

term rates were trending downward, while short-term rates were rising. And it was not until the spring of 1965, when commercial paper rates had risen to a level near rates on corporate new issues, that long-term borrowing costs showed any significant rise. In previous expansions long-term rates had risen earlier, along with short-term rates. The relative stability of long-term rates contributed to expansion in the domestic economy, whereas the rising short-term rate helped to ameliorate short-term capital outflows.

DEVELOPMENTS IN 1966

In mid-1965 interest rates began to rise throughout the maturity spectrum because of the mounting credit demands associated with the more rapid pace of economic activity that accompanied the increase in defense expenditures. Interest rates accelerated even faster in 1966, as monetary restraint reinforced the pressures on rates caused by heavy demands for credit. By the early autumn market yields on all classes of debt instruments had risen far above earlier postwar peaks. The changing relationship between market rates and the rates paid by banks on time and savings deposits reduced the relative attractiveness of bank deposits, and the expansion in time deposits began to slow down.

Deposit flows. During the first 8 months of 1966 the deceleration in time deposit inflows of banks was relatively moderate. Yields on market securities showed substantial increases, but banks took advantage of the higher rate ceilings on time deposits established in December 1965 to maintain their competitive position. Despite large outflows of passbook savings—on which ceiling rates were not increased—total interest-bearing deposits of banks rose at an annual rate of more than 11 per cent in the period from the end of 1965 through August of 1966, compared with an average of 15 per cent for the 4 years 1962 through 1965.

The increasing competition from banks and the market, however, led to a sharp reduction in inflows of funds to nonbank intermediaries. Inflows had already slackened in 1965, but in the first three quarters of 1966 the combined inflow to savings and loan associations and mutual savings banks declined to an annual rate of just above 3 per cent.

Several developments tended to retard the inflow of bank time deposits after mid-1966. The Board of Governors in July reduced the maximum rate that member banks may pay on time deposits on which the holder has more than one maturity option. Also in July, and again in September, reserve requirements on those time deposits—other than savings accounts—in excess of \$5 million at

NONBANK DEPOSITS

Per cent increase

1963	11.9
1964	10.9
1965	8.0
1966 (Jan.-Sept.)	3.1

Flow of funds data for savings and loan assns. and mutual savings banks. Data for 1966 are at a seasonally adjusted annual rate.