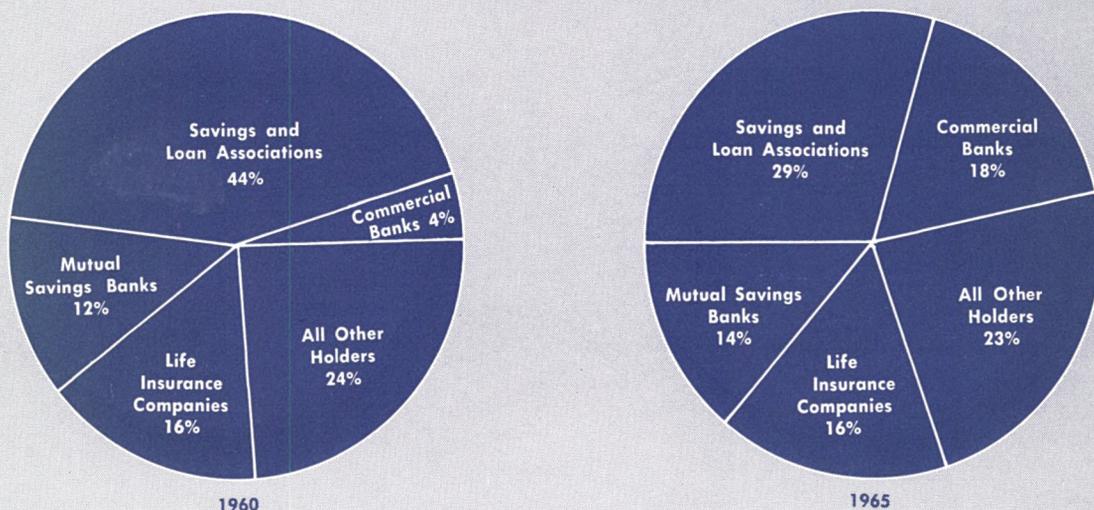
Since World War II, savings and loan associations have competed successfully with mutual savings banks and commercial banks for the savings of in-

dividuals. Their dividend rates, based on the yields earned on conventional home mortgages, have generally been high relative to rates paid on savings by other depositary-type institutions. The net increase in savings capital at savings and loan associations followed a steady upward trend from 1946 through 1964, and their assets approximately doubled every five years during this period for an average annual growth rate of 14.5%.

Over the years, savings and loan associations have been successful in acquiring mortgage loans, although recently their share of these loans has been declining. One factor which has contributed to their success is that most associations may lend up to 90% of the value of the property on conventional mortgages, as opposed to somewhat less for most other large regulated institutions. As late as 1961, savings and loan associations supplied a hefty 45% of that year's increase in total mortgage debt. During the past five years, however, the mortgage activity of commercial banks has grown faster relative to that of savings and loan associations. As the pie chart shows, savings and loan associations supplied only 29% of the net increase in mortgage loans outstanding in 1965.

In regard to flexibility of asset management, mutual savings banks lie somewhere between commercial banks and life insurance companies, on the one hand and savings and loan associations on the other. Like savings and loan associations, their asset mix is heavily weighted with mortgages which make up about 76% of their total assets, but within the mortgage category there is greater diversity.

**SHARE OF THE NET CHANGE IN MORTGAGE DEBT OUTSTANDING, BY TYPE OF HOLDER**



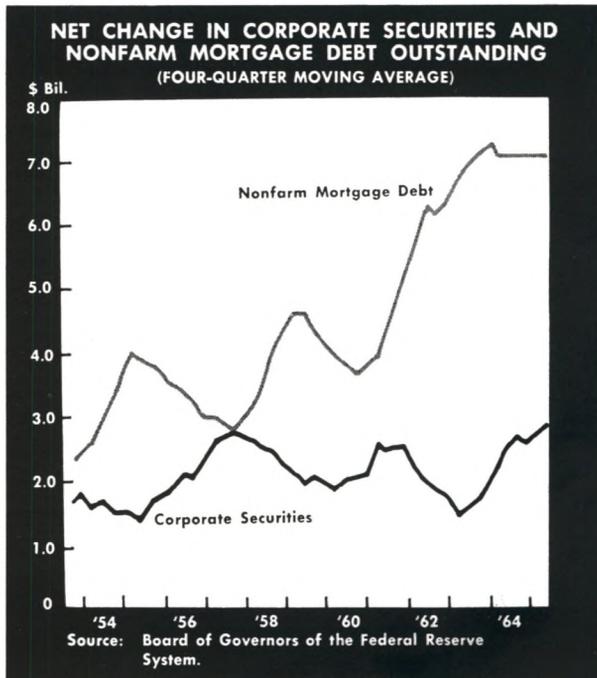
Source: Board of Governors of the Federal Reserve System and the National Bureau of Economic Research.

About 68% of their loans are for nonfarm 1-4 family dwellings, about 22% are for apartments for more than four families, and 10% are for nonresidential purposes. Almost two thirds of all their mortgage holdings are FHA and VA insured.

Because mutual savings banks are located primarily in the northeastern and middle Atlantic states, they did not become important nationally as suppliers of mortgage funds until after 1950, when most states which charter savings banks amended their statutes to permit investment in out-of-state Federally underwritten mortgages. Since 1955, mutual savings banks have held about 13% of total mortgage debt.

Commercial banks are such diversified lenders that they are often called "department stores of credit." Mortgages constitute only a small fraction of their assets, but the fraction has grown over time from about 6% in 1950 to 13% in 1965. Their mortgage lending policies tend to change in response to changing conditions, and policies vary widely from bank to bank depending on size, supervisory policies, state laws, location, and management of the individual institution. Over most of the postwar period, commercial banks' share of the residential mortgage market declined, but this trend was reversed in the early 1960's and their share has risen slightly from a low of about 13% in 1961 to 15% in 1965. Of the \$49.7 billion of mortgages held by commercial banks in 1965, 65% were mortgages on nonfarm residential properties, the remainder consisting primarily of loans on commercial properties. The majority of their residential loans are conventional, with about 32% carrying Federal insurance or guarantees.

Like commercial banks, life insurance companies have diversified portfolios and a wide degree of investment latitude. To the extent that their institutional arrangements permit, they are guided in their investment decisions mainly by yield differentials. Most large life insurance companies maintain stable relationships with correspondent organizations, such as mortgage companies, which acquire and service mortgages outside the state where the insurance company is located. Because of these arrangements, life insurance companies are often committed to basic minimum mortgage programs regardless of changes in mortgage yields, and may allocate funds as much as a year ahead. Over and above such commitments, however, life insurance companies generally have large, predictable flows of funds which may be shifted between bonds and mortgages depending on yield differentials. Mortgages average about 38% of total assets, while stocks and bonds account for about 42%. Most of their mortgages represent permanent, long-term financing of large



housing projects or large-scale income properties, rather than loans for single residences. Of their total mortgage holdings in 1965, 66% were conventional and the rest Federally insured.

Other lenders, which together hold an estimated 32% of total mortgage debt outstanding, include pension funds, endowed institutions, trust departments of banks, mortgage investment companies, individuals, and others. These do not follow uniform lending practices and are generally not regulated. They can, and do, take greater risks than regulated institutions, make loans with higher loan-value ratios, and several of them are sources of funds for second and third mortgage financing.

**Effect of Monetary Policy** Restrictive monetary policy influences the mortgage market in a number of different ways, with the net result that investment funds tend to be diverted from mortgage to non-mortgage uses. This is very evident from the above chart which shows that during periods of business expansion when monetary policy becomes restrictive, the flow of funds into corporate securities tends to increase while the flow into mortgages tends to decline. This pattern is due in part to the tendency for mortgages to become relatively unattractive during periods of tight money. Because of usury laws and other institutional rigidities, such as ceiling rates of interest on FHA and VA loans, mortgage rates tend not to rise as quickly or as high as rates on other investments. Bond yields, for example, tend to rise relative to mortgage yields, and institutions, such as life insurance companies, which are

flexible in their investment policy, tend to shift from mortgages into bonds.

Monetary policy also influences the mortgage market through its effect on the share of the savings flow captured by savings and loan associations and mutual savings banks. These institutions, which have the bulk of their funds tied up in mortgages, make long-term loans at fixed rates of interest. The income from these loans and, therefore, the interest or dividend rates paid to depositors tend to be inflexible in the short run. In periods of tight money, when market rates of interest generally rise faster than rates paid on savings, some individuals decide to channel their new savings into higher yielding market securities. This diversion of funds from institutions which specialize in mortgage lending tends to reduce sharply the supply of mortgage money.

The problem has been intensified in recent years as a result of more effective competition from commercial banks. As market rates of interest have risen during the past four years, the Board of Governors of the Federal Reserve System has raised the ceiling rates payable by commercial banks on time and savings deposits, and these institutions have taken advantage of the increased leeway to compete vigorously for savings money. Although commercial banks have increased their mortgage lending, they do not commit as high a percentage of their savings flows to mortgages as do savings and loan associations and mutual savings banks.

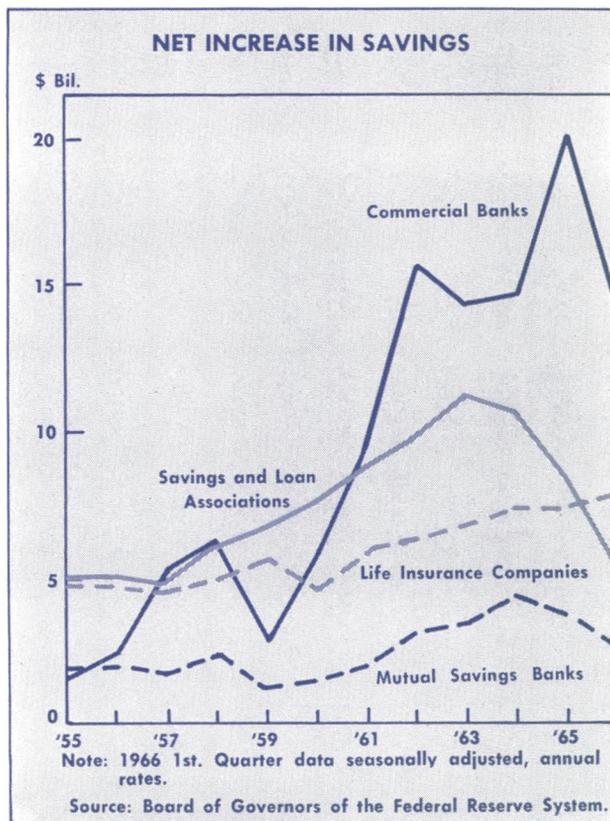
**Current Trends in Savings Flows** As typically happens in tight money periods, savings are being diverted from savings institutions to market instruments. Flow of funds data show that individuals' direct investment in the capital market was almost four times larger in the first quarter of this year than in the same period a year ago. Between December and June the inflow of savings to all savings-type institutions declined sharply. Aggregate inflows into savings and loan associations, mutual savings banks, and commercial banks totaled only \$21.3 billion at a seasonally adjusted annual rate in the first six months of this year. This was the slowest rate of inflow since 1961 and compares with the record inflow of \$31.9 billion in 1965.

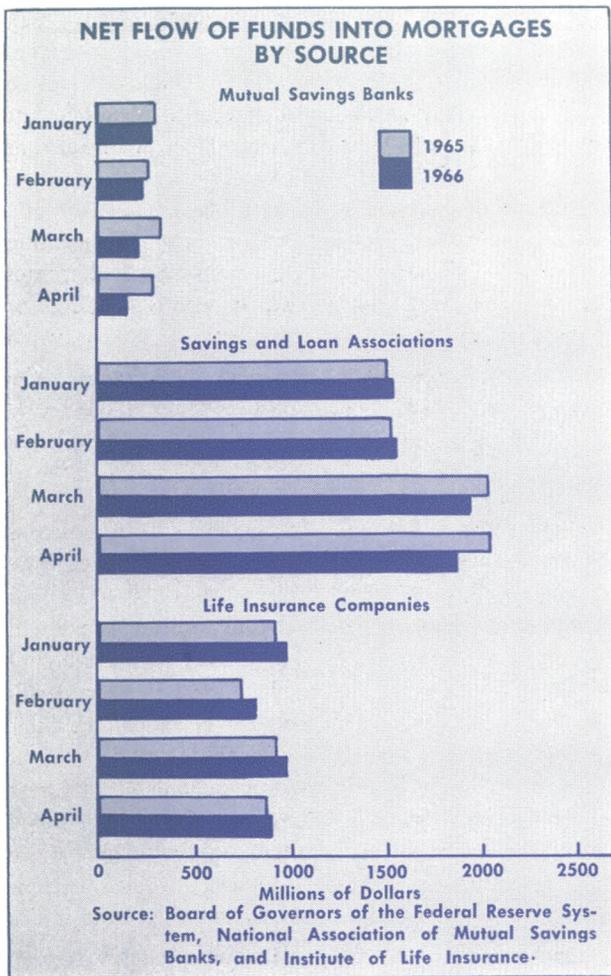
In recent months heavy demands in the capital market by corporations, state and local governments, and Federal agencies have intensified competition for investment funds. First quarter 1966 offerings of corporate securities, for example, were almost twice as large as in the same quarter of 1965. The average yield on new corporate issues, adjusted to a triple-A basis, rose over 80 basis points, to about

5.64%, between January and July. Life insurance companies, attracted by the high yields, invested almost \$1.5 billion more in corporate bonds in the first four months of this year than in the same months of 1965.

Restrictive monetary policy impinges most directly on the mortgage market by affecting the lending patterns of commercial banks. As money becomes tighter, these institutions tend to satisfy demands for consumer and business loans first. With the rapid growth of savings deposits which began in 1962, commercial banks became quite active in the mortgage market, and real estate loans increased 13% per year from 1962 through 1965. Because of tighter money, a reduced inflow of time and savings deposits, and continuing strong demand for business loans, real estate loans increased at an annual rate of only 10.6% in the first five months of 1966.

While all three types of institutions were affected by the slowdown, savings and loan associations and mutual savings banks were hit the hardest. Savings and loan associations were unable to pay over 5% on their savings shares without forfeiting the privilege of borrowing at the Federal Home Loan Banks. Later this ceiling was raised to 5½%, and finally abandoned altogether in July. While mutual savings banks have not been restrained from competing by a legal limit on their rates, they have been reluctant to raise rates because of the resulting squeeze on earnings. Commercial banks, however, have been permitted to pay





up to 5½% on time deposits with maturities of 30 days or longer since December 1965. Although the ceiling rate on commercial bank savings deposits was left unchanged at 4%, commercial banks soon competed for small savings through the issuance of small-denomination, nonnegotiable savings certificates or bonds, usually maturing within one year.

The chart on page 12 shows the annual net increases of savings funds by the four major mortgage suppliers. For the second consecutive year, and for the only two years since 1945, savings capital at savings and loan associations failed to show a larger increase than the previous year. At a seasonally adjusted annual rate the net inflow to savings and loan associations in the first six months of this year amounted to \$4.0 billion, less than half as large as the net of \$8.4 billion in 1965. The increase declined 50% at mutual savings banks from \$3.6 billion in 1965 to \$1.8 billion in the first half of 1966. The decline at commercial banks was only 23%, from \$20.0 billion to \$15.5 billion, and, while in absolute terms this was very large, the net increase through June was still approximately equal to the expansion in the years 1962 through 1964.

**Current Trends in Mortgage Lending** Of considerable significance for the mortgage market and the future level of construction activity has been a sharp cutback in mortgage loan commitments. A recent survey by the Federal Reserve System revealed that in 10 of the 12 Federal Reserve districts mortgage commitments by major lenders have been reduced by 20% or more from year-ago levels. Although the survey revealed substantial differences from place to place, savings and loan associations apparently made the largest reductions, followed in rank order by mutual savings banks and mortgage companies, life insurance companies, and commercial banks. Cutbacks were apparently largest for residential properties, which is not surprising in view of the dominance of savings and loan associations and mutual savings banks in the residential field.

These cutbacks in loan commitments have not yet been fully reflected in reductions in mortgage disbursements since present disbursements are being made from previous commitment backlogs. The bar chart suggests that reduced commitments are perhaps beginning to show up in disbursement figures, however. Loans made by savings and loan associations and mutual savings banks in March and April were significantly below year earlier levels.

Striking evidence of the present squeeze in the mortgage market has been the swift rise in mortgage rates. After holding steady at 5.80% from April 1963 through September 1965, the average rate on conventional mortgages on new homes has risen to 6.40%, with most of the increase occurring since February. The effective rate on FHA-insured 30-year mortgages has shot up from about 5.45% in October 1965 to 6.45%, 70 basis points above the legal ceiling of 5¾% set by the FHA.

As money has become progressively tighter, Fannie Mae has been called upon to absorb Government-backed mortgages from mortgage holders needing liquidity. In order not to exceed its legal borrowing authorization, the agency made four reductions between December and May in the price it pays for mortgages, raised the price of Fannie Mae common stock which mortgage sellers are required to purchase, and, in early April, lowered the size of mortgages it buys to an unpaid balance of \$15,000, from \$30,000. Nevertheless, Fannie Mae's total portfolio expanded \$800 million in the first quarter, compared with a net increase of only \$319 million in all of 1965. These purchases by Fannie Mae have served as a buffer between the mortgage market and other financial markets, but they have not insulated the mortgage market from the general trends operating in the financial markets as a whole.



# THE FIFTH DISTRICT

High level business activity continues in most parts of the Fifth District. The demand situation generally appears to be somewhat stronger now than in late Spring and early Summer. The impact of Federal Government spending for defense needs is increasingly being felt by District manufacturing industries, and business capital outlays are also helping to sustain the present levels of employment and output.

The latest statistics suggest that consumer willingness to spend is picking up again. Even automobile dealers are reported optimistic. While it is too early to say definitely, recent sales figures suggest that the worst of the slump may be over and that the months ahead will bring rising sales. Other durables—most notably air conditioners—have been selling well during the summer months.

District labor markets are apparently tighter now than they were a month ago, and it is clear that in a number of industries further output gains will be limited by shortages of skilled workers. Reports from several cities indicate that office workers are in particularly short supply. Some firms have temporarily solved this problem by hiring college and high school students for the summer months. In September, of course, other adjustments will be necessary.

The growing tightness in local markets is perhaps best evidenced by the current unemployment data. In each of the five states and D. C., rates of insured unemployment have fallen to record lows for the statistical series now in use. The table at the bottom of this page traces the steady year-to-year decline of these rates since 1961 and also points up the unusually rapid drop of rates during the first six months of 1966.

**The Textile Outlook** June and July are always slow months for textile producers. This year was no exception. Mills have received relatively little new business during the past six weeks. Most producers have welcomed the lull, however, since order backlogs are at or near an all-time high and many mills have already sold their output through the first quarter of next year.

In large measure, the current prosperity of the industry is based on military demand. The Defense Department's textile and apparel purchases during the fiscal year ending June 30 are estimated by the American Textile Manufacturers Institute at \$1.1 billion, more than three times their volume in the preceding fiscal year. The Institute estimates that the primary textile industry supplied to the military

## INSURED UNEMPLOYMENT Weekly Rates

	Annual Averages						Monthly Averages—1966					
	1960	1961	1962	1963	1964	1965	January	February	March	April	May	June
Maryland	5.0	5.4	4.4	3.7	3.1	2.4	2.9	3.5	2.3	1.5	1.2	1.1
District of Columbia	2.0	2.2	2.0	2.2	1.8	1.6	1.7	2.2	1.6	1.1	1.1	1.0
Virginia	2.7	3.0	2.0	1.8	1.5	1.1	1.1	1.7	1.3	0.8	0.7	0.6
West Virginia	7.6	8.1	6.7	5.8	4.6	3.6	4.8	5.2	3.7	2.8	2.3	2.1
North Carolina	4.5	5.1	3.8	3.8	3.3	2.5	3.1	3.2	2.4	1.9	1.7	1.6
South Carolina	3.5	4.2	3.4	3.2	2.8	2.2	2.4	2.1	1.7	1.4	1.3	1.3

Source: U. S. Department of Labor.

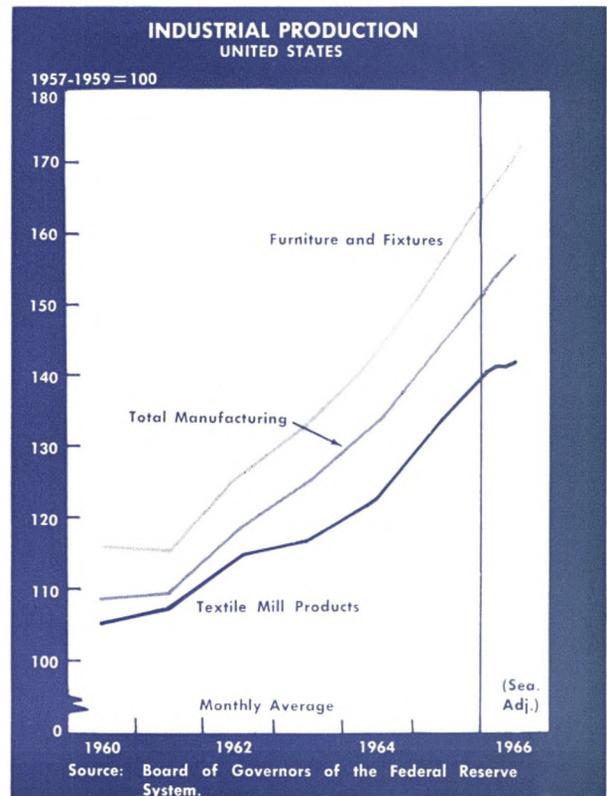
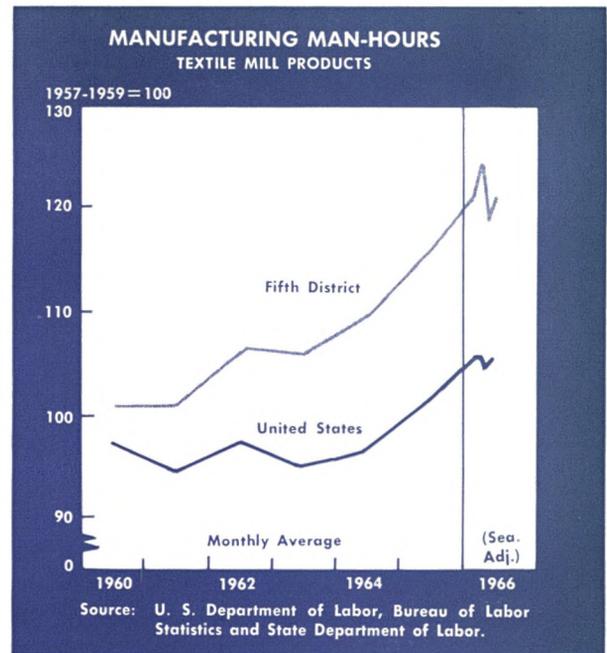
about a half billion yards of material in fiscal 1966.

The outlook for the intermediate-term future is buoyed by anticipation of a continuing substantial volume of military purchases. The Defense Personnel Support Center, purchasing agent for the Armed Services, has forecast large volume buying of primary textiles and apparel during the final half of 1966.

**Recent Growth in Textiles** Some perspective on the growth of the textile industry in recent years may be gained from the two charts on this page. The chart in the top right-hand corner shows indexes of manufacturing man-hours in textiles for the United States and for the Fifth District. Between 1960 and 1965, the labor input in the national textile industry as a whole, as reflected by the man-hours index, rose 4%. By comparison, the labor input at Fifth District mills rose 15% during the same period. There is a twofold explanation for this difference. First, a more than proportional share of total industry growth over this period has occurred in Fifth District states. Second, the manufacture of textiles is, on average, a more labor intensive process in the District than in the nation as a whole. This difference between the District and nation may be expected to diminish during the next several years as District mills continue to make high level capital outlays for modernization.

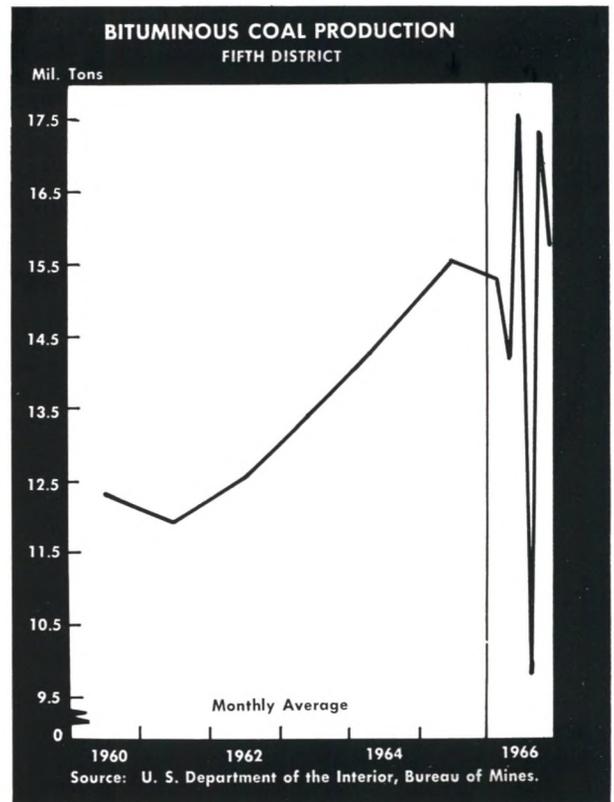
In the District and the nation, outlays for plant and equipment, both to replace outmoded equipment and to expand capacity, have been proceeding at an unprecedented rate. Capital expenditures in 1965 were more than double the amount spent in 1959, and 1966 outlays are projected at a level more than three times above that of 1959. The investment trend has been pervasive within the industry. Not only have the larger textile firms continued to build automated plants for the production of high-volume goods, but smaller and more specialized producers have been updating equipment and introducing labor-saving devices.

The introduction of new equipment has boosted productivity significantly throughout the industry. The chart at the lower right on this page shows the recent growth of textile output in the nation, measured by the industrial production index for textile mill products. Between 1960 and 1965, output rose 28%. As noted above, the labor input for the national industry, as measured by the index of man-hours, rose only 4% during the same time span.



**Prosperity and Problems in Furniture** Production at District furniture factories continues close to practical capacity. But sustained operation near the maximum output level is causing producers an increasing number of headaches. Sales continue brisk. At the Southern Furniture Market this summer, all lines moved well, and dealers were reported quite optimistic regarding prospects for the fall. Prices were up on a number of the lines, but the increases appear to have had no dampening effect on sales.

Despite problems of labor availability, the District's furniture industry has been able to expand output at a remarkable rate during the past several years. The expansion was accompanied by increases in employment and working hours, as is reflected in the chart on this page showing the rise of man-hours. Between 1960 and 1965, furniture and fixture man-hours at District manufacturing establishments went up 35%, more than twice the national gain. Productivity gains were also a factor. Figures on increased output per man-hour for District-based firms as a separate group are not available, but the general picture of what has been happening can be gained from national averages. The chart below shows an increase in production in the 1960-1965 period of 36%, more than twice the 16% rise in labor inputs. The relatively large productivity gains suggested by these figures are all the more remarkable because



much of the work in the furniture industry must be done by hand.

**Cigarette Sales Up** For the District tobacco industry, happy times apparently are here again. Sales are climbing, stimulated by rising demand from armed forces overseas—in particular, the troops in Viet Nam. According to the latest U. S. Department of Agriculture estimate, 534 billion cigarettes were consumed during the fiscal year ending June 30, 1966. This was a 2 billion increase over consumption in the preceding fiscal year. Shipments to overseas forces were the largest since 1952, and the rise in these shipments accounted for most of the increase in total consumption.

**Continued Improvement in Coal** In the bituminous coal industry, the undramatic but steady improvement which has been going on for several years continues. Employment has been running about 1% to 2% ahead of last year. In four of the first six months of 1966, production ran ahead of average monthly output in 1965, as indicated in the chart above. April production was depressed by strikes.

With electric utility consumption of coal still on the rise, the intermediate-term industry outlook is favorable.

