Finance: restraint versus inflation

Inflation was a dominating force in financial markets in 1979. Despite a slowing economy, credit flows were only slightly less than the record growth reached in 1978. Against the Federal Reserve's intensified efforts to fight inflation by monetary restraint, credit demands pushed interest rates far higher than the country had seen in this century. But inflation itself, combined with the public's sinking hopes that it would diminish much in the foreseeable future, was an important element contributing to high interest rates.

Although expensive, credit remained generally available in most sectors of the financial markets—even for residential mortgages, which had been severely affected in earlier periods of tight money. As usual in the late expansion phase of the business cycle, business increased its share of the total demands on credit markets, and commercial banks became more important as suppliers of funds, financing their own growth mainly by increased reliance on money market sources and the six-month money market certificates. Reflecting the combination of high interest rates and regulatory ceilings on savings and small time deposits, many consumer funds were recycled to lending institutions through money market mutual funds. The funds were heavy buyers of large CDs, which are not subject to rate ceilings.

Actions to restrain rapid expansion in money and bank credit—to combat inflation, speculative activities, and a weakening dollar—intensified in early October. At that time the Federal Reserve announced that all its restrictive policy tools were being brought to bear in an effort to reduce credit growth and keep monetary aggregates from exceeding the target ranges set in February for the year as a whole. Money and credit growth moderated significantly in the fourth quarter.

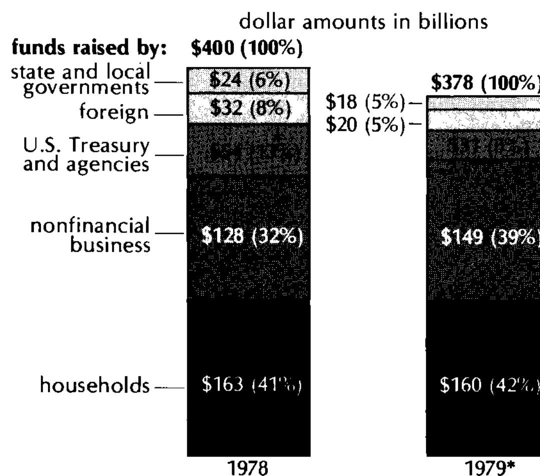
Credit market financing down

Aggregate credit flows were down last year for the first time since 1974, largely because of weakness in the fourth quarter when conditions were tighter. Despite higher inflation, net funds raised in the debt and equity markets by nonfinancial sectors were an estimated 5 percent lower than in 1978. This financing amounted to 16 percent of nominal GNP, down from 19 percent in 1978.

Of the major nonfinancial sectors, only business increased its effective credit demands. Combined net business borrowing and equity sales totaled about $150 billion, more than in 1978. As their external financing needs increased, firms relied more on short and intermediate-term borrowing both in the commercial paper market and from banks. Commercial bank loans accounted for about a third of the net new business financing, the dollar increase exceeding the earlier record set in 1973. Commercial mortgage financing also rose sharply. The pace of bond financing, on the other hand, remained moderate as corporations avoided increasing their long-term debt at prevailing high interest rates.

Households, with borrowings at $160 billion, remained the biggest credit users. This debt rose about 2 percent less than in 1978, however, mainly because of the slower

Less funds raised by all sectors but business



*Preliminary.
NOTE: Totals may not add due to rounding.

growth in auto loans. Despite record-high nominal mortgage interest rates, home mortgage lending remained close to the historically high 1978 gain.

As record-high short-term interest rates constrained mortgage lending at savings and loan associations—the single most important source of funds to the home mortgage market—thrift institutions' share of this market declined. Many savers switched from S&L deposits to such higher yielding investments as Treasury securities and money market mutual fund shares. Exacerbating S&Ls' problems was the elimination of their rate advantage over commercial banks in selling money market certificates. In mid-March, the rules were changed to eliminate the quarter-point differential when the ceiling rate is 9 percent or more. At the same time, both banks and savings institutions were prohibited from compounding interest on money market certificates. At times during the year, some S&Ls chose to limit their mortgage lending while directing more funds to money market instruments. This was a response to the pressure on earnings as the marginal cost of funds exceeded the then-current mortgage loan rates, a problem made worse in some areas by state usury ceilings. Moreover, as mortgage rates accelerated sharply late in the year, demand for mortgage credit declined. The rapid increase in mortgage pools ($28 billion in 1979 against $18 billion in 1978) played a major part in maintaining the flow of funds into home mortgages.[1]

Credit demands of government were drastically lower last year. Combined federal, state, and local government net borrowing was nearly 40 percent less than in 1978. Total government borrowing accounted for 13 percent of the funds raised by all nonfinancial sectors. That was the lowest percentage of the total since 1973.

Commercial banks supplied about one-third of total credit market financing—slightly more than in 1978 despite a reduced share in the final quarter. An increased portion of household savings was channeled into credit markets through money market mutual funds. Assets of these funds increased more than $30 billion. Direct investments by households in credit market instruments and equities increased about $50 billion, only slightly less than in 1978.

In contrast to 1978, when foreign sources supplied credit markets $40 billion, foreigners liquidated investment in credit market instruments last year by more than $5 billion. Strength of the dollar relative to foreign currencies, especially during the first half of the year, greatly reduced foreign exchange market intervention by central banks, thereby reducing their demand for U.S. government securities.

Interest rates to record highs

Both short and long-term interest rates ended the year sharply higher than at the beginning. Most interest rates passed the peaks reached the previous interest rate cycle. Movements responded to comparatively strong credit demands, increased inflationary expectations, and action taken by the Federal Reserve to curb monetary and credit growth. By year-end, the Federal Reserve's discount rate stood at a record 12 percent, up 250 basis points during the year.

The inverted yield curve that emerged in the fall of 1978 continued through the end of 1979, reflecting investor expectations that rates would soon decline. In the previous cycle, a similar yield curve pattern lasted from mid-1973 through late 1974.

With the economy showing signs of weakening and only a modest uptick in the federal funds rate (then the key operating target of Federal Reserve open market policy), other short-term interest rates were quite stable in the first half of 1979. Later, as the Federal Reserve responded to rapid

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[1]These are mortgage pools against which marketable securities have been issued. Timely payment of interest and principal is guaranteed by either the Government National Mortgage Association or the Federal Home Loan Mortgage Corporation. The mortgage pools are made up predominately of single-family home mortgages. Some, however, are composed of multifamily or farm mortgages.

monetary growth accompanied by continued high inflation and a stronger-than-expected economy with a more restrictive monetary policy, short-term interest rates increased. Increases ranged from 250 basis points on six-month Treasury bills to 400 basis points on the bank prime loan rate. Late in the year, these rates eased down slightly as credit demands subsided.

Bond yields, as measured by standard rate series, rose by as little as 80 basis points on long-term municipals to more than 200 basis points on new high-grade utility issues. As with short-term yields, most of the increases were late in the year. Except in the municipals market, long-term yields exceeded historical highs by more than 100 basis points. The tax-exempt market benefited from a reduction in gross offerings. The amount offered would have been still less, except for the continued issuance of mortgage revenue bonds. Demand for municipal securities was especially strong from property and casualty insurance companies.

Yield spreads between long-term Treasury and corporate issues widened, partly reflecting the reduction in Treasury financing as the deficit narrowed. Quality spreads also widened but far less than when interest rates approached their peaks in 1974.

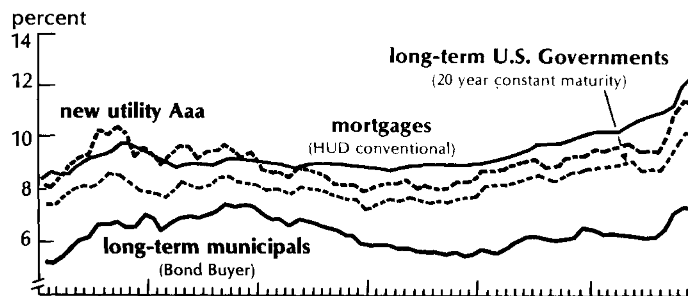
Mortgage interest rates, already at record highs when the year began, rose another 250 basis points before it ended. By year-end, rates on standard new mortgages averaged around 13 percent, plus points. Mortgage demand remained strong as consumers continued to view housing purchases as an inflation hedge. Many state usury ceilings were lifted or suspended to sustain the supply of mortgage funds. Further, as the cost of funds increased for mortgage lenders, mortgage rates were raised to maintain profit margins. In addition to the increases in contract rates, nonprice forms of mortgage credit rationing, such as larger downpayments and shorter maturities, became widespread.

Monetary aggregates and policy actions

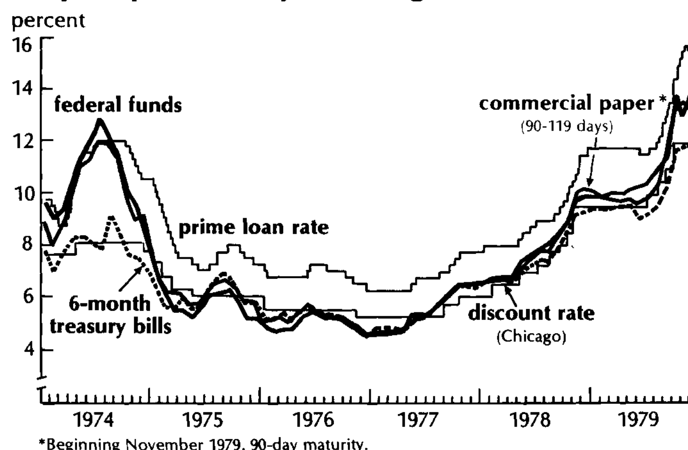
Last year was the first year that monetary policy decisions were reviewed within the framework of the Full Employment and Balanced Growth Act of 1978. This act (Humphrey-Hawkins) provides for a more formal coordination between monetary and fiscal policy.

In February, the Federal Open Market Committee set target monetary and credit aggregate growth ranges for the period from the fourth quarter of 1978 to the fourth quarter of 1979. In the judgment of the com-

Most long-term interest rates and . . .

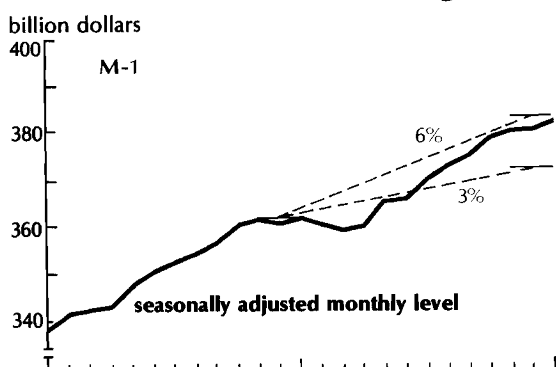


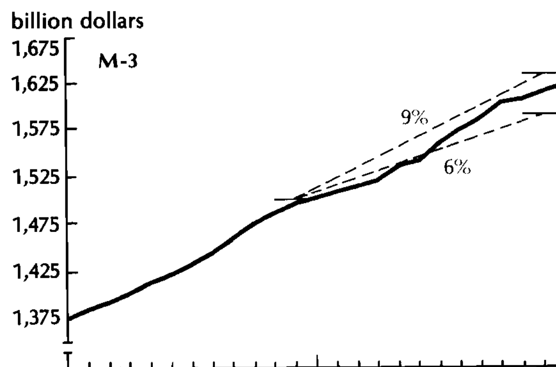
. . .short-term interest rates surpass previous cyclical highs



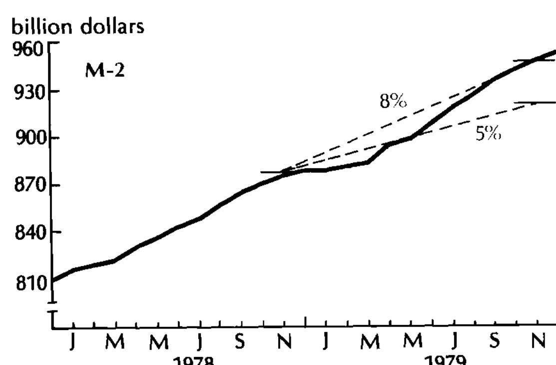
*Beginning November 1979, 90-day maturity.

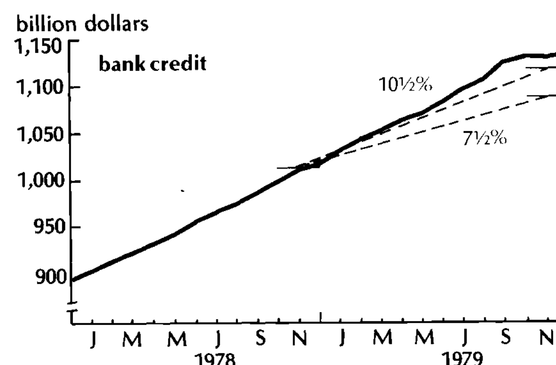
M-1 and M-3 within 1979 ranges . . .





. . . but M-2 and bank credit above





NOTE: Ranges specified from 3-month average in fourth quarter 1978 to 3-month average in fourth quarter 1979. Bank credit data adjusted for breaks in series due to reclassifications.

mittee, monetary expansion within these ranges would be consistent with achieving the broader economic objectives that were also stated goals of fiscal policy—the gradual unwinding of inflationary pressures, the maintenance of a stronger position for the dollar in foreign exchange markets, and the encouragement of moderate economic growth. The following ranges were specified:

M-1[2]	1½-4½ percent (3-6, adjusted)
M-2	5-8 percent
M-3	6-9 percent
Bank credit	7½-10½ percent

[2]M-1 includes currency and commercial bank demand deposits held by the public. M-2 includes M-1, plus commercial bank savings and time deposits other than large negotiable CDs. M-3 includes M-2, plus deposits of mutual savings banks and shares at savings and loan associations and credit unions.

The M-1 range specified in February assumed that shifts from demand deposits to automatic transfer from savings (ATS) accounts and New York negotiable orders of withdrawal (NOW) accounts, first authorized in November 1978, would reduce M-1 growth in 1979 by 3 percentage points.[3] Such shifts were later estimated to have reduced M-1 growth in 1979 by only 1½ percentage points. The equivalent longer-term M-1 growth range, therefore, is 3 to 6 percent.

The actual increases over the policy period were about 5½ percent for M-1, 8¼ percent for M-2, and 8 percent for M-3, compared with 7.2, 8.7, and 9.5 percent, respectively, in 1978. Bank credit rose about 12¼

[3]A federal court ruled in April that ATS accounts, credit union share drafts, and S&L point-of-sale terminals would be illegal after 1979. In late December, Congress extended the deadline to March 31, 1980.

percent in 1979. Although credit also slowed from the pace of the previous year, it exceeded the upper end of the range specified.

While monetary expansion was generally within the targets over the year as a whole, there was considerable variation in growth rates during the year. Because of the volatility of money demand over short periods, the Federal Reserve responded gradually, its actions tempered by incoming evidence regarding the strength of the economy and associated inflationary pressures.

Monetary growth slowed significantly in the first quarter. M-1 declined at a 1.3 percent annual rate, while M-2 expanded at only 2.8 percent and M-3 only 5.3 percent. With inflation accelerating, however, the Federal Reserve took no stimulative action. Throughout the first quarter, reserves were supplied to the banking system at around a 10 percent federal funds rate.

As monetary growth accelerated sharply in the second quarter, the Federal Reserve became less accommodative. Reserves were supplied at a federal funds rate of 10¼ percent from late April through most of June. Not only were there indications of a weakening economy, but further restraint in the second quarter was not called for under the long-term growth targets. Because of the first-quarter slowdown, monetary aggregates at midyear were still near the lower limits of their long-term growth ranges.

Growth in money continued to accelerate in the third quarter. Inflation, moreover, continued at a torrid pace and incoming economic information suggested some bounce-back in production and income. Over the third quarter, the Federal Reserve took several restrictive steps. Every month of the quarter, the discount rate was increased 50 basis points, pushing the rate to a record 11 percent. In addition, reserves were supplied at a progressively higher federal funds rate. By the end of September, the rate was around 11½ percent, up 1¼ percentage points over the quarter.

Despite these actions, inflationary forces in the economy remained strong; the dollar came under additional pressure in the foreign exchange markets; and speculative excesses associated with deeply entrenched inflationary expectations appeared in the financial and commodity markets. In light of these developments—and to give public notice of its determination to take a firm stand against inflation—the Federal Reserve announced a three-part program on October 6 designed to ensure better control of monetary and credit growth.

First, the discount rate was raised a full percentage point to a record 12 percent. Second, a marginal reserve requirement of 8 percent was imposed on increases (above the larger of $100 million or the base period level) in the total managed liabilities of member banks, Edge corporations, and U.S. agencies and branches of foreign banks.[4] Finally, the FOMC approved a change in the target used in determining day-to-day open market transactions. Instead of focusing on the estimated price of reserves (the federal funds rate) consistent with a desired path for money, the new method focuses on the estimated quantity of reserves consistent with that path.

Interest rates increased sharply after October 6 and fluctuated over broader ranges than before. The federal funds rate, now free to reflect demand relative to the volume of reserves provided, rose to a high of 15.61 percent (on a weekly average basis) in late October and ended the year trading around 13½ percent. A significant reduction in the rate of expansion in the monetary and credit aggregates in the fourth quarter attested to the initial success of the program.

Despite the improved performance of the aggregates relative to predetermined goals, concern remained over whether those aggregative measures (as currently defined) adequately represent the funds actually available to the public for spending. Financial innovations and regulatory changes over the past decade have tended to blur the distinc-

[4]Managed liabilities include large denomination time deposits with maturities of less than a year, Eurodollar borrowings, repurchase agreements against U.S. government and federal agency securities and borrowings of federal funds from institutions other than members of the Federal Reserve System.

tions between different types of deposits, deposits at different types of institutions, and between deposits and other liquid assets. Early last year, the staff of the Board of Governors proposed new definitions for the monetary aggregates. That proposal has since been under study, and new definitions are expected to be adopted early this year.

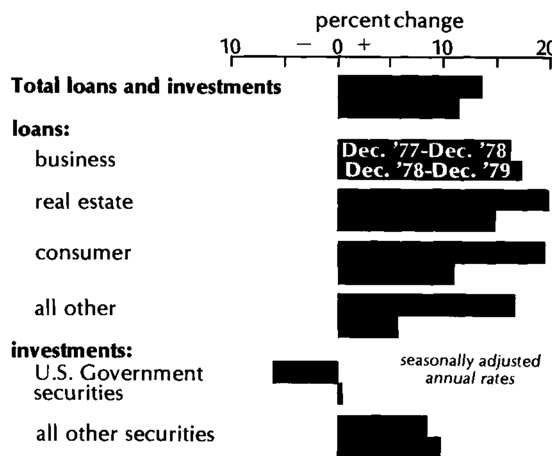
Bank portfolio shifts

As in 1978, loans accounted for most of the expansion in total bank credit. Despite heavy credit demands from businesses and increased monetary restraint, the commercial banking system did not, on balance, liquidate securities. Total loans, in fact, did not rise as fast as in 1978 and investments grew faster.

More than two-fifths of the 13 percent increase in loans last year was business loans, compared with a third in 1978. Commercial and industrial loans expanded at a 20 percent annual rate during the first three quarters before leveling off in the fourth quarter. Business loans were up about 17 percent for the year, compared with 16 percent in 1978.

Corporate borrowing strengthened at money center banks and accelerated further at U.S. branches and agencies of foreign banks. These institutions were generally aggressive in seeking to increase their loan business. Until October 6, many domestic banks were offering certain credits at less than the prime loan rate to meet competition from foreign-related banking institutions. Some term loans were made at fixed rather than floating rates.

Total bank credit expansion slows despite faster pace in business loans and investments



Most large banks were able to pass on the rising cost of funds, thus maintaining their earnings margins. By mid-November, the prime rate reached 15¾ percent, 375 basis points above its mid-1974 peak, before easing down to 15¼ percent at year-end. After October 6, many banks tightened their terms of lending (price and nonprice) because of their higher cost of funds. Some borrowers were effectively priced out of the loan market, but competition continued to temper restrictive policies. Credit was still widely available for normal business needs, and there was evidence that special arrangements were being worked out for weaker customers that would have been severely hurt by money market interest costs.

While bank loans to businesses increased in 1979, loans to other borrowers slowed. Real estate loans at commercial banks, nevertheless, rose 15 percent over the year and consumer loans rose 11 percent.

Sources of loanable funds

Growth in demand deposits was modest last year, but as market interest rates rose, outflows of savings deposits picked up. Some of the outflow went into small denomination time deposits, which provided an estimated $60 billion of loanable funds, compared with $20 billion in 1978. All the net growth in small CDs could be attributed to increases in six-month money market certificates, which rose about $80 billion at commercial banks nationwide.

Large CDs were allowed to run off in the first half of the year, as the 2 percent marginal reserve requirements imposed in late 1978 increased the cost of funds from this source. Late in the year, however, issuance of CDs resumed. The faster growth in CDs in the second half resulted from several factors, including strong third-quarter loan demands,

weakness in other time and savings deposits, and the rising cost of funds from other sources. To a considerable degree, the savings funds flowed back to large banks through CD purchases by money market mutual funds.

Other "managed liabilities" were tapped extensively. These nondeposit sources—which include federal funds and security repurchase agreements with nonbanks, net Eurodollar borrowings, and sales of loans to nonbank affiliates—rose over $45 billion in the first three quarters, financing more than 40 percent of the increase in bank credit over that time. The new marginal reserve requirements were intended to slow the credit expansion financed by these sources. Given the basic weakness of "core" demand and savings deposits in a high interest-rate environment, however, financing any resurgence in loan demand is likely to require further additions to managed liabilities.

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

	Loans[1]	Securities	Demand deposits	Time and savings deposits	Loans as percent of deposits	
	(percent change, Nov. 29, 1978 to Nov. 28, 1979)				11/78	11/79
Large banks[2]						
Chicago	16.7	3.3	5.6	-1.1	95.7	110.3
Detroit	6.2	22.6	2.5	3.5	71.7	73.8
Indianapolis	14.9	- 7.0	-4.1	8.5	72.8	80.6
Other cities	6.2	9.4	0.6	3.7	83.3	86.1
Other member banks						
Illinois	2.0	-1.0	-2.6	4.7	65.8	65.5
Michigan	5.7	-2.3	-1.9	4.5	71.2	73.1
Indiana	6.1	5.5	1.7	9.1	67.3	66.8
Wisconsin	11.2	6.6	--	4.4	68.7	74.0
Iowa	4.6	-1.8	-2.4	3.4	68.6	70.7

[1]Excludes fed funds sold.

[2]Large weekly reporting member banks with domestic office assets of $750 million or more as of December 31, 1977.

Banking in the district

Credit at member banks in the Seventh District expanded less than in 1978. Excluding interbank loans but including loans sold to affiliates, total loans and investments of member banks in the district rose 7.9 percent, compared with 10.5 percent in 1978. Loans accounted for most of the rise. Unlike 1978, when there was a net reduction in total bank holdings of securities, district banks acquired securities in 1979. Total bank loans expanded 9.4 percent, compared with an expansion of 15.7 percent in 1978.

The district data illustrate the greater impact of cyclical fluctuations on large banks than small banks. Loans expanded faster at large banks than at small and medium-sized banks, where demands had been strong the three previous years. Real estate lending was still the strongest element of growth in bank loans, although business lending picked up at the largest Chicago banks.

Although ratios of loans to deposits, often used as an inverse indicator of liquidity, rose more at large banks and were considerably higher, these institutions had many sources of liquidity. Many were still below their desired loan levels. Smaller banks, close to what they considered loaned-up positions, were more constrained in their lending. Net time and savings inflows were less at large banks, as some large denomination deposit certificates were not replaced at maturity. Most of the growth in time and savings deposits at large banks was due to a $2.5 billion increase in money market certificates.

In the year ended in November, total deposits at all district member banks were up only 3 percent, leaving most of the growth in loans to be financed by nondeposit sources. At Chicago banks with assets totaling $1 billion or more, these sources provided about $5 billion of loanable funds.

District holding company activity

During 1979, 102 applications were decided on involving Seventh District holding companies. Fifty-eight one-bank formations were approved, and 27 banks became subsidiaries of multibank holding companies.

At the national level, 547 applications were decided on in 1979, up from last year's total of 523 completed cases. Holding companies nationwide currently control 52.6 percent of the 50,422 commercial banking offices in the United States.

Four holding company applications involving district banks were denied on the basis of adverse competitive factors. One, for the formation of a one-bank holding company in Iowa, involved a chain banking situation. The Board took the position that approval of the application would perpetuate a situation that was already anticompetitive, further removing the possibility that banks in the chain could compete in the future.

Two applications by multibank holding companies to acquire additional banks were denied—one in Iowa and another in Michigan—on grounds that significant existing competition would be eliminated without enough outweighing convenience and needs factors.

One merger application was denied on grounds not of existing competition but concern over the concentration of statewide banking resources and the elimination of potential competition. Proposed was the merger of the sixth and twelfth largest banking organizations in Michigan. Completion of the merger would have given the resulting organization control of 5.1 percent of the deposits in the State. The Board determined that both holding companies had the potential for expanding *de novo* into the other's markets and that several of the markets were attractive for *de novo* entry.

Eight of the applications completed in the district were the subjects of substantive protests. Five of the applications were filed by the same Michigan multibank holding company, and all were contested under the new Community Reinvestment Act (CRA) by a community group in Detroit.

The group protested the proposed acquisitions of an existing bank and four *de novo* banks on grounds the banking organization had done little lending in low and moderate-income areas in the Detroit SMSA. The protests also charged racial discrimination in the lending pattern and challenged the delineation of one subsidiary bank's lending community. These were the first CRA protests filed against a holding company in the Seventh District.[5]

The Board approved the applications in November but directed the holding company to broaden its lending and marketing efforts in low and moderate-income areas. The holding company had contended that its lending performance before November 6, 1978, when CRA became effective, should not be considered. The Board found, however, that the convenience and needs analysis had meeting the credit needs of its community. Also, stressing the importance of technical compliance with the act, the Board reprimanded the holding company for technical violations regarding, for example, failure to post CRA notices and not making CRA statements available.[6]

Other CRA protested cases outside the Seventh District are pending Board action. Resolution of these cases will provide additional insights into the regulatory parameters used in evaluating a bank's lending record under CRA.

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[5]The Board had ruled on two CRA-protested applications from other districts. See Board Order of June 16, 1978, approving the merger of Commerce Bancshares, Inc., Kansas City, Missouri, with Manchester Financial Corporation, St. Louis (64 Federal Reserve Bulletin 576). Also see Board Order of May 31, 1979, approving the merger of the Ohio Citizens Trust Company, Toledo, and The Peoples State Bank, Wauseon, Ohio (65 Federal Reserve Bulletin 517).

[6]See Board Order of November 30, 1979, approving the acquisition of the following five Michigan banks by Michigan National Corporation, Bloomfield Hills, Michigan: Litchfield State Savings Bank, Litchfield; Michigan Bank-Livingston, Brighton; Michigan Bank-Midland, Midland; Michigan Bank-Northwest, Petosky; and Michigan Bank-South Metro, Lincoln Park.