Finance: restraint without imbalance

Expansion in economic activity combined with accelerated price inflation last year to sustain the strong demands for credit and money that characterized 1977. Credit flows, spurred by growth in business and household borrowings, reached a new high, although the rate of increase was sharply less than in the two previous years.

In an effort to reduce inflationary pressures from excessive expansion in money and credit and stabilize the dollar in the international exchange markets, the Federal Reserve was less accommodative in providing reserves to the banking system. Moreover, the discount rate was raised to the highest level in its history.

In this environment, money-market interest rates rose sharply but held well below the peaks reached in 1974. Rates on Treasury coupon obligations and residential mortgages, however, rose to new highs, reflecting the heavy credit demands, rising costs of funds to lenders, and investor expectations of continued inflation.

While the cost of borrowing rose sharply, those willing to pay the higher rates had little difficulty obtaining financing. Moreover, because of actions taken to sustain the supply of funds available to finance residential construction, effects of restraint were spread more evenly over the economy than in previous periods of tight money. Nevertheless, growth in the credit and money aggregates slowed late in the year. If this moderation continues, it should have a favorable effect on inflation in the months ahead.

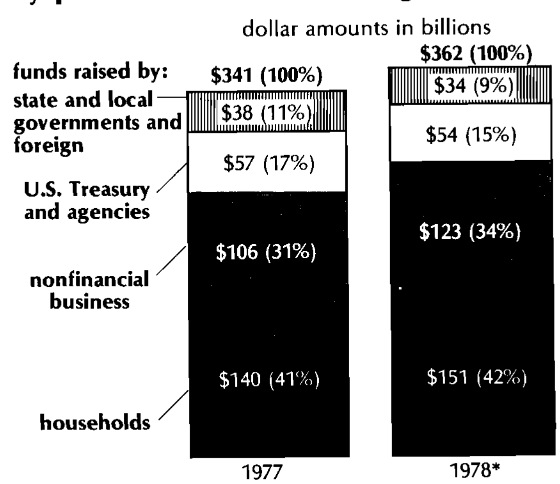
Record credit flows

Funds raised in the equity and credit markets by economic sectors other than financial institutions totaled $362 billion in 1978. While a record, this represented only a 6 percent increase over 1977. In the two previous years, increases ranged from 25 to 30 percent. More of the financing needs also reflected rising prices. Total funds raised amounted to 17 percent of nominal GNP compared with 18 percent in 1977.

All of the increase in funds raised in 1978 can be attributed to the private sector. Its combined net borrowing and equity sales increased $28 billion, to $274 billion. Treasury borrowing decreased somewhat. At $54 billion, federal borrowing accounted for 15 percent of the funds raised in credit markets. That is a historically high proportion for this stage of an economic expansion. State and local governments issued a large amount of securities during the year but invested much of the proceeds in Treasury securities.

Nonfinancial businesses raised $123 billion in 1978—16 percent more than in 1977.

Record credit flows were paced by private sector borrowing



*Preliminary.

Business mortgages, which accounted for more than 35 percent of the total funds raised by businesses, rose 27 percent more than in 1977. Demand for nonmortgage business credit rose even faster. The $30 billion increase in bank loans was one-third greater than in 1977 but slightly lower than the previous record set in 1973. Business borrowing in the commercial paper market also accelerated.

Households continued to raise more funds than any other sector, though the increase over 1977 was only about 7 percent. Home mortgages rose $94 billion, which, even with record-high mortgage interest rates, was slightly above 1977. Strong housing demand, combined with rapid appreciation in home prices, the general rate of inflation, and the tax advantages of home ownership, have largely offset the dampening effects of high nominal mortgage rates on home buying.

The supply of mortgage funds was sustained mainly by two factors. First, S&Ls, the main suppliers of household mortgage credit, increased their borrowings from the Federal Home Loan Banks by $12 billion. Second, beginning June 1, savings and loan associations were allowed to offer $10,000 minimum-denomination, six-month maturity time certificates at maximum issuing rates 25 basis points above the average weekly issuing rate on six-month Treasury bills with the same maturity. Through these money-market certificates (MMCs), S&Ls were able to compete more effectively for savings than in previous periods of high market interest rates. By late November, total outstanding MMCs at S&Ls were estimated at $37 billion.

Another factor helping sustain the availability of mortgages was the sale by some larger financing institutions of mortgages or mortgage-backed securities to supplement deposit flows.

Other household credit, led by a rapid rise in automobile loans, surged ahead by $57 billion. That was about 22 percent more than in 1977.

Lenders and investors supplied funds only at rising interest rates. Net credit advanced by commercial banks and their affiliates was $94 billion—16 percent more than the 1977 increase.

Nonbank financial institutions—S&Ls, savings banks, and credit unions—were again the biggest source of credit. Their net lending did not increase as fast as in 1977, however, reflecting a marked slowdown in deposit inflows early in 1978. Through the first half of the year, households stepped up their purchases of Treasury securities in response to rising yields on frequent offerings. Later, savings institutions' lending picked up again as MMCs attracted funds—though at comparatively high costs to the issuers. Nevertheless, the net increase in direct acquisition of credit-market instruments by households was close to twice as much as in 1977.

Funds advanced by foreign sources slowed to $31 billion from a record $42 billion in 1977. Foreign central banks purchased large amounts of U.S. government securities during the first quarter of 1978 and again in the fall. These were periods when the dollar was under extreme pressure in foreign exchange markets. Foreigners liquidated U.S. Governments in the second quarter.

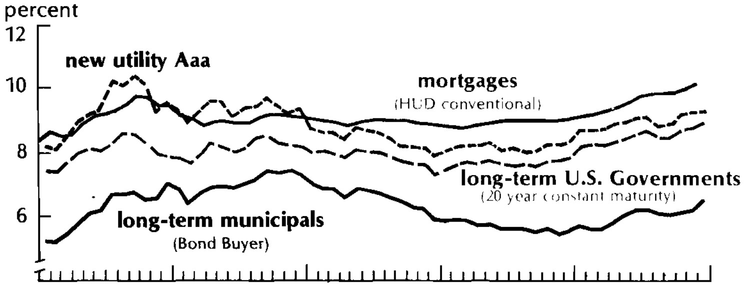
Sharply higher interest rates

As a result of record credit demands, increased inflationary expectations, and Federal Reserve policy actions designed to temper undesirably rapid growth in monetary aggregates, interest rates rose at an accelerated pace in 1978. Federal Reserve policy actions were manifested in a fed funds rate around 10 percent at the end of the year—about 350 basis points higher than at the beginning of the year—and discount rate of a record 9½ percent.

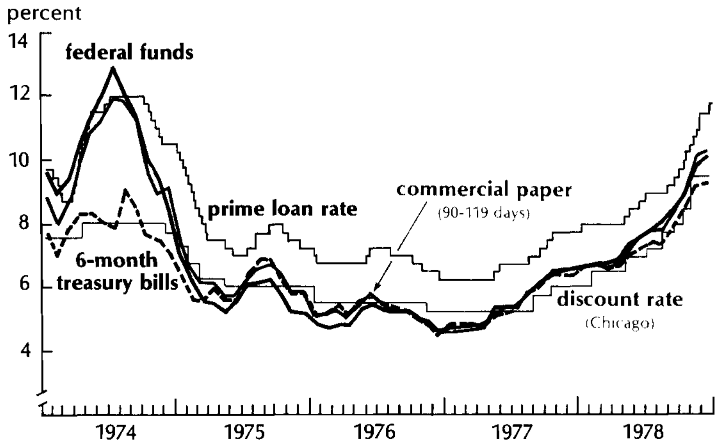
The year also saw the re-emergence of an inverted yield curve—short-term interest rates higher than long-term rates. In the past, inverted yield curves had usually come late in an interest rate cycle. In the previous cycle, yields on Treasury securities inverted in mid-1973 and remained so through late 1974.

Over the year, representative short-term

Rising long-term interest rates. . .



. . . were surpassed by sharply higher short-term rates



interest rates increased between 300 basis points on six-month Treasury bills and 400 basis points on 90 to 119-day commercial paper and the bank prime loan rate. Reflected in the increases were both the surge in business demands for short-term credit and monetary policy actions which usually have their initial impact on the money market.

Rates on long-term securities other than Treasury issues rose about 100 basis points over the year. Despite a record volume of new issues of state and local government securities, average yields on municipals remained well below the peak reached in the previous cycle. Strong demand for tax-exempt securities—by individuals and by property and casualty insurance companies—attenuated yield increases on these securities. Corporate bond yields, as measured by the new issue Aaa utility bond rate of 9.28 percent at year-end, were still about 100 basis points short of 1974 highs.

By contrast, yields on intermediate and long-term Treasury securities exceeded the peaks reached in the previous cycle. Twenty-year government bonds closed out the year at 8.90 percent—30 basis points above the previous record high in 1974. These record-high Treasury bond yields reflected both the coincidence of heavy net borrowing by the federal government with record private credit demands and the Treasury's continued efforts to lengthen the maturity structure of its debt.

Individuals that obtained home mortgage loans in 1978 also paid record-high interest rates. The conventional home mortgage rate average finished the year at 10.10 percent—30 basis points above its previous high established in 1974. However, without the new six-month certificates and record Federal Home Loan Bank advances, which enabled S&Ls to maintain loanable funds, even higher mortgage rates—or some nonrate rationing of mortgage credit—would have been likely.

Monetary aggregates and monetary policy actions

Domestic monetary policy was directed to the achievement of financial conditions consistent with reduced inflationary pressures and an improved international payments position while being supportive of moderate economic expansion. Given that excessive monetary growth is likely to induce expectations of increasing inflation, the Federal Open Market Committee responded to the strong demand for money and credit by supplying reserves only at a higher cost to the banking system. The increase in the discount rate, coming in early January in the wake of growing disorders in foreign exchange markets, signaled the added emphasis the Federal Reserve would put on international considerations in 1978.

Since 1975 the Federal Reserve's quarterly reports to Congress have specified annual ranges of monetary growth expected to be consistent with economic objectives.[1] Projections are made for M-1, (currency and demand deposits held by the public), M-2 (M-1 plus commercial bank savings and time deposits other than large CDs), and M-3 (M-2 plus mutual savings bank deposits and shares at S&Ls and credit unions).

The year began with growth in M-1 running well above the range specified for 1977 and M-2 and M-3 at the top of their ranges. Growth in each of these aggregates, measured from the fourth quarter of 1977 to the fourth quarter of 1978, was slower than in 1977.

Growth in M-1 was about 7 percent, compared with nearly 8 percent in 1977—but still above the 4 to 6½ percent range specified for the period QIV-77 to QIV-78. Growth in M-2 and M-3 was near the midpoints of their specified ranges. The increase in M-2 was about 8 percent, down from 9.8 percent in 1977 and well within its 6½ to 9 percent target range. The increase in M-3 was about 9 percent, down from 11.7 percent in 1977 and also within its 7½ to 10 percent range. As usual, however, there was considerable variation in growth rates over the year, which made it difficult to discern underlying trends as the year progressed. Growth in M-1 did not slow significantly until the last quarter.

Policy actions were aimed at reducing inflation and strengthening the dollar while seeking to sustain moderate economic growth. The year began with the Board of Governors approving an increase in the discount rate from 6 to 6½ percent. The rate Federal Reserve banks charge on loans to member banks was increased because the Federal Reserve believed "the recent disorder in the foreign exchange market constitutes a threat to orderly expansion of the domestic and international economy."

In support of this action, the FOMC became less accommodating in supplying reserves to the banking system and allowed the fed funds rate (the market price of reserves) to move up from 6½ percent to 6¾ percent. Weather and strikes, however, reduced both economic activity and the need for transaction balances through the rest of the first quarter and the fed funds rate leveled off.

With the economy rebounding in the second quarter, transaction balances surged. To restrain monetary growth without choking off financing needed to sustain real activity, the FOMC moved gradually to increase the cost of deposit-supporting reserves. By mid-August, the fed funds rate was near 8 percent.

Increases in the discount rate were approved in May (to 7 percent) and July (to 7¼ percent) to bring the discount rate into closer alignment with other short-term interest rates and thus reduce the incentive for banks to borrow reserves at the discount window.

With foreign exchange markets still disorderly and domestic inflation serious, the discount rate was raised another 50 basis points in August (to 7¾ percent), and the Board of Governors announced that reserve requirements on foreign borrowings were being reduced to zero.

The persistence of inflation and problems with the dollar combined with another surge in monetary aggregates in late summer to prompt the FOMC to tighten money-market conditions further. By late October, the fed funds rate was around 9¼ percent. Another increase in the discount rate (to 8 percent) had already been approved in September, and in October it was raised to 8½ percent.

The package of policy actions announced in support of the dollar on November 1 in-

[1]From 1975 through 1977, quarterly reports to Congress were in response to House Congressional Resolution 133 passed March 24, 1975. The Federal Reserve Reform Act of 1977, approved November 16, 1977, amended the Federal Reserve Act to require such reports.

Monetary growth in 1978 slowed from previous year

	M-1		M-2		M-3	
	Projected range	Actual	Projected range	Actual	Projected range	Actual
	(percent, seasonally adjusted annual rates)					
Annual*						
1973		6.2		8.8		9.0
1974		5.1		7.7		7.1
1975		4.6		8.4		11.1
1976	4.5–7.5	5.8	7.5–10.5	10.9	9.0–12.0	12.8
1977	4.5–6.5	7.9	7.0–10.0	9.8	8.5–11.5	11.7
1978	4.0–6.5	7.2	6.5– 9.0	8.0	7.5–10.0	9.1
1979**	2.0–6.0		6.5– 9.0		7.5–10.0	
Quarterly						
1978-1		6.2		6.9		7.7
2		9.9		7.9		7.8
3		7.6		8.9		10.1
4		4.4		7.5		9.7

*Annual data based on fourth-quarter averages.

**Ranges in effect at the end of 1978 applying to the third-quarter 1978 to third- quarter 1979 period.

cluded an increase of a full percentage point in the discount rate to a record 9½ percent and a supplementary 2 percent reserve requirement on large time deposits at member banks. At the same time, open market operations were designed to supply reserves consistent with a fed funds rate between 9½ and 9¾ percent. The FOMC agreed before year-end to aim for a fed funds rate of 10 percent.

Despite the momentum of the economy, growth in both M-1 and M-2 slowed appreciably in the last two months of the year. In addition to earlier policy measures, another factor weakening M-1 in the last few weeks of the year was the introduction of automatic transfers. Effective November 1, an amendment to Federal Reserve Regulation D permitted banks, on preauthorization by customers, to cover overdrafts by transferring funds automatically from savings to checking accounts (ATS). By year-end, balances in savings accounts authorized for transfer under ATS arrangements were estimated at more than $3 billion. Of that, 50 to 60 percent was believed to have been shifted out of demand deposits.

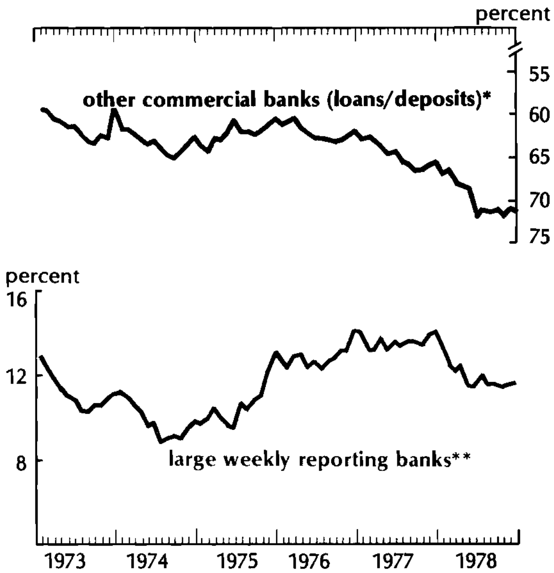
Recognizing the uncertainty of effects of ATS on M-1, the FOMC lowered and widened the M-1 target range for the year ending with the third quarter of 1979—to 2 to 6 percent—and placed more emphasis on M-2 in assessing the behavior of the aggregates. M-2 was largely unaffected by ATS-related shifts. The attractiveness of savings and small time deposits, however, including bank MMCs with maximum rates 25 basis points less than S&Ls could pay, declined relative to other outlets available for savings. Some investors, giving increased weight to the probability that interest rates were nearing their peaks, acted to extend currently high returns by lengthening maturities.

Bank loans and liquidity

Commercial banks feel pressures from restrictive monetary policy from two sides. Because of rising prices and the growing need for working capital—plus an unwillingness to issue long-term debt at current interest rates—business demand for bank credit increases. At the same time, loanable funds become less available and more expensive.

Both elements were at work in 1978. While the expansion of total funds raised in credit markets slowed, outstanding loans and investments of commercial banks rose at about the same pace as in 1977—11 percent. Loans accounted for most of the rise. Bank holdings of state and local securities continued to expand, but the expansion was largely offset by a decline in Treasury issues.

Liquidity ratios weakened at all banks in 1978



*Last Wednesday of the month except for June and December Call dates. Total loans exclude loans to banks and total deposits exclude cash items in process of collection.

**Ratio of liquid assets to liabilities. Monthly averages of Wednesday figures. Liquid assets include Treasury and other securities maturing in one year or less, loans to brokers and dealers and domestic commercial banks, holdings of bankers' acceptances and gross sales of fed funds. Liabilities are total liabilities less capital accounts, valuation reserves, and demand deposits due to banks.

Total bank loans increased 15 percent, also about the same as in 1977.

Loan growth and smaller savings inflows reduced bank liquidity significantly. This did not result in any appreciable tightening in loan policies of large banks, since many were still below desired loan levels. Nor was there any evidence of severe constraint on the availability of credit overall. By year-end, however, even large banks were screening applications more carefully, and there were signs that some potential applicants were discouraged by the high costs of borrowing.

Real estate and consumer loans were again the strongest elements of growth in bank credit last year. Both rose more than 18 percent, matching the record 1977 gains. Loans to business rose rapidly in the first half, but later slowed. For the year as a whole, commercial and industrial loans rose $27 billion. That was an increase of 13 percent, compared with 12 percent in 1977 and 20 percent in 1973. Business lending picked up at the very largest banks, however, while moderating at smaller banks where demands had been strong in 1976 and 1977.

Aggressive competition for loan business and the purchase of participations from regional banks that were loaned up helped bolster loans at large banks. There were other elements, however, holding them down. Outstanding commercial paper issued by large nonfinancial firms rose by almost a third last year. Business loans at U.S. branches and agencies of foreign banks were also up sharply. The cost of funds from these sources was generally less than charges based on the bank prime loan rate.

Despite the competition by large domestic banks for loan business, the prime rate was increased 14 times last year, rising to within a quarter-point of its historic 12 percent peak reached in mid-1974. Late in the year, some banks adopted a "two-tier" prime. Under this arrangement, when the prime rate set for large borrowers rose above a specified level, the base rate for small companies was set at some margin (such as 125 basis points) below the prime. While this arrangement mitigated to some extent the heavy interest burden on small businesses, by keeping the rates on most of their lending closely aligned with the marginal cost of loanable funds, the major banks tempered loan volume and avoided the squeeze on earnings they had experienced in 1973.

Growth in demand deposits continued strong throughout most of 1978, but as market interest rates rose, savings inflows dwindled. Savings and small-denomination time deposits, which had supplied almost $32 billion of loanable funds in 1977, rose only $16 billion in 1978, with most of the gain attributable to the new MMCs. While MMCs helped stem outflows into direct market investments, because of the better return on identical obligations offered by S&Ls, they did not produce a great deal of new money for banks.

With consumer-type savings flows weak and the need for loanable funds rising, banks increased their reliance on certificates of deposit of $100,000 or more, which are exempt from rate ceilings. Altogether, large CDs increased about $47 billion last year, financing roughly half the growth in total bank credit. Negotiable CDs issued by large banks accounted for half this gain. Outstandings at year-end were at a record $100 billion.

Rates paid for these funds ranged from 10½ to 11½ percent in the last two months of the year, and their cost was increased even more by the imposition of the 2 percent marginal reserve requirement in early November.

As banks found deposits insufficient to meet credit demands, they also tapped "nondeposit" sources of funds. These sources—which include fed funds and security repurchase agreements with nonbanks, borrowings from foreign branches, and sales of loans to nonbank affiliates—rose about $15 billion.

District banking

Credit growth at banks in the Seventh Federal Reserve District kept pace with the expansion of bank credit nationwide. Total loans and investments of member banks in the district, exclusive of interbank loans, rose 10.5 percent, compared with 8.8 percent in 1977.

Nearly all the expansion was accounted for by loans, which rose more than $10 billion. That was an increase of 15.7 percent. Holdings of Treasury securities declined almost $1.2 billion, more than offsetting the dollar gain in holdings of municipals, agencies, and other securities. Portfolios of non-Treasury securities rose only 3.9 percent, compared with 7 percent in 1977.

In contrast to the two previous years, loans expanded faster at large banks than at small and medium-sized banks. Loans at large banks submitting weekly condition reports increased 16.5 percent. Gains were especially strong in Chicago. Loan growth at the large banks was broadly based. Gains in all three of the main loan categories—consumer instalment, real estate, and commercial and industrial—were more than 15 percent. Loans to nonbank financial institutions also rose, while loans on securities declined from a year earlier.

Loans at small banks—for which a breakdown by type is not yet available—rose 13 percent, down from 17 percent in 1977. While loan demand was reportedly strong, many of these banks had to tighten their lending policies because of greatly reduced liquidity.

Aggregate demand deposits for all member banks in the district were virtually unchanged over the year, leaving net growth in loans to be financed by interest-bearing funds. Total time and savings deposits at all

Strong loan demand set pattern for district banking
(Nov. 30, 1977 to Nov. 29, 1978)

	Loans[1]	Securities	Deposits: Demand	Deposits: Negotiable CDs[2]	Deposits: Other time and savings
			(percent change)		
Large banks[3]					
Chicago	19.3	-12.4	2.5	28.9	-0.8
Detroit	15.2	1.7	-6.9	64.9	1.4
Indianapolis	9.5	- 7.2	8.6	22.8	4.1
Milwaukee	16.7	21.6	1.2	8.9	0.6
Des Moines	16.6	12.6	2.8	187.5	8.6
Other member banks					
Illinois	13.7	1.5	2.9		6.5
Michigan	13.8	4.5	5.3		10.2
Indiana	15.0	3.1	4.3		6.7
Wisconsin	11.4	1.5	-2.3		5.0
Iowa	11.1	3.2	7.1		9.2

[1]Excludes fed funds sold.
[2]Data not available on negotiable CDs at smaller member banks.
[3]Large weekly reporting member banks.

member banks in the district increased 8.2 percent—11.6 percent at large banks and 7.8 percent at other banks. Excluding large negotiable CDs, time and savings deposits at large banks rose less than 1 percent.

Gains in time and savings deposits at money-center banks in Chicago and Detroit included an increase of more than $600 million in MMCs after June 1. After November 1, all banks in the district with $1 billion or more in deposits offered their customers automatic transfer service. By year-end, savings balances authorized for transfer at these banks totaled more than $170 million in about 19,000 accounts.

Bank holding company developments

Eighty-five bank holding company applications were decided on from the Seventh District last year compared with 98 in 1977. Two of the sixty one-bank holding company formations were denied, while only one of the twenty multibank acquisitions and proposals for additional shares was denied. Three applications for acquisition of existing nonbank activities were approved as were two bank holding company mergers.

Nationwide, 523 applications were completed last year, compared with 428 in 1977. The record was set in 1973, when 723 applications were completed.

The Supreme Court has found that the Board of Governors has authority under the Bank Holding Company Act of 1956 to deny the formation of a bank holding company solely on grounds of financial or managerial unsoundness. The decision, in *Board of Governors of the Federal Reserve System v. First Lincolnwood Corporation*, was delivered December 11.

The court found that the Board's authority is not limited to situations where the formation of a holding company would cause a bank to be unsound or where it would exacerbate the unsoundness of a bank. The court, therefore, affirmed authority of the Board of Governors to require that a bank's financial position meet Board standards before a bank holding company application is approved. This is regardless of the agency that is the bank's primary regulator.

Newly enacted legislation

Two fairly new pieces of legislation will have a direct effect on banks and bank holding companies. One is the Community Reinvestment Act of 1977. The other is the Financial Institutions Regulatory and Interest Rate Control Act of 1978.

The major purpose of the Community Reinvestment Act (CRA) is to encourage subject financial institutions—banks, savings and loan associations, and mutual savings banks—to meet the credit needs of their communities, including low- and moderate-income neighborhoods. This has to be done, of course, in accordance with safe and sound operations.

When applications for branches, mergers, charters, deposit insurance, and bank holding company acquisitions are filed, the regulatory agency will assess the institution's past performance to determine if the credit needs of the *entire* community are being met.

Financial institutions had to have CRA statements delineating their local lending community and the types of credit available on file by February 4, 1979. The statement and all correspondence regarding the institution's CRA compliance must be available to the public. The availability of this information had to be announced in a public notice posted in the lender's lobby by the deadline. The purpose of the information is to improve public awareness of the organization's obligation to the community, especially low- and moderate-income neighborhoods.

Several sections of the Financial Institutions Regulatory and Interest Rate Control Act (FIRA) relate specifically to banks and bank holding companies. Under this act, the Board of Governors can require a holding company to divest itself of a nonbank subsidiary or cease a nonbanking activity when there is reason to believe the financial safety of a subsidiary bank is at stake.

The act also deals with insider transactions. Aggregate total loans of more than $25,000 to an officer, director, or 10-percent shareholder require advance approval of a majority of the directors, not including the interested party. These loans have to be made on essentially the same terms as comparable loans made at the same time. Overdraft payments on the accounts of officers and directors are prohibited. The act also authorizes the Board of Governors to assess civil penalties of $1,000 a day against banks and individuals for violations of the Bank Holding Company Act. Cease and desist orders can be brought against individuals as well as banks and bank holding companies.

Regulatory agencies can remove officers, directors, or others involved with a bank for violating a final cease and desist order. Individuals that have engaged in unsafe or unsound banking practices that might cause a bank to suffer financial loss or that have gained financially as a result of personal dishonesty or willful disregard for a bank's safety and soundness can also be removed.

Banking structure will be affected by Title II of FIRA, which deals with management and director interlocks in all types of depository institutions. Interlocks between banks (or thrift institutions) in the same SMSA—or the same, contiguous, or adjacent city, town, or village—are prohibited. The SMSA test does not apply to financial institutions with assets less than $20 million. Interlocks are also prohibited, regardless of geographic limits, where one institution has assets of more than $1 billion and the other institution has assets exceeding $500 million. Existing interlocks that would otherwise be legal are grandfathered for ten years.

Title VI of FIRA, also called the Change in Bank Control Act of 1978, gives regulatory agencies authority to disapprove an individual's acquisition of control of a bank holding company or an insured bank. An individual has to give to the agency 60 days prior written notification of the proposed acquisition. The applicant must furnish personal, financial, and legal history, as well as plans for the organization to be controlled. The proposed acquisition can be denied on either competitive or managerial grounds. Under Title VI, insured banks are required to report any loans secured by as much as 25 percent of the stock of another insured bank.

Another significant change brought on by FIRA is the establishment of a new federal financial institution examination council. The council will consist of a governor of the Federal Reserve System, the Comptroller of the Currency, and chairmen of the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the National Credit Union Administration. The council will make recommendations for the development of uniform reporting and examination standards for financial institutions supervised by federal agencies.