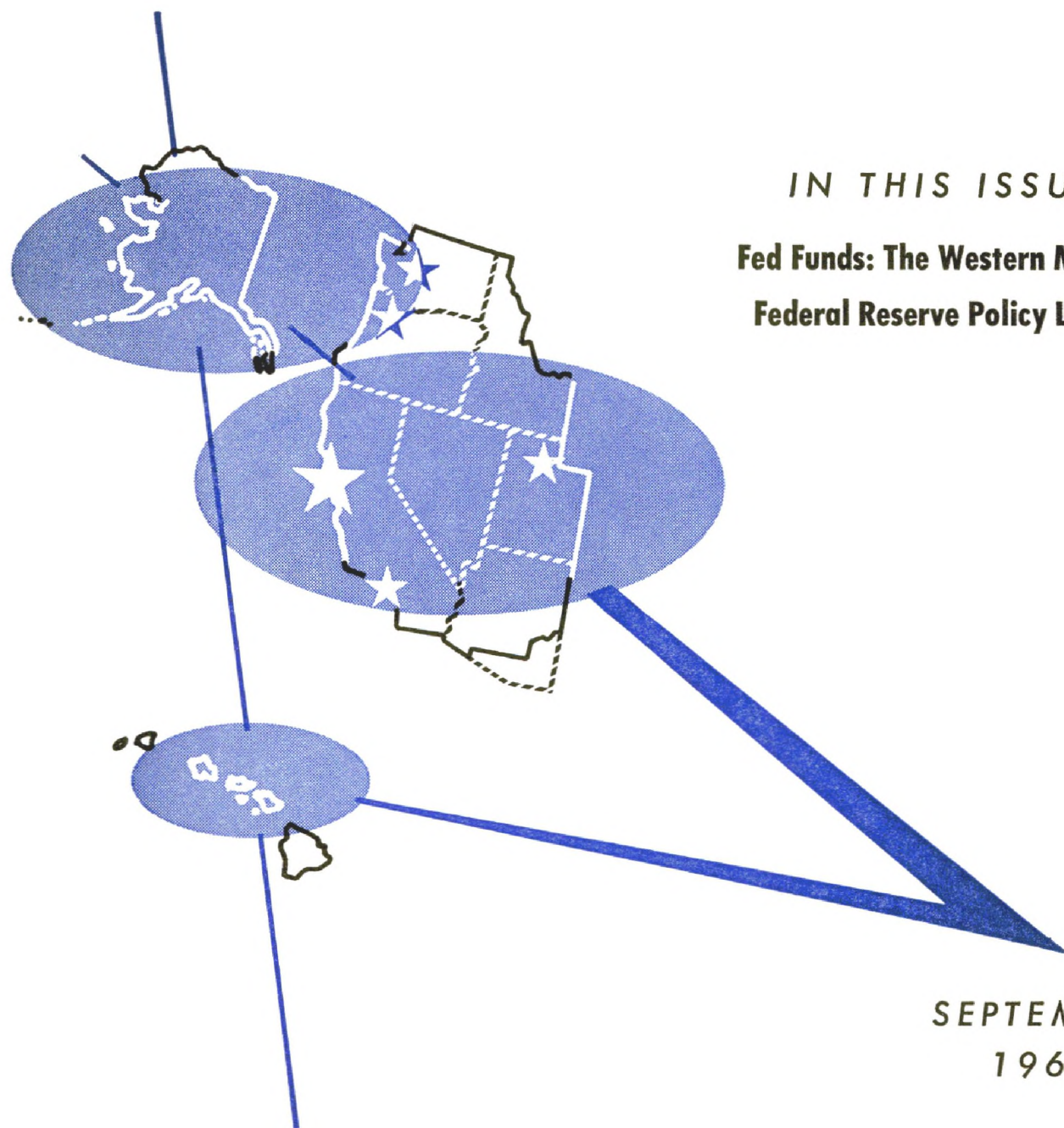


FEDERAL RESERVE BANK OF SAN FRANCISCO

# MONTHLY REVIEW



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**SEPTEMBER**  
**1966**

### **Fed Funds: The Western Market**

. . . Major District banks, with over one-sixth of the national market, continue to expand their Fed-funds trading activity.

### **Federal Reserve Policy Letter**

. . . Text of the letter sent to member banks regarding the growth of bank credit and the use of the System's discount facilities.

**Editor: William Burke**



# Fed Funds: The Western Market

**F**EDERAL FUNDS are funds held by a commercial bank in the form of reserve balances on deposit with its Federal Reserve bank. They are also one of the most important short-term money market instruments in the nation's financial system, as is evidenced by the rapid upsurge in Fed-funds trading activity over the past decade or so. These transactions channel funds from the banks which hold deposits at the Federal Reserve in excess of their required reserves, to those banks which need such funds to adjust their reserve accounts or for other purposes.

The leading Western banks, with over one-sixth of the national market, are surpassed only by the largest New York banks in the extent of their Fed-funds trading activity. This article attempts to outline the dimensions of the Twelfth District market—but first, it describes the past growth and the present characteristics of the overall national market.

## Market characteristics

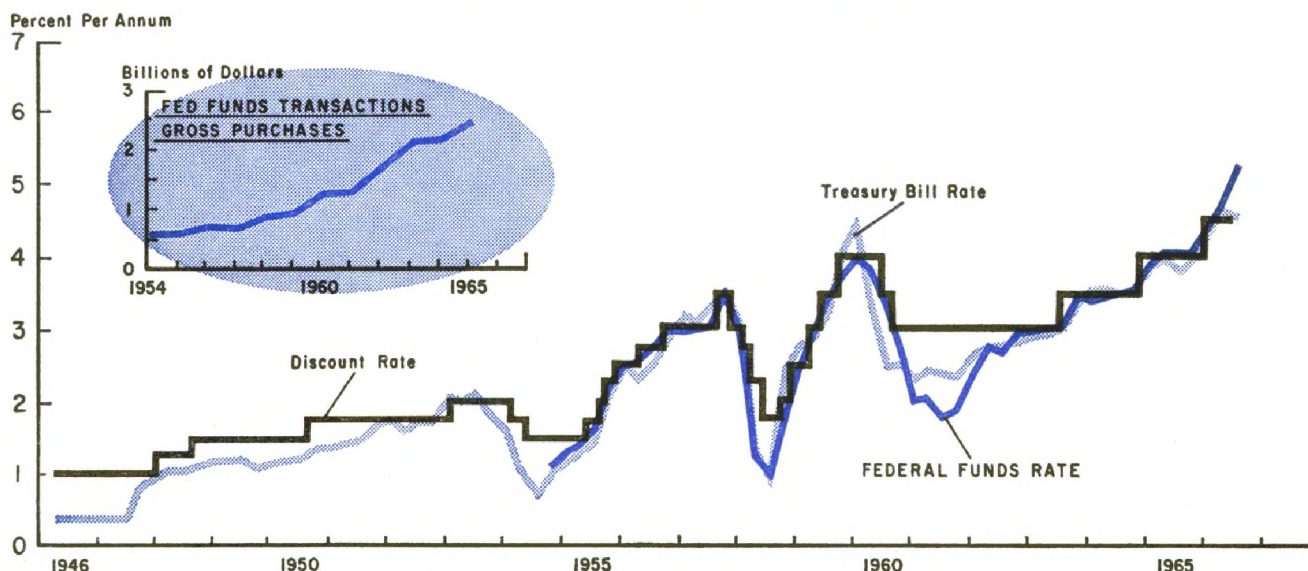
Fed funds are distinguished by being immediately available to the payee. Funds transferred by a check drawn on a member bank's

reserve account become available upon presentation of the check at any office of the Federal Reserve bank—in contrast to funds transferred by a check drawn on a commercial bank, which must be cleared so that the funds are not available to the payee until at least one day after the check is written. Moreover, Fed-funds transfers may be made across district boundaries through the Federal Reserve's wire transfer facilities.

Fed funds thus are used in situations where this characteristic can be utilized, that is, in cases where immediate payment or loss of a day's interest are important considerations. Adjustment of commercial-bank reserves accounts for the largest amount of such trading. In addition, new issues of U. S. government securities purchased by government securities dealers must be paid for in Fed funds, and payment for many other types of transactions involving government securities are now frequently made in Fed funds.

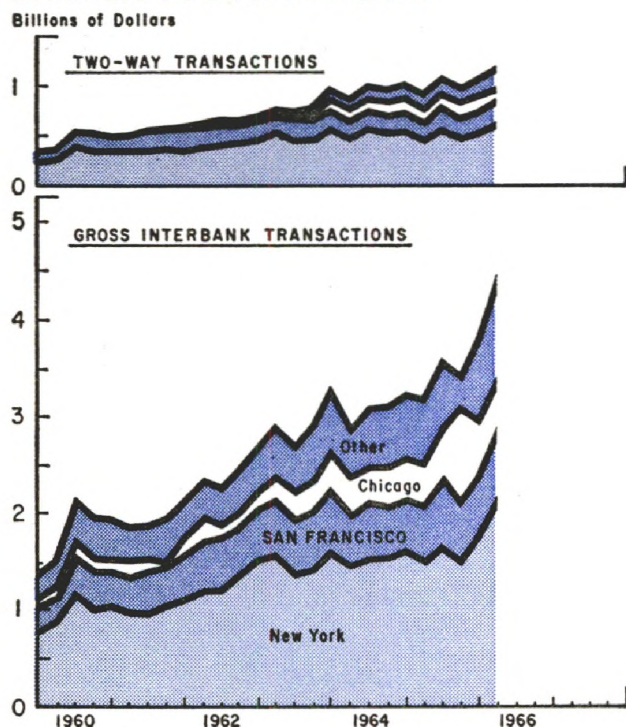
A commercial bank becomes a potential lender ("seller") of Fed funds when it has deposits at the Federal Reserve in excess of its

**Rapid expansion of Fed-funds activity reflects rising interest rates, which stimulate activity from both the demand and supply side**





## New York and Twelfth District dominate Fed-funds market



required reserves. These excess deposits, and consequently the volume of Fed funds a bank is able to lend, vary from day to day in response to changes in its deposits, loans, and security holdings. A borrower ("buyer") of Fed funds, therefore, generally cannot rely on the same source of funds for longer than one or two days: it will use Fed funds only to provide interim financing or to cover extremely short-term needs such as temporary fluctuations in bank reserves.

The unstable supply of Fed funds permits many institutions to operate as dealers in the market, and thus eliminates the necessity for lenders and ultimate borrowers to find each other. A few large banks and two New York brokerage houses operate as dealers in Fed funds on a national scale, and many smaller big-city banks have begun to function as Fed-funds dealers on a regional scale or on a correspondent basis.

### Early growth

Commercial banks first traded their ex-

cess balances at Federal Reserve banks during the recession of 1921, when some banks had excess reserves while others were pressed to maintain reserve balances. Brokers and dealers in acceptances and government securities, besides using Fed funds for their own purposes, also served as brokers between prospective borrowers and lenders of funds. However, the volume of trading was not large, rarely exceeding \$200 million a day. Trading died out during the Great Depression, and the survivors of that holocaust found themselves with excess liquidity and no suitable investments. The practice did not reappear in any volume until interest rates began to rise from their low depression and wartime levels in the late 1940's.

The volume of trading thereafter grew rapidly; after passing the levels of the 1920's in the early 1950's, volume quadrupled over the ensuing decade. Moreover, between late 1959—when the present statistical series began—and the middle of 1966, the 46 major banks which account for the vast bulk of the market increased their gross transactions (purchases plus sales) from \$1.4 billion to \$4.3 billion. (*All figures are given on a daily-average basis.*)

Even at the outset, Federal funds represented only one of a number of available credit-market instruments. During the 1920's, commercial banks, acceptance houses, stock market brokers, securities dealers, and other participants in the short-term money market could and did shift their funds among a variety of instruments—demand deposits, call money, acceptances, commercial paper, and Federal funds—in part, responding to changing interest-rate differentials. During the 1930's and 1940's, several of these instruments either declined in importance in the money market (acceptances) or disappeared from it entirely (interest-earning demand deposits, and call money through the call loan desk). The choices of instruments for making adjustments in



bank liquidity thus narrowed, and the relative importance of some instruments increased. Despite the later development of other means of adjustment, banks pressed for short-term funds generally sold government securities (mainly Treasury bills), borrowed at the Federal Reserve discount window, or borrowed from other banks through the purchase of Fed funds.

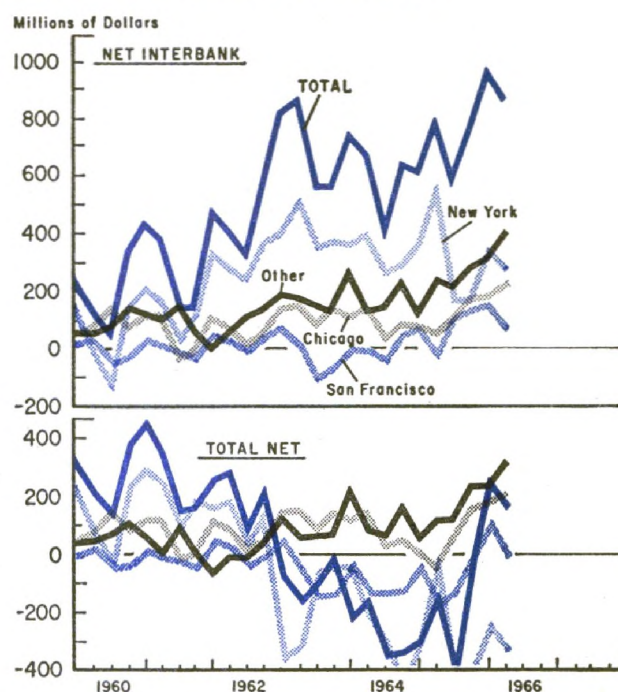
### Postwar growth

This third alternative became increasingly favored over the postwar period, primarily because of the general rise in the level of interest rates. Rising rates meant increased costs of discounting, increased risks of capital loss on Treasury-bill sales, and increased supplies of Fed funds as banks came to understand the opportunity costs of holding excess reserves. Improvements in the Federal Reserve's wire transfer facilities and in telephone and telewriter communication also lowered the transactions cost of Fed-funds trading relative to that of discounting and Treasury-bill trading.

At the same time, corporations have come to watch their short-term cash positions more closely, because of rising interest rates and the prohibition of interest payments on demand deposits, and this development has contributed to an increase in deposit turnover, with consequent instability for the liabilities of individual commercial banks. As a consequence, banks have come to rely on a reserve-adjustment medium which can be altered by large amounts on a day-to-day basis—the Fed-funds mechanism. Thus, in effect, rising interest rates and improved communications have increased the supply of Fed funds, while increasing deposit instability has generated new demands for Fed funds.

Government securities dealers, along with commercial banks, have contributed to the sharp postwar expansion of the market. Securities dealers, as a result of difficulties experienced during tight-money periods in obtaining their customary day-to-day financing

### Major banks record net purchases in interbank dealings but sometimes net sales in total transactions



from New York City banks in the form of clearing house funds, began to tap sources outside New York City through the financing procedure called the repurchase agreement.

Under such an arrangement, a dealer "sells" securities to a bank (or, through a bank, to another financial intermediary or corporation) in exchange for Fed funds. On the same day the dealer writes a check drawn on its account to the bank—but this check is not collected by the bank until the following day, and by that time the dealer has "bought back" the securities from the bank.

Until 1958, most Fed-funds transactions went through a single dealer in New York. However, as the market developed, some large banks felt it necessary to develop a more certain supply of Fed funds by becoming dealers themselves.

Several large banks became dealers on a national scale around the turn of the decade, and other banks began to do this on a regional



scale in more recent years. The practice of accommodating the Fed-funds needs of correspondent banks has also grown in recent years, to the point where most major banks now regard this as a normal service for their smaller correspondents.

### **Reinforced growth**

The growth of Fed-funds trading has slowed somewhat since 1962, apparently in response to a tighter monetary policy inhibiting the supply of funds and to a leveling off in the demand for financing by government securities dealers. Moreover, further rapid expansion was almost precluded by the fact that most large banks were already active in the market by that time.

Yet, in general, the growth of the Fed-funds market has reinforced itself. As the market becomes better organized, more banks are attracted to it. Then again, when some banks offer a Fed-funds service to their smaller correspondents, other banks must follow suit in order to hold correspondent balances. The market has come to provide a way for all but the smallest banks to maintain more fully invested positions.

The volume of gross transactions has tripled since the turn of the decade, to more than \$4 billion, and all regions of the country have shared in this growth. The major New York and Twelfth District banks have continued to dominate the market, but banks in Chicago and other centers have recorded the sharpest rise in transactions, as a reflection of the growing market participation by banks outside the major money-market centers. (The banks in the reporting sample include 8 in New York, 7 in the Twelfth District, 5 in Chicago, and 26 elsewhere.) In early 1966, New York banks accounted for almost one-half of gross transactions, Western banks accounted for more than one-sixth, and the remaining one-third of the total was distributed among banks elsewhere.

### **Two-way transactions**

The importance of New York and Western banks is demonstrated by their heavy volume of two-way transactions. Such transactions occur when an individual bank records offsetting purchases and sales of Fed funds, and a high proportion of two-way to total transactions indicates that a bank is doing a great deal of borrowing and relending of funds but relatively little trading to adjust its own reserve position.

New York and Western banks have consistently carried out a large volume of two-way transactions in recent years; in the first quarter of 1966, 56 percent of New York gross transactions and 66 percent of Twelfth District transactions have involved two-way trades. But banks elsewhere have increasingly moved in the same direction in recent years, that is, have begun to set up regional trading centers and to act as dealers in this activity.

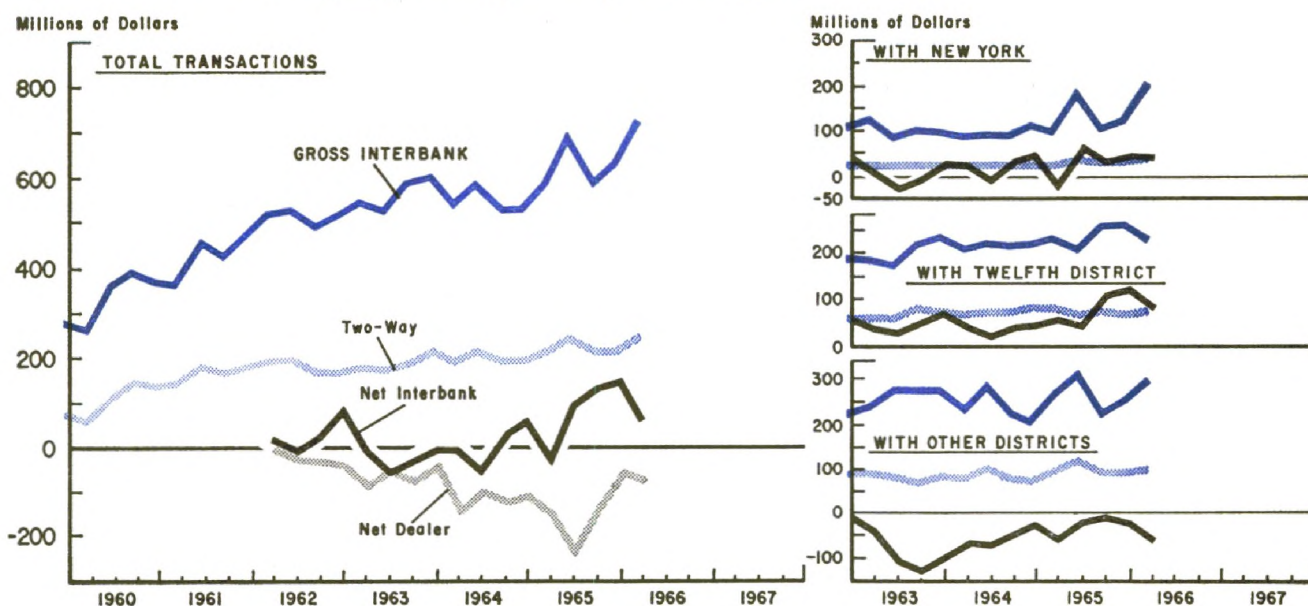
The Twelfth District's high proportion of two-way transactions and its overall importance in the market have developed because of such factors as time differentials and large bank size. The time differential between the West and other parts of the country permits large Western banks to sell Fed funds to Eastern banks late in the Eastern banking day, and at the same time allows them ample time to replenish their reserves by purchasing from smaller Western banks. Moreover, the large size of Western branch-banking systems—measured by deposits, the District contains 5 of the nation's 15 largest banks—enables these systems to handle very large requests for Fed funds with very little strain.

### **Interbank; security dealers**

District banks in the 46-bank national sample show a different pattern of net interbank transactions than banks elsewhere. Since the turn of the decade, Western banks have been net buyers and net sellers of funds with equal frequency, unlike New York and other banks,



## Major Western banks expand transactions with all sections of country . . . importance of role highlighted by heavy two-way transactions



which have increasingly become net purchasers of funds.

The net borrowing (buying) position of the total national sample reflects the growing pressure on large banks' reserve positions during the current tight-money period. Another factor has been the increased reliance on Fed-funds purchases (rather than discounting or Treasury-bill sales) as a reserve-adjustment mechanism. On the other hand, the frequent net selling position of Western banks reflects the time advantage which these banks possess in supplying Eastern banks with funds. But since the transactions of the banking system as a whole must net out to zero, the usual net borrowing position of the 46-large-bank sample indicates that the typical movement of Fed funds is from country and smaller city banks to the major city banks.

The major banks, especially those in New York and the Twelfth District, have also recorded substantial gains in loans to government security dealers. These dealer loans are predominantly sales of Fed funds for a single day or for indefinite short periods. Major Dis-

trict banks have expanded their loans from about \$20 million prior to 1962 to a \$100-million daily average in 1964 and 1965, as a consequence of increasing bank interest in this field, the growth of dealer inventories, and the expanded use of repurchase agreements. Nonetheless, District banks still do only a fraction of the business which New York banks handle in this field.

In overall terms, combining interbank and security-dealer transactions, District banks generally have recorded a net selling position. Like New York banks—and unlike Chicago banks and banks elsewhere—these Western banks have made extensive use of Fed funds as a vehicle for obtaining profitable short-term investments, and not only as a reserve-adjustment mechanism.

### Expansion everywhere

The large Western banks in the sample have expanded their transactions with every major section of the country, according to data which show the location of the trading partners of these banks. In the first quarter of 1966, these District banks recorded gross



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transactions of \$200 million with New York banks and an even greater volume of transactions with other banks.

Gross interbank transactions with New York banks were generally stable in the 1963-1964 period, at about \$100 million, but they have since fluctuated widely as special situations have arisen under tight-money conditions. Two-way transactions with New York have only accounted for about one-third of gross transactions—a considerably smaller proportion than has occurred in trading elsewhere. And in net interbank transactions with New York, District banks normally have been purchasers of funds, primarily in the fourth quarter of each year.

Gross interbank transactions within the Twelfth District have grown irregularly, ranging between about \$170 million in late 1963 and \$270 million in late 1965. Two-way transactions accounted for more than two-thirds of total transactions until late 1965, when the proportion dropped because of large purchases of funds from smaller Western banks. And again, in net interbank transactions, the major Western banks have consistently been net purchasers of funds, especially in the fourth quarter each year.

Gross transactions with banks elsewhere—outside the major centers of New York and the Twelfth District—have generally ranged

between \$220 million and \$320 million, with no particular trend. Two-way transactions of District banks have accounted for as much as three-fourths of total transactions with these other banks. In net interbank transactions, Western banks have consistently been net sellers, although their volume of sales has been smaller over the past year than it was in earlier periods.

This breakdown of Fed-funds trading activity shows that funds generally have moved from smaller Western banks to the larger Western banks and thence to banks outside New York or to government security dealers. Less regularity shows up in the trading pattern with New York City, perhaps because New York banks serve as a residual source of (or outlet for) Western funds.

At any rate, the major Western banks account for a very important share of the Fed-funds market outside New York City. The volume and the regularity of this activity, along with the high proportion of two-way transactions, attest to the dependence of smaller banks throughout the nation on the dealer activities of the major Western banks. A further breakdown of "other" banks by district probably would show less dependence on the part of some regions than of others, but the overall data nonetheless show the growing importance of the Twelfth District role.

—Jacob Allan Toby

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# Federal Reserve Policy Letter

*On September 1, the Presidents of the twelve Federal Reserve Banks sent a letter to all member banks regarding the growth of bank credit and the administration of credit assistance to member banks through the System's discount facilities. The full text of the letter follows:*

"It is the view of the Federal Reserve System that orderly bank credit expansion is appropriate in today's economy. However, that expansion should be moderate enough to help insure that spending—and particularly that financed by bank credit—does not exceed the bounds that can be accommodated by the nation's growing physical resources. An excessive expansion of bank credits would aggravate inflationary pressures that are already visible.

"While the growth of total bank credit and total bank lending has moderated somewhat as compared with last year, total bank loans plus investments have grown at an annual rate of over 8 percent during the first eight months of this year, and total bank loans at a rate of over 12 percent. Meanwhile, bank lending to business has increased at an annual rate of about 20 percent.

"It is recognized that business demands for bank credit have been particularly intense. While such credit requests often appear justifiable when looked at individually, the aggregate total of credit-financed business spending has tended towards unsustainable levels and has added appreciably to current inflationary pressures. Furthermore, such exceedingly rapid business loan expansion is being financed in part by liquidation of other banking assets and by curtailment of other lending in ways that could contribute to disorderly conditions in other credit markets.

"The System believes that the national economic interest would be better served by a slower rate of expansion of bank loans to business within the context of moderate overall money and credit growth. Further substan-

tial adjustments through bank liquidation of municipal securities or other investments would add to pressures on financial markets. Hence, the System believes that a greater share of member bank adjustments should take the form of moderation in the rate of expansion of loans, and particularly business loans.

"Accordingly, this objective will be kept in mind by the Federal Reserve Banks in their extensions of credit to member banks through the discount window. Member banks will be expected to cooperate in the System's efforts to hold down the rate of business loan expansion—apart from normal seasonal needs—and to use the discount facilities of the Reserve Banks in a manner consistent with these efforts. It is recognized that banks adjusting their position through loan curtailment may at times need a longer period of discount accommodation than would be required for the disposition of securities.

"This program is in conformity with the provision in section 201.0, par. (E) of the Board's Regulation A governing lending to member banks:

'In considering a request for credit accommodation, each Federal Reserve Bank gives due regard to the purpose of the credit and to its probable effects upon the maintenance of sound credit conditions, both as to the individual institution and the economy generally . . . '

"Federal Reserve credit assistance to member banks to meet appropriate seasonal or emergency needs, including those resulting from shrinkages of deposits or of other



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sources of funds, will continue to be available as in the past.

"A slower rate of business loan expansion is in the interest of the entire banking system and of the economy as a whole. All banks should be aware of this consideration, whether or not they need to borrow from the Federal Reserve. Management of bank resources in accordance with the principles outlined above can make a constructive contribution to sustained economic prosperity, and the Federal Reserve System is confident that the banks will give their whole-hearted support to this effort."



*On September 21, immediately after President Johnson signed a bill permitting greater flexibility in interest-rate ceilings, the Federal Reserve Board of Governors reduced to 5 percent from 5½ percent the maximum rate that member banks may pay on time deposits of less than \$100,000. This change in the Board's Regulation Q applies to "consumer-*

*type" time deposits that are deposited or renewed on or after September 26.*

*The Reserve Board left unchanged the 4-percent ceiling on regular savings accounts, as well as the 5½-percent ceiling on "business-type" time deposits of over \$100,000 (CD's) and the 4-percent and 5-percent ceilings on certain multiple-maturity time deposits.*

*The new action was one of a series of measures taken in recent months to temper the aggressive competition for funds among commercial banks and other financial institutions, and at the same time to assure an orderly and moderate rate of growth in bank credit in order to restrain inflationary pressures. Earlier actions included a lowering of interest-rate ceilings on time deposits with multiple maturities, two increases in the reserves that member banks must maintain against some of their time deposits—as well as the above statement concerning the need to adopt lending policies that will tend to reduce the expansion of business loans.*

## TWELFTH DISTRICT BUSINESS

Year and Month	Condition items of all member banks (millions of dollars, seasonally adjusted)				Bank debits 31 cities (1957-59 = 100)	Bank rates: short-term business loans	Total nonfarm employment (1957-59 = 100)	Industrial production (1957-59 = 100)		
	Loans and discounts	U.S. Gov't. securities	Demand deposits adjusted	Total time deposits				Lumber	Refined Petroleum	Steel
1959	15,908	6,514	12,799	12,502	109	5.36	104	109	101	92
1960	16,612	6,755	12,498	13,113	117	5.62	106	98	104	102
1961	17,839	7,997	13,527	15,207	125	5.46	108	95	108	111
1962	20,344	7,299	13,783	17,248	141	5.50	113	98	111	100
1963	22,915	6,622	14,125	19,057	157	5.48	117	103	112	115
1964	25,561	6,492	14,450	21,300	169	5.48	120	109	115	130
1965	28,115	5,842	14,663	24,012	182	5.52	125	111	120	138
1965: July	27,327	5,813	14,532	22,718	186	...	124	111	125	143
Aug.	27,283	5,881	14,521	22,805	180	...	125	109	122	139
Sept.	27,409	5,894	14,730	23,084	187	5.53	125	111	121	134
Oct.	27,595	6,203	14,705	23,261	188	...	126	114	122	126
Nov.	27,796	6,103	14,653	23,596	184	...	127	111	123	125
Dec.	28,115	5,842	14,663	24,012	187	5.62	128	118	115	121
1966: Jan.	28,497	5,840	14,761	23,869	195	...	129	120	122	128
Feb.	28,748	5,737	14,790	23,904	206	...	130	111	119	135
Mar.	28,938	5,638	15,027	24,164	212	5.89	130	108	117	143
Apr.	29,267	5,309	14,924	24,579	227	...	130	113	122	147
May	29,157	5,128	14,812	24,735	221	...	131	107	125	145
June	29,688	4,919	14,780	25,001	220	6.18	131	104	128	144
July	29,791	5,071	14,753	25,265	227	...	131	...	...	143



## Western Digest

### Banking Developments

Total bank credit increased \$22 million at District weekly reporting banks in the mid-August period (August 10-24). Loans declined \$84 million, but security portfolios rose by \$106 million over the two-week period . . . Business loans dropped by \$56 million, but the major part of this decline was due to seasonal loan repayments by retail trade firms. Loan demand from the manufacturing sector continued strong, on the part of both durable and nondurable goods industries. . . . Total time deposits rose \$74 million, despite a \$22-million reduction in deposits of states and political subdivisions. Savings deposits rose slightly—the first increase since midyear—and other consumer-type time deposits increased by \$85 million.

### Savings-and-loan Associations

District insured savings-and-loan associations lost \$199 million in savings accounts during July. However, this loss amounted to less than 1 percent of total savings, as opposed to a 1.6-percent loss at S&L's elsewhere in the nation. . . . Southern California associations accounted for over one-half of the District decline, but greater relative declines occurred in Idaho and Nevada, where outflows amounted to about 5 percent of total savings. . . . Real estate loan portfolios of District associations declined for the second month in a row during July. For the January-July period as a whole, loans closed were almost 40 percent less than during the comparable 1965 period. . . . S&L borrowings from the Federal Home Loan Banks and other sources continued to climb during July. The increase was \$139 million in the District and \$297 million elsewhere.

### Labor Force Developments

California's nonfarm employment remained virtually unchanged during August, and the state's unemployment rate rose from 5.0 to 5.2 percent over the month. (For the nation as a whole, the jobless rate remained unchanged at 3.9 percent during August.) California's rising jobless rate reflected the prolonged airline strike as well as the slowdown in the auto-manufacturing and construction industries. . . . Employment at California aerospace firms increased by 2,900 in August. This increase came on the heels of a very sharp (28,000) rise in District aerospace employment in the June-July period. The two-month gain represented about one-fourth of the total increase recorded by the industry since its spring-1965 lowpoint. . . . About 40 percent of the recently hired workers at California aerospace firms were non-production workers, whereas practically all of the workers hired in earlier months were assigned to production lines.



