Finance: credit demands strong

As economic expansion progressed, financing in the credit markets rose, along with the demand for transactions balances. Growth in the narrow money supply (M-1) was close to 7½ percent for the year, the largest since 1972. In an effort to reduce monetary growth to a pace consistent with a lower rate of inflation, the Federal Reserve supplied the reserves that supported the deposit expansion at only a slightly higher cost to the banking system. Although short-term interest rates moved up from the cyclical lows reached late in 1976, funds were in plentiful supply as evidenced by the record amount raised in the credit market. Intermediate- and long-term interest rates ended the year at levels inside or below their range of fluctuation in 1976.

Commercial banks supplied about one-fifth of the total funds advanced—roughly the same proportion of the total as in 1976. However, there was a significant shift in the use of bank funds. Credit provided to the private nonbank sectors of the economy by the banking system more than doubled in 1977 despite continued weakness in loan demand by major national corporate customers at the big money center banks.

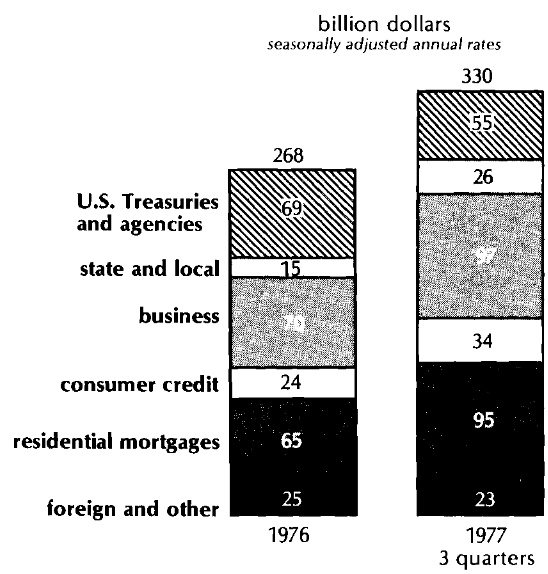
Credit flows higher

Funds were raised in the credit markets by individual businesses, nonfinancial businesses, and governmental units at an annual rate of nearly $330 billion during the first three quarters of 1977 (seasonally adjusted)—almost one-fourth higher than during 1976. All of the increase was accounted for by the private sector. Higher borrowings by state and local authorities were more than offset by lower borrowings at the federal level. Higher prices increased financing needs for all sectors.

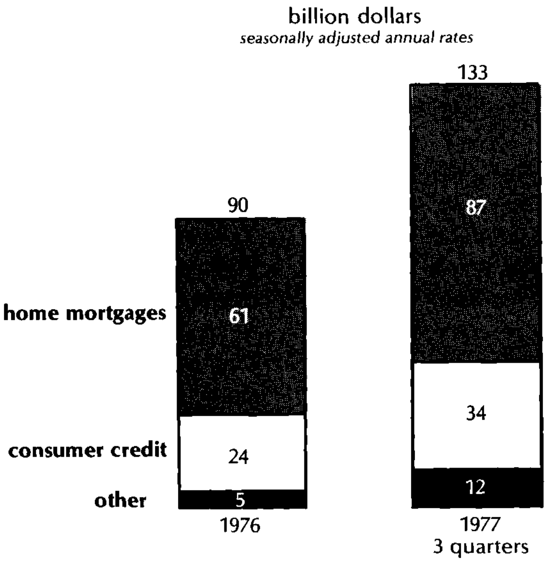
Within the private sector, consumer borrowing led the pace in the credit area, reflecting the large consumer expenditures on autos and houses. Record increases in both consumer credit and home mortgage credit accounted for two-thirds of the overall increase over 1976 in credit market financing. Businesses also borrowed almost two-fifths more than in the prior year, especially through short-term obligations.

Strong demand for single-family homes and continued inflows of savings to depository institutions, especially during the first half of the year, produced record mortgage lending activity. In the latter part of the year, thrift institutions relied heavily on advances from Federal Home Loan Banks and on borrowings from other sources. Although thrift institutions were again the major source of home mortgage financing, their share declined. The amount supplied by the commercial banking system doubled as mortgage interest rates remained relatively attractive at historically high rates. The sale of securities backed by pools of mortgages in the capital markets by the federally sponsored agencies

Funds raised up sharply . . .



. . . with household sector accounting for most of the increase



continued to be a growing source of mortgage funds.

Commercial banks dominated the provision of consumer credit to households, supplying about one-half of the total, the same as in the prior year. Credit unions and finance companies provided most of the balance.

Nonfinancial corporate businesses expanded their credit market borrowing in 1977 to almost the 1974 level. Funds were used to finance increased capital expenditures not covered by internally generated funds and larger and higher cost inventories. New equity issues declined to 9 percent of net funds raised after increasing from 5 percent in 1974 to 27 and 18 percent in 1975 and 1976, respectively. Commercial bank loans to business (excluding mortgages) represented almost three-fourths of the increase in debt financing by business, but such bank loans were still at only two-thirds of the 1973 and 1974 rates. The balance of the increase in business debt was mostly in finance company loans, primarily to finance automobile inventories, and in commercial mortgages.

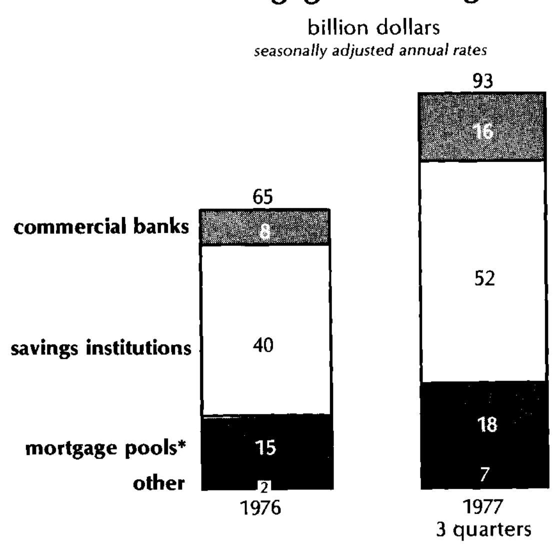
State and local governments refunded substantial amounts of securities issued at artificially high rates in 1974 and 1975. Municipal interest rates remained relatively low throughout the year as commercial banks and fire and casualty insurance companies, buoyed by increased profitability, returned to the tax-exempt market. Local governments invested the proceeds in special Treasury issues when the terms of the original issue prevented immediate refunding. Local governments raised about the same amount as they supplied to the U.S. Government market.

Reduced borrowing by the federal government and the purchase of Treasury issues by state and local governments and foreign accounts mitigated the impact of the U.S. government on the credit markets. The foreign sector was the largest purchaser of Treasury securities in 1977, doubling the amount purchased in 1976 and absorbing two-fifths of the net increase. State and local governments accounted for 29 percent.

Mixed demand at banks

Commercial bank credit rose more than 11 percent in the year ended November 30, 1977, compared with 8 percent in the previous

Savings institutions provide bulk of home mortgage financing



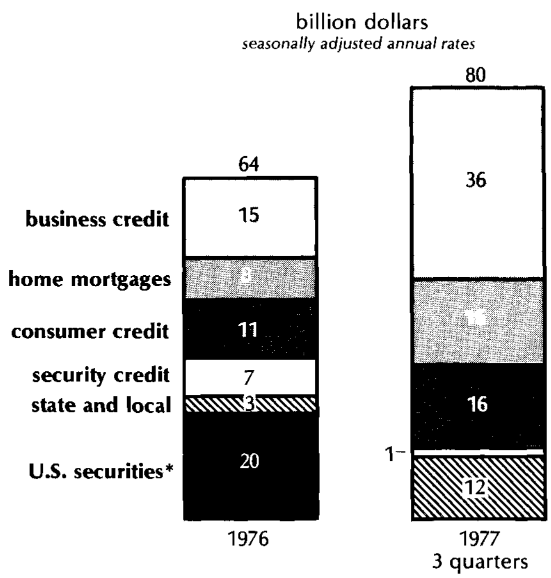
*GNMA, FHLMC, and Farmers Home Administration pools.

year. Bank loans accounted for the gain. Total loans increased about 15 percent for the year, while bank acquisition of securities was up about 4 percent. The expansion in loans was largely a reflection of the firmness in household credit demands, although business loan demands increased also. Continuing the uptrend that persisted throughout 1976, household credit demands at all commercial banks increased markedly as the year progressed and were up about 15 percent for the year as a whole compared with an 11 percent rise in 1976.

Real estate loans rose at a much faster pace than in 1973 when construction activity as reflected in starts and completions was emphatically greater. Consumer instalment loans increased faster than in any other year, although the bulk of the rise was in the last three quarters of the year.

Bank loans to business borrowers rose more than 12 percent in 1977, after rising less than 1 percent in 1976, with the rate of growth accelerating during the year. In the fourth quarter business loans were up 15 percent. Business loans expanded more rapidly at small- and medium-sized banks than at large banks. The contrast was much sharper earlier in the year, but in the fourth quarter business loan demands at large banks came on strongly. In the fourth quarter of the year business loans rose at an annual rate of about 16 percent at the large banks and only 13 percent at the smaller banks.

Commercial bank credit up moderately



*U.S. securities were -1 billion dollars for first three quarters of 1977.

Bank acquisition of U.S. Governments decreased sharply last year. Holdings of Treasuries at all commercial banks declined more than 3 percent, after rising 23 percent in 1976. By contrast, bank acquisition of other securities, mainly obligations of states and political subdivisions, rose more than 7 percent in 1977 compared with a 2 percent rise in the previous year.

While the banking industry enjoyed rapid demand deposit expansion in 1977, growth in total time and savings deposit increased sharply. Time and savings accounts, other than large certificates of deposits (CDs), rose very rapidly in the first half of the year but at a much slower rate thereafter. Large CDs rose only moderately in the first half of the year, reflecting the modest rise in business loan demands. As the year drew to a close, however, the growth in CDs was the fastest since the recession. The faster growth in CDs resulted, in part, from the expansion of business loans and a decline in consumer-type savings flows at the large banks.

The increase in the prime loan rate of the large banks, which closed the year at the highest level in two years, lagged the rise in short-term market interest rates. During the early part of the year major banks allowed a large spread to develop between their prime rate and the market rate on commercial paper—an alternate source of funds for large firms. As loan demand rose and banks competed for customers, the spread was reduced. At year-end the prime-paper rate spread had narrowed to about 100 basis points compared to 160 basis points earlier.

Although the prime rate rose about 150 basis points in 1977, competition for loan business intensified as the year progressed. Nonprice terms were reported eased somewhat, with more flexibility in compensating balance requirements and some term loans made at fixed rates. Before year-end some large banks were aggressively seeking loan business through below-prime commercial paper-type arrangements. While such actions will undoubtedly increase loan volume, the strength of business loan demands will have an important bearing on the flexibility of lending terms.

Monetary aggregates and interest rates

As the economy moved into its third year of economic expansion in the spring of 1977, the Federal Reserve in conducting monetary policy sought to sustain economic growth and to restore price stability. Projected annual growth ranges for the monetary aggregates were gradually reduced during the year to dampen inflationary expectations and renew public confidence both at home and abroad. With the income velocity of money increasing at a more normal rate than in the first year of recovery and credit expansion proceeding at a brisk pace, the Federal Reserve sought to restrain monetary growth to within desired ranges by supplying reserves only at a higher cost to the banking system.

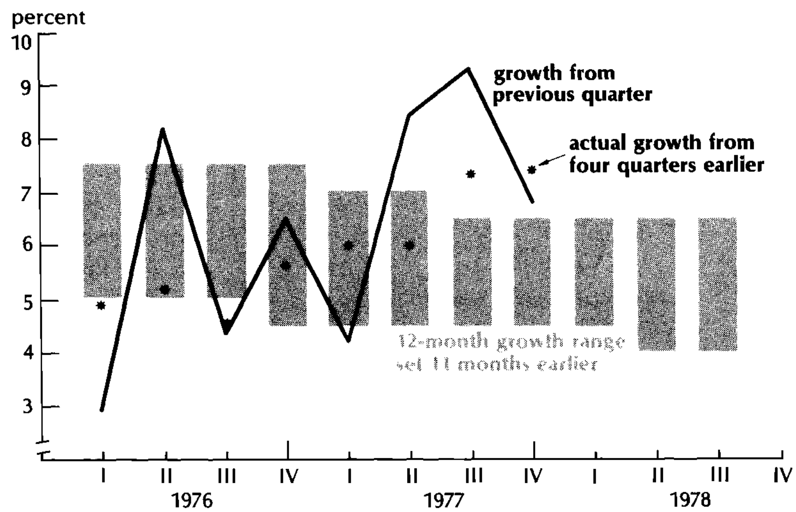
In quarterly reports to Congress, the Federal Reserve specifies annual monetary growth ranges expected to be consistent with achieving economic objectives. Annual growth projections are made for M-1, which includes currency and commercial bank demand deposits held by the public; for M-2, which includes—in addition to M-1—commercial bank savings and time deposits other than large CDs; and for M-3, which includes—in addition to M-2—mutual savings bank deposits and shares at savings and loan associations and credit unions. The projec-

Growth in the broader aggregates was in line with projections . . .

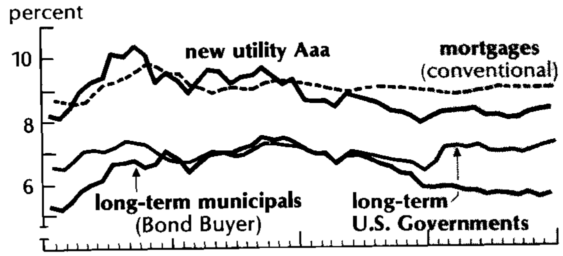
	M-1		M-2		M-3	
	January projection	Actual	January projection	Actual	January projection	Actual
	(percent, seasonally adjusted annual rates)					
1972		8.4		11.2		13.6
1973		6.2		8.8		9.1
1974		5.1		7.7		7.1
1975		4.4		8.3		11.1
1976	4.5-7.5	5.6	7.5-10.5	10.9	9.0-12.0	12.8
1977	4.5-6.5	7.4	7.0-10.0	9.6	8.5-11.5	11.6
1977-1		4.2		9.9		11.3
2		8.4		9.2		10.0
3		9.3		10.3		12.4
4		6.8		7.6		10.7

NOTE: Annual data based on fourth-quarter averages.

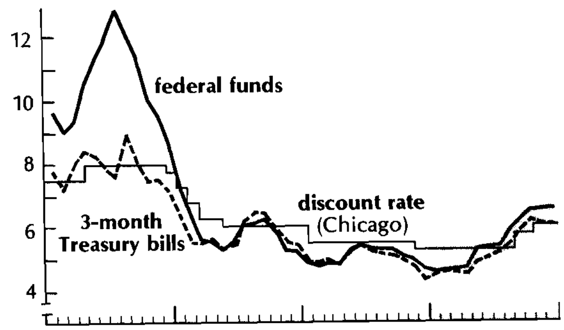
. . . but rapid rise of M-1 in second and third quarters pushed it above lowered target ranges



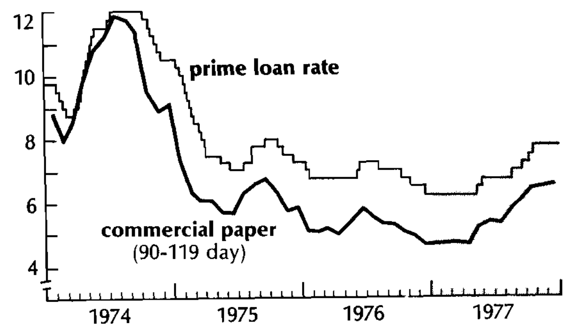
Not much change in long rates . . .



. . . as money rates moved up moderately . . .



. . . and banks kept prime above market cost of funds



tions take account of developments that may influence the expected rate at which money balances will be used.

As the third year of the current expansion progressed, the income velocity of M-1 (V-1)—a measure of the intensity with which the public uses transactions balances relative to GNP—increased at a somewhat slower rate. Over the last three quarters of 1977 V-1 increased at about 3 percent, below the 3.5 percent average annual postwar rate experienced in the second year of the current expansion and in sharp contrast to the average 8.3 percent rate of the first year.

Actual growth in the monetary aggregates over the year was near or above the upper limits of projected ranges specified in quarterly reports to Congress. The first quarterly report of 1977 specified growth ranges of 4½-6½ percent for M-1, 7-10 percent for M-2, and 8½-11 percent for M-3 over the fourth-quarter 1976 to fourth-quarter 1977 period. Actual M-1 growth over this period was 7.4 percent, up from 5.6 percent in 1976 and the fastest since 8.4 percent in 1972. In contrast, actual 1977 growth rates for M-2 and M-3 of 9.6 and 11.6 percent, respectively, were somewhat slower than in 1976.

As it had done in 1975 and 1976, the Federal Open Market Committee (FOMC) progressively lowered annual monetary growth ranges through 1977. By year-end the ranges, applying from third-quarter 1977 to third-quarter 1978, had been reduced to 4-6½ percent for M-1, 6½-9 percent for M-2, and 8-10½ percent for M-3.

After the first quarter, as public demand for transactions balances strengthened and monetary aggregate growth—especially for M-1—exceeded desired growth, the FOMC became less accommodative in supplying reserves to support the deposit expansion. Rapid monetary growth in April and July prompted the FOMC to allow the federal funds rate—the market price of reserves—to rise from the prevailing 4⅝ to 4¾ percent to around 5⅜ percent in early May, to 6 percent by mid-August, and to 6½ percent by mid-October. In addition, the discount rate—the rate charged by the Federal Reserve on loans to member banks—was increased 50 basis points to 5¾ percent at the end of August and an additional 25 basis points to 6 percent in late October.

As the year progressed, short-term interest rates moved higher mirroring the 191 basis point increase in the federal funds rate. In contrast, borrowing costs in capital markets changed little during 1977. The December 1977 new utility Aaa bond rate was but 40 basis points higher than its cyclical low reached in December 1976. The long-term municipal bond rate continued to decline through 1977 reflecting renewed investor confidence in the tax-exempt market.

District banking

At Seventh District member banks credit expanded more during 1977 than during the previous year and kept up with the pace nationally. Total loans and investments (excluding fed funds) of all District members rose about 9 percent in the year ended November 30, 1977, compared to 6 percent in 1976. The 13 percent rise in loans accounted for most of the 1977 credit increase whereas in 1976 emphasis was on U.S. Treasury securities. Much of the growth in loans was concentrated in areas outside of the major cities. Money center banks in Chicago felt the effects of light loan demand by large business customers, while agricultural-based banks experienced heavy loan demand and very tight liquidity positions. In all District areas loan growth in 1977 was stronger than in 1976.

Consumer-type savings inflows were weak at District large weekly reporting banks in 1977 compared to 1976. This was true during the first half and even more so in the third quarter when "wild cards" (4-year time certificates issued in late 1974 without a ceiling rate) were maturing. Some of these funds left commercial banks and flowed into S&Ls primarily because of the rate differential. However, during third-quarter 1977, District banks acquired additional deposits through stepped-up sales of large CDs.

Nonbank financial institutions continued to offer more competition to commercial banks as they sought to expand services available to customers. Credit Unions in Wisconsin and Indiana aggressively expanded share draft accounts, while those in Iowa, Michigan, and Illinois were hampered by litigation. The number of Illinois S&Ls in the District offering NINOWS increased to about 60 compared to 46 the previous year.

Approximately 25,000 NINOW items were processed daily during December, representing an average volume of about $3 million. This was almost four times the daily average number and dollar amount processed during the same month in 1976. However, the impact of NINOWS on commercial bank deposits in Illinois was minimal.

The first statewide, shared electronic funds transfer system was introduced by the commercial banks in Iowa. The Iowa Transfer System (ITS), owned by about 550 of the 650 banks in Iowa, had close to 40 banks participating during the year. Because of Iowa's sharing law, small banks have the same ITS opportunities as do the larger ones. Services available through ITS include point-of-sale terminals and both on- and off-premise automated teller machines.

Loans dominate credit growth in 1977

	Loans[1]		U.S. Govt. securities		Other securities	
	Nov. 1976	Nov. 1977	Nov. 1976	Nov. 1977	Nov. 1976	Nov. 1977
	(percent change)					
Large banks[2]						
Chicago	- 2.3	8.4	40.2	-17.7	0.7	19.9
Detroit	- 1.2	11.1	- 0.6	15.0	1.8	0.3
Indianapolis	- 5.7	5.8	11.0	63.8	41.4	-22.6
Milwaukee	2.3	14.9	58.9	-19.1	-12.6	2.3
Des Moines	14.9	26.5	20.5	89.7	2.3	3.0
Other member banks						
Illinois	11.9	16.4	17.2	- 7.8	4.6	5.6
Michigan	11.0	16.7	19.9	- 0.1	6.8	7.6
Indiana	11.3	16.2	23.9	-18.3	9.7	1.2
Wisconsin	11.7	16.6	22.3	- 5.7	3.3	3.8
Iowa	18.1	18.4	8.9	-13.6	9.0	0.5

[1]Excludes fed funds.

[2]Large weekly reporting member banks.

District holding company activity

During the past year 63 of the District's commercial banks became subsidiaries of holding companies. Twenty-seven of these banks became subsidiaries of one of the District's 55 multibank holding companies operating in Iowa, Michigan, and Wisconsin, where multibank holding companies are legal. By year-end holding companies controlled 774 banks or 23 percent of all commercial banks in the Seventh District.

The Board of Governors and the Federal Reserve Bank of Chicago, acting under delegated authority, ruled upon 98 bank holding company and merger applications that involved District banks last year. Eighty-three of the applications were approved and 15 (15.3 percent) were denied. Decisions on applications stressed the financial and managerial soundness of the bank holding companies and their subsidiaries. Of the applications denied by the Board, 11 were on grounds that the proposals would have created or added to strains on the financial and managerial resources of the applicant company or a bank or nonbank company involved. Four applications were denied because the acquisitions were judged to eliminate or significantly diminish competition, without sufficient offsetting convenience and needs or public benefits. Of these, two involved chain banking relationships. The Board has stated that where a proposed acquisition involves the use of a holding company by a group of individuals to acquire control of a bank that is a competitor of another bank under the control of essentially the same individuals, consideration must be given as to whether the formation would entail significant anti-competitive effects.[1] Only one of the 11 applications to engage in permissible nonbanking activities was denied; and that denial was incidental to the denial of the formation of the one-bank holding company. The most frequently entered nonbanking fields during 1977 were insurance and consumer finance.

[1]See Board Order of May 11, 1977, denying the application by Mahaska Investment Company, Oskaloosa, Iowa, to become a bank holding company through the acquisition of 51.47 percent of the voting shares of Farmers Savings Bank, Fremont, Iowa (63 *Federal Reserve Bulletin* 579). Also see Board Order of November 18, 1977, denying the application by Citizens Bancorp., Inc., Hartford City, Indiana, to become a bank holding company through the acquistion of 80 percent or more of the voting shares of the Citizens State Bank, Hartford City, Indiana.

Bank holding company applications processed during 1977

	Holding company formations		Multibank and additional shares proposals		Merger proposals		Nonbanking activities*	
	Approval	Denial	Approval	Denial	Approval	Denial	Approval	Denial
Illinois	10	2	1	—	—	—	4	—
Indiana	2	1	2	—	—	—	—	—
Iowa	22	3	2	—	1	—	6	1
Michigan	1	—	13	1	2	1	1	—
Wisconsin	7	1	9	5	—	—	—	—
Seventh District	42	7	27	6	3	1	11	1

*Excludes 23 4(c)(8) notifications by bank holding companies to engage in permissible nonbanking activities on a de novo basis.