Finance: funds widely available

Credit markets in 1976 were easier, on average, than in 1975. Moderate gains in economic activity were accompanied by stronger credit demands from the private sector; U.S. Government borrowing needs, although high, were lower than 1975 requirements. Meanwhile, increased earnings, savings, and efforts to build liquidity produced a very large supply of investment funds, especially through financial intermediaries.

With the objective of encouraging noninflationary expansion in the economy, Federal Reserve policy sought a moderate rate of monetary growth. Reserves to support deposit growth were provided at a lower average cost to banks. The discount rate was reduced twice—from 6 to 5½ percent in January and by another quarter to 5¼ percent in November. In mid-December the Board of Governors acted to reduce reserve requirements on demand deposits at member banks.

On balance, these forces resulted in lower interest rates and greatly increased fund availability. Although lenders continued to pay close attention to credit quality, financial institutions were in a good position to meet the needs of creditworthy borrowers. Competition for loan business and lower money market interest rates led to easier loan terms. Time and savings deposits rose rapidly as market yields declined. In view of this inflow and declining returns on loans and investments, a considerable number of banks and thrift institutions had reduced rates paid on some categories of deposits by year-end.

Record credit flows

On the basis of data covering the first three quarters of the year, it appears that the overall volume of funds raised in the credit markets (exclusive of flows to financial intermediaries) was in the neighborhood of $250 billion, nearly one-fifth higher than in 1975. Treasury and federal agency borrowing declined from 40 to 30 percent of the total, but remained the largest component. Funds raised by other borrowers were about 10 percent below the record 1973 totals despite an increase of roughly 30 percent in prices over the past three years. Local governments sold a record volume of new issues as market receptivity in this sector improved markedly. Household borrowing through consumer and residential mortgage credit was up almost 60 percent over 1975. Businesses tapped the markets for about one-quarter more, including equities, than in the previous year despite net paydowns of bank loans.

Market absorption of this record volume at lower interest rates attests to the huge supply of funds available for investment. Moreover, as market interest rates declined, savings and time deposits at financial intermediaries became relatively more attractive, and a large portion of investment funds reached the Treasury and the mortgage market through these channels.

The portion of funds advanced to nonfinancial sectors by commercial banks had been relatively small in 1975 and shrank somewhat further in 1976—to less than 10 percent of the total compared with 35 percent in 1973 when business credit demands were very strong. By contrast, nonbank financial institutions accounted for more than half of the total supplied as their deposit growth broke all previous records.

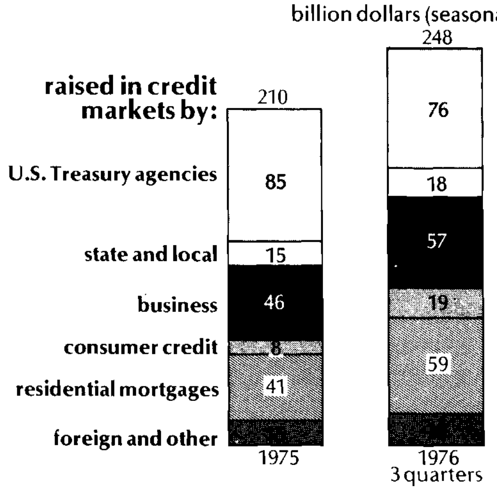
Business loans remain weak

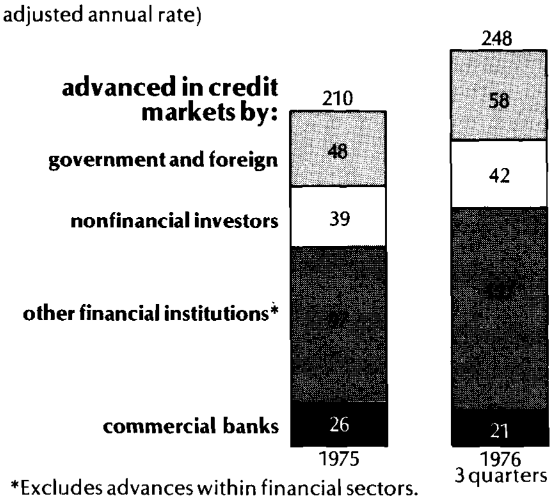
The modest expansion in bank credit was largely a reflection of the weakness in business loan demand, although acquisition of Treasuries slowed also. Continuing the downtrend that persisted throughout 1975, business loans at all commercial banks declined through midyear but were up about 1 percent for the year as a whole compared with a 4 percent decline in 1975. Smaller banks accounted for the gain. In late December

Credit flows reached new record as private sector borrowing rose . . .

. . . but banks' share continued to shrink

billion dollars (seasonally adjusted annual rate)





*Excludes advances within financial sectors.

commercial and industrial loans at large city banks were still $3 billion below year-earlier levels and would have been off even more except for the acquisition of highly liquid bankers' acceptances. Major corporations continued to pay down their bank borrowings with the proceeds of security sales, while rising earnings and cautious inventory policies cut their overall needs for outside financing.

While the banking industry enjoyed heavy savings inflows, growth in demand deposits continued modest and the large city banks allowed their negotiable certificates of deposit to decline as major businesses repaid loans. With little patronage by their principal customers, these banks found it difficult to use all available funds profitably even though smaller businesses borrowed more. The need to increase capital also acted as a constraint on deposit and loan expansion.

As usual, changes in the prime loan rate lagged market interest rates. But despite an unusually large spread between commercial paper rates and the prime rate at major banks during most of the year, expansion in commercial paper was also relatively small, reflecting business' modest needs and preference for longer-term financing. Meanwhile, for some banks that rely heavily on the money market as a source of funds, lower average interest costs helped to strengthen earnings that had been depleted by unusually heavy loan losses in the two previous years and to improve capital ratios.

As the year drew to a close, however, competition for loan business intensified. Most major banks reduced the prime to 6¼ percent and a few moved it down to 6 percent—the lowest in nearly four years. Nonprice terms were also reported eased somewhat, with more flexibility in compensating balance requirements and some term loans made at fixed rates. Some commercial banks acted to reduce their average cost of funds by ceasing to offer long-term high rate certificates and/or by reducing rates offered on some maturities below the applicable legal ceilings. Before year-end at least two regional banks announced reduction in the passbook savings rate. Such actions, however, appeared to be much less widespread for banks than among nonbank thrift institutions.

Interest rates—downtrend extended

The year began and ended with relatively easy conditions in the credit markets. Money rates and most bond yield averages were off by 100 basis points or more from December

1975 to December 1976. The downtrend was interrupted in the second quarter as money demand rose and the Federal Reserve supplied reserves to the banking system less freely in order to restrain rapid monetary expansion. The federal funds rate, which responds quickly to the availability of reserves required to support deposit growth, rose from the prevailing 4¾ percent level to about 5½ percent. As the lull in activity persisted and money growth slowed by midyear, however, the System resumed a more accommodative posture, and the fed funds rate declined gradually to a new four-year low of around 4⅝ percent before year-end.

Securities markets were extremely sensitive to any developments affecting expectations of policy changes. Long-term yields rose along with money rates in the spring but were affected also by the large amount of corporate securities offered, some in anticipation of rising interest costs.

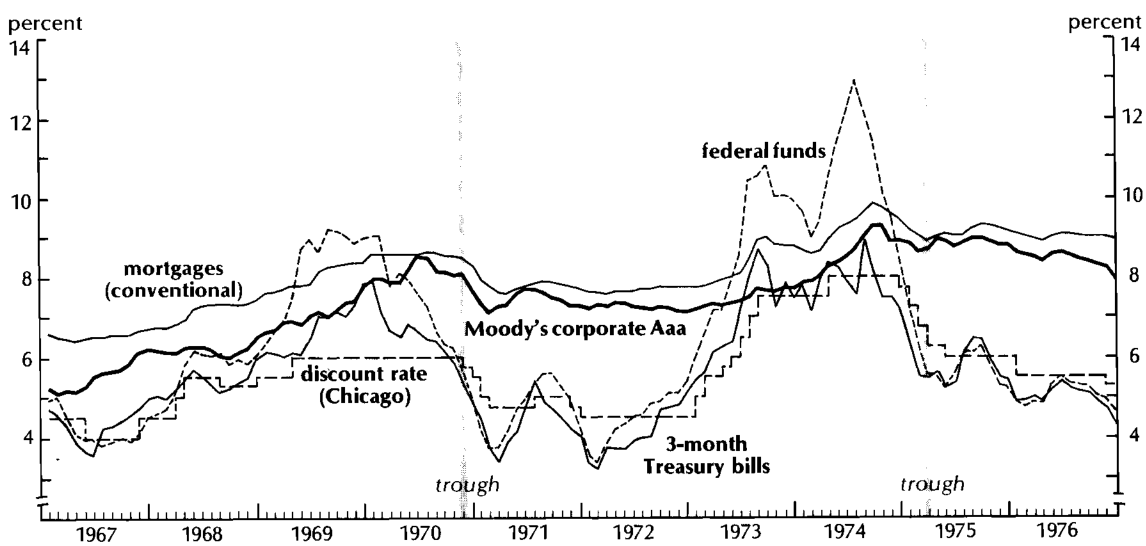
Wide spreads between short- and long-term rates persisted for an unusually long time. In the second year of earlier recoveries, short-term interest rates have usually risen rapidly while bond rates continued to edge down or to rise with a marked lag. In December, however, Moody's Aaa corporate bond yield average was still 360 basis points above 3-month Treasury bills, not much different from the spreads prevailing 20 months earlier.

The steepness of the yield curve over such a prolonged period reflects several factors that were less important in earlier cycles. These include a strong preference for liquidity on the part of both lenders and borrowers, investor expectations of continuing inflation, and the Treasury's policy of lengthening the average maturity of the public debt by much greater use of intermediate and long-term obligations rather than bills in its financings.

Monetary aggregates and policy action

In its efforts to provide a healthy financial environment for income expansion without inflation, the Federal Reserve pays close attention to the rate of expansion in the money supply on the theory that it is an important element in the economy's spending potential. The "monetary aggregates" include a number of measures of money.

Long-term interest rates lagged decline in money rates more than in the previous recovery



*Market rates are monthly averages of daily figures.

Besides currency and commercial bank demand deposits held by the public (M_1), broader concepts of money embrace various interest-bearing financial assets with a high degree of liquidity, particularly time and savings deposits. These aggregates, especially M1, often fluctuate rather widely in the short run and are not subject to direct control by the monetary authorities. Nevertheless, growth trends can be influenced over periods of several weeks or months.

The Federal Reserve System, in supplying reserves to the banking system to support deposit growth, pursues its monetary objectives via its influence on the price of these reserves in the market—the federal funds rate. The policy decision process involves an estimation of the level of this key money market rate consistent with the desired rate of monetary expansion in the weeks ahead. That level depends largely on the strength of credit demands in that same period.

The path of the fed funds rate over the course of 1976 was affected by the System's efforts to counteract developing trends in the monetary aggregates outside the growth ranges believed conducive to a healthy economy. Thus, following the rapid first-quarter increase in activity and the sharp April rise in the monetary aggregates, reserves were supplied through open market operations only at a somewhat higher federal funds rate. But as money growth slowed during the extended pause in the economic expansion, the System again accommodated reserve needs at a lower interest rate level.

Actual growth in the monetary aggregates over the year as a whole was generally consistent with the prospective ranges specified in the Board of Governors' quarterly reports to the Congress. (See table.) The so-called target ranges for M_1, M_2, and M_3 are set by the Federal Open Market Committee (FOMC) for annual periods from the average of the latest calendar quarter to the same quarter of the following year. Included in M_2, besides M_1, are savings and time deposits at commercial banks other than large negotiable CDs. M_3 has all the components of M_2 plus deposits and shares of mutual savings banks, savings and loan associations (S&Ls), and credit unions. During much of 1976 narrowly defined money supply tended to expand at the low end of the ranges specified while the broader aggregates were on the high side. In the final quarter M_1 was 5½ percent higher, M_2 11 percent higher, and M_3 13 percent higher than a year ago—all somewhat faster than 1975 growth.

The growth targets were themselves modified in the course of the year. Late in January the FOMC reduced the low end of the M_1 range, applicable to the period from fourth-quarter 1975 to fourth-quarter 1976, from 5 to 4½ percent. The upper end of the M_1 range was reduced from 7½ to 7 percent in July and again to 6½ percent in November. Since actual growth was already well below those levels, these changes did not entail any need to apply restrictive actions, but rather indicated the FOMC's resolve to resist any sustained tendency for monetary expansion to rise at a pace believed likely to aggravate inflation. The top ends of M_2 and M_3 were also lowered by 1 percentage point as higher market interest rates around midyear temporarily slowed savings inflows. But part of this was restored in the final quarter.

In setting the ranges and in judging whether the performance of the aggregates is satisfactory, the Committee takes account of developments that may change the relationship between the rates of expansion in money and income and between various concepts of money. Changes in payments practices in recent years have entailed substantial shifts from M_1 into M_2 and M_3. A significant factor in 1976 was the buildup of business savings deposits. These deposits, first permitted up to $150,000 per account at commercial banks in November 1975, were estimated to be in excess of $6 billion at year-end. Such balances can be transferred to checking accounts when needed.

An even greater impact on the expansion in broad money aggregates comes from fluctuations in market interest rates. Deposits have always served a mixture of savings and transactions functions, but the greater interest-sensitivity of savers in recent years

Broad aggregates accelerated more than M_1

Annual	M_1 Final quarter	M_1 Final month	M_2 Final quarter	M_2 Final month	M_3 Final quarter	M_3 Final month
	(percent change over year ago)					
1971	6.7	6.5	11.4	11.4	13.5	13.5
1972	8.4	9.2	11.2	11.4	13.3	13.4
1973	6.2	6.0	8.8	8.8	9.0	8.8
1974	5.0	4.7	7.7	7.2	7.1	6.8
1975	4.4	4.1	8.3	8.5	11.1	11.3
1976*	5.4	5.8	10.9	11.3	12.8	13.1

Quarterly	M_1 Average	M_1 Final month	M_2 Average	M_2 Final month	M_3 Average	M_3 Final month
	(percent change from previous quarter)					
1976-1	2.7	4.5	9.7	11.0	11.2	12.3
2	8.4	6.8	10.8	9.3	12.0	11.0
3	4.1	4.1	9.2	10.3	11.6	13.1
4*	6.0	7.3	12.1	12.9	14.0	13.7

*Preliminary.

. . .and prospective growth ranges were adjusted to reflect structural shifts

Date established	Base quarter	End quarter	M_1 Specified range	M_1 Actual	M_2 Specified range	M_2 Actual	M_3 Specified range	M_3 Actual
			(percent change from base to end quarter)					
1975 Apr.*	75-I	76-I	5.0-7.5	4.9	8.5-10.5	9.6	10.0-12.0	12.2
July	75-II	76-II	5.0-7.5	5.2	8.5-10.5	9.6	10.0-12.0	12.0
Oct.	75-III	76-III	5.0-7.5	4.4	7.5-10.5	9.3	9.0-12.0	11.5
1976 Jan.	75-IV	76-IV	4.5-7.5	5.4	7.5-10.5	10.9	9.0-12.0	12.8
Apr.	76-I	77-I	4.5-7.0		7.5-10.0		9.0-12.0	
July	76-II	77-II	4.5-7.0		7.5- 9.5		9.0-11.0	
Nov.	76-III	77-III	4.5-6.5		7.5-10.0		9.0-11.5	

*Initial projection from March to March. Later ranges based on average for quarter.

NOTE: All data are annual rates of change in seasonally adjusted daily average amounts.

has increased the variability of this mix. When yields on short-term investments, such as Treasury bills, fall below returns available on deposits, investment-type funds flow into deposits, swelling M_2 and M_3. This was the situation as 1976 drew to a close.

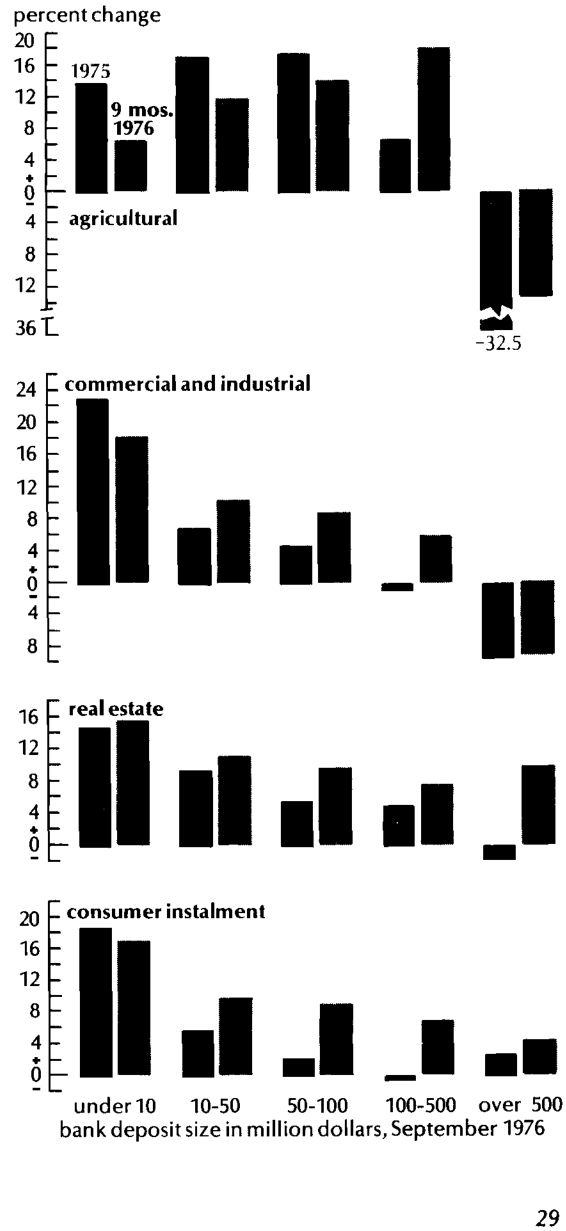
District banking

Reports from district member banks provide evidence of very substantial contrasts within the banking industry with respect to the impact of 1976 economic developments. District membership covers banking institutions with widely diverse business—from the multibillion dollar multinational giant to the small country bank whose services are oriented toward the residents of rural communities. While a relatively few major banking institutions dominate banking trends as measured by the total dollar volume of assets and liabilities, these trends often vary significantly from the experience of the great majority of smaller banks. Almost 70 percent of member banks in this district have total deposits of less than $50 million, while the 20 largest banks account for more than two-thirds of the assets and deposits of all member banks in the district.

Total loans and investments of all district members rose 6 percent in the year ended November 24, 1976, compared with 2 percent in the previous year. Loans declined by 1 percent at the large banks in the four largest district cities while rising 10 percent at other banks. The primary reason for this difference was the heavy repayment of business loans by large corporate customers of the major banks. At smaller banks business loans rose much faster than in 1975, reflecting rising credit needs of smaller businesses that do not borrow directly in the capital markets. Real estate and consumer loans rose faster at both large and small banks. Agricultural loans rose sharply at the small banks, as farm income declined. The very large banks reduced credit to agriculture—a very small portion of their business.

Most banks continued to build up their security portfolios, although at a slower pace than in the previous year. These gains, except in Michigan, were generally larger in the major cities where loan demand was weaker. In 1976, as in 1975, almost three-fourths of the rise in investments was in Treasuries, which now account for 40 percent of total portfolios—up from 30 percent two years ago. At the large banks almost two-thirds of the in-

Loans were stronger at the smaller banks



Member bank asset and deposit changes reflect area differences in credit demands

	Loans[1]	Securities	Demand deposits	Time and savings deposits
	(percent change, Nov. 24, 1976 from Nov. 26, 1975)			
Large banks[2]				
U.S. total	0.8	9.5	1.8	- 0.9
Chicago	- 2.1	17.0	0.6	- 8.3
Detroit	- 1.1	0.8	- 6.7	5.7
Indianapolis	- 4.2	29.4	6.5	4.2
Milwaukee	5.4	22.4	1.0	5.0
Des Moines	16.2	21.5	0.7	3.8
Other member banks				
U.S. total	11.3	9.7	5.4	14.3
Illinois	11.2	8.8	4.1	11.4
Michigan	10.9	10.8	4.3	12.0
Indiana	10.2	15.4	7.9	13.1
Wisconsin	9.7	9.9	0.7	10.8
Iowa	17.9	9.0	- 1.2	17.3

[1]Excludes federal funds sold.

[2]Weekly reporting banks.

crease in Treasury securities were in the one- to five-year maturity category, and holdings of longer-term issues nearly doubled. Lengthening in the average maturity of Treasury portfolios reflected both the larger proportion of longer issues sold and banks' efforts to maintain investment income in the face of declining short-term interest rates.

Time and savings deposits were again the major source of funds of member banks, with gains ranging from 11 to 17 percent in the five states excluding the major city banks. The relatively modest growth or decline at the city banks reflects the liquidation of almost $3 billion in large negotiable CDs, concentrated at the very large Chicago banks. Demand deposits were strongest at Indiana banks, while financing problems of Iowa farmers held down checking accounts at Iowa banks.

Deposit trends of district banks are affected not only by income, savings, and general swings in market interest rates but also by developments affecting their ability to compete with other financial institutions. Such competition takes two major forms—the amount of interest paid on deposits and deposit services offered. Regulation Q prohibits payment of interest on demand deposits and sets the maximum rates that banks can pay on consumer savings-type deposits, generally ¼ percentage point below those imposed on thrift institutions. With a growing number of S&Ls and credit unions now offering third-party payment services, the unique advantage banks once had as the sole sellers of checking accounts and the full package of financial services is diminished.

New developments in electronic funds transfer systems (EFTS) have important implications with respect to deposit competition. Off-premise teller machines and point of sale terminals in retail outlets have been ruled branches for banks but are not branches for S&Ls. Moreover, laws of district states governing branching are much more restrictive for banks than for S&Ls, expecially in Illinois. Most state legislatures are now considering changes in the statutes that would be more compatible with growing EFT capability. The specifics of these changes plus the results of the considerable amount of litigation already in process on new practices eventually will define new limits to the areas of competition. But the strength of credit demands will have an important bearing on how vigorously banks press these limits.