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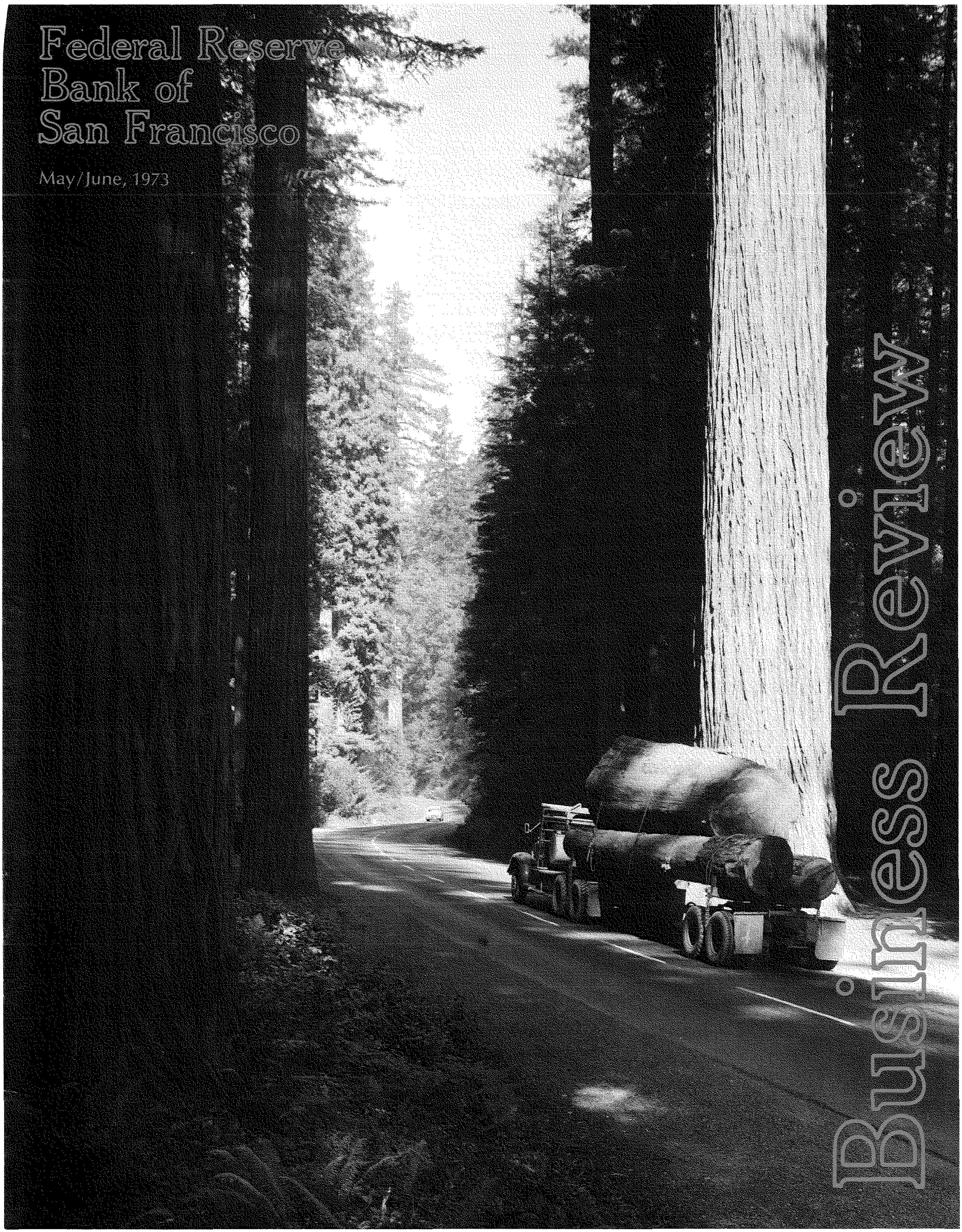
Business Review



Boom in the West

. . . The West participated fully this spring in the nationwide business upsurge.

Banking the Boom

. . . Western banks obtained funds at ever-higher rates to finance the spectacular boom.

Cyclical Patterns

. . . Cyclical swings in income tend to be more moderate in the West than in the nation.

Business Review is edited by William Burke, with the assistance of Karen Rusk (editorial) and Janis Wilson (graphics).
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Banking the Boom

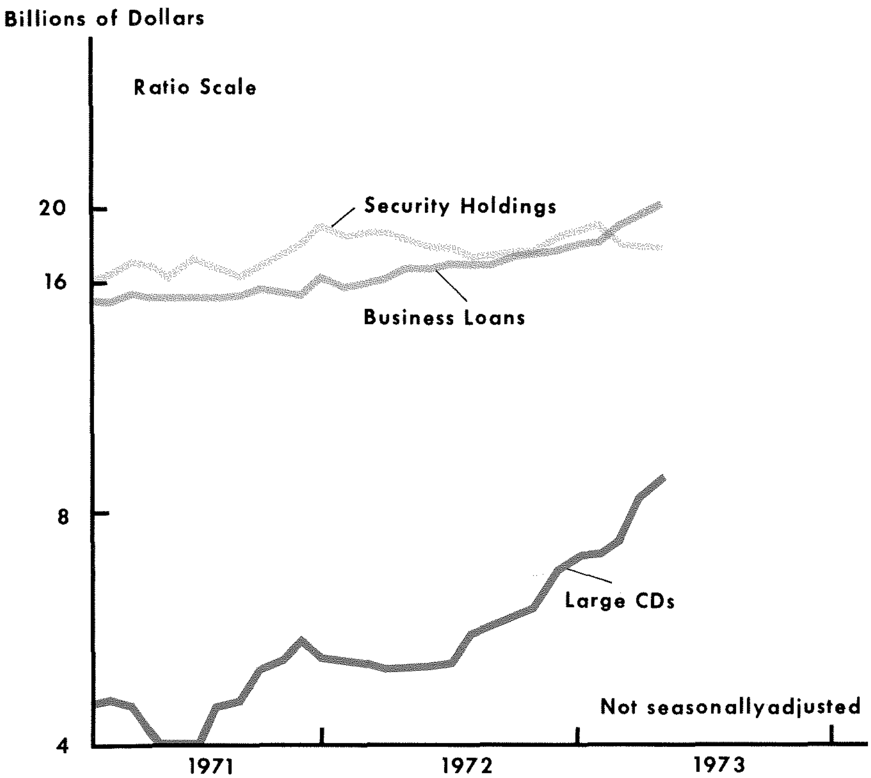
Western banks had difficulty accommodating the extremely heavy loan demand which arose as a result of the swift-moving domestic and foreign developments in the first five months of the year. First of all, there was the heavy credit demand stemming from the cyclical expansion of the economy. Superimposed on this, however, were the financing needs arising from the international currency crises of February and early March, and the unusually heavy draw-downs under loan commitments attributable to the relatively low prime rate on commercial loans.

These factors combined to produce a $6.4-billion increase in total loans over the January-May period. (The total is adjusted to include loans sold outright to affiliates, and to exclude a one-day transaction which distorted May data.) This 25-percent annual rate of increase in total loans, and an associated 31-percent rate of gain in business loans, both exceeded the increases recorded elsewhere in the nation.

Because of mounting reserve pressure and rising money rates, Western banks found it increasingly costly to obtain the funds needed to finance the spectacular growth of business borrowing and the continued heavy volume of mortgage and consumer credit. They found the funds, however, by reducing their security holdings (mainly short-term issues), by increasing their borrowings from the Federal Reserve and from other commercial banks, and in particular by bidding aggressively for large-denomination negotiable certificates of deposit. They obtained over $2.4 billion in CD money alone in the January-May period.

Deposit upsurge

Because of this latter factor, total deposits of District member banks jumped $3.8 billion, on a daily average basis, during the first five months of 1973. This represented a 14-percent annual rate of gain—even faster than the late-1972 pace. Almost all of the deposit gain came in time deposits—and over half of that increase came from the influx of CD money. Banks bid aggressively for these large deposits, although the offering rates on most maturities still subject to rate ceilings reached their ceiling



Banks obtain funds for business-loan upsurge by selling securities and by bidding aggressively for CD money

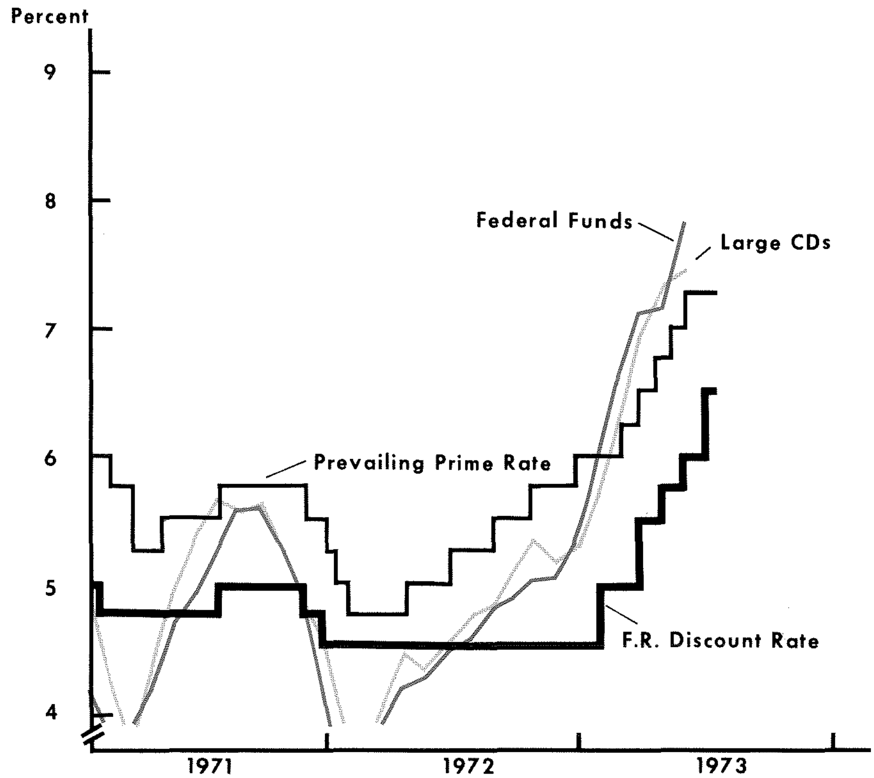
levels in early March. To obtain funds thereafter, banks had to issue most of their CD's with maturities of 89 days or less—the sector free from rate ceilings—and thereby created for themselves a dangerous concentration of short-term liabilities. The situation was eased only when the Federal Reserve Board of Governors lifted CD rate ceilings completely in May.

Large District banks experienced a $423-million reduction in passbook savings in the January-May period, contrasting with an increase of even greater magnitude in the year-ago period. This decline was more than offset, however, by a strong $742-million gain in other consumer-type time deposits, which offered higher rates than passbook accounts. Time deposits of states and political subdivisions rose by a contra-seasonal $930 million, reflecting both the improved financial position of these governmental units and the relatively favorable bank rates on such deposits, which matched the rates offered to corporate depositors.

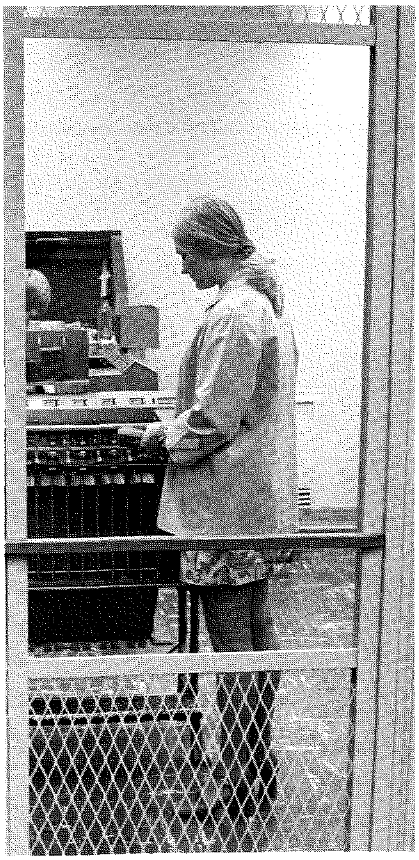
Net demand deposits expanded at a 3.5-percent annual rate during the January-May period —considerably below the late-1972 pace—as a consequence of the increasingly restrictive stance of monetary policy and the resultant slowdown in the narrowly defined money supply. Most of the increase was in Treasury rather than private demand deposits, reflecting the unusually liquid position of the Federal Government during the early months of the year.

Rising rates

Banks everywhere were faced with profit-margin problems in the early months of 1973, as they attempted to cope with the sharply rising cost of funds. Rates on short-maturity CD's rose from 5 percent in December to 7 percent or over in March, and then reached 8 percent by early June. The Fed-funds rate rose from about 5¼ percent in December to over 7 percent in March and to more than 8 percent in early June, while the cost of borrowing from the Federal Reserve went from 4½ to 6½ percent between December and early June.



Banks cope with sharply rising cost of funds (evidenced by Fed-funds and CD rates) by boosting prime business-loan rate



To stem the outflow of funds from their passbook-savings accounts, District banks raised their offering rate on such accounts to the 4½ percent ceiling rate, effective the first of March. (The rate had been maintained at 4 percent ever since early 1972.) This action immediately increased their interest costs by about $90 million on an annual basis.

To offset the rise in costs, District banks raised their prime rate on business loans, in a number of small increments, from 5¾ percent in late 1972 to 6½ percent in late March and to 7½ percent in early June. This increase in loan rates, along with the extremely large increase in loan volume, made it possible for banks to report healthy year-to-year increases in net income during the early part of the year. In addition, some banks obtained sizable profits from their overseas operations, partly as a result of foreign-currency revaluations. It should be noted, however, that the comparison is with the early-1972 period, when loan rates were at the lowest level in more than a decade.

Reserve squeeze

Despite the sharp increase in deposits subject to reserve requirements—$3.8 billion, on a daily average basis—required reserves of District member banks rose only slightly over the early months of the year. This reflected the concentration of the deposit gain in time deposits, which carry lower requirements than demand deposits, as well as a late-1972 restructuring of reserve requirements under the Federal Reserve's Regulation D.

Because of the strong demands on the banking sector, however, District banks increased their borrowings from the Federal Reserve Bank to a daily average of $133 million in the first quarter and $157 million in the April-May period. These represented the highest levels of borrowing since mid-1969. Net borrowed reserves increased to $103 million in the first quarter—ten times above the late-1972 pace—and then rose further to $140 million in April-May.

Banks also obtained substantial amounts of funds through borrowings of reserves from each other. In the first quarter, net interbank purchases (borrowings) of Fed funds reached a daily average of $512 million—compared with a net sales (lending) position in the previous quarter—and this high level of borrowing continued in April and May. In early 1973, banks also increased their borrowings under repurchase agreements with public agencies and corporations, to a daily average of $2.3 billion. This reflected the increased amount of public funds available for investment, just as did the sharp rise in public time deposits. In April-May, however, borrowings of this type fell off substantially.

Looking ahead

The continued expansion of loan revenues seems all but assured in coming months, because of the uptrend in the prime business-loan rate and the spectacular growth in loan portfolios. Profit margins also may widen because of the rise in the prime, along with some upward adjustment in mortgage rates. Generally, however, rates on mortgage, consumer and small-business loans should show only modest increases, because of banks' adherence to the guidelines set forth by the Committee on Interest and Dividends.

Banks may continue to encounter difficulties in finding sources of funds, although they have demonstrated their willingness to pay increasingly high rates for CD's, Fed funds, and other borrowings. Passbook savings actually declined in April, and turned upwards again only in the last several weeks, despite the massive flow of income-tax refunds to consumers. On the other hand, banks recorded a large seasonal gain in public time deposits in April, as tax receipts were placed in time certificates. In coming months also, they should be able to widen their access to corporate funds because of the recent suspension of rate ceilings on all CD maturities.

Ruth Wilson