Four Periods of Tight Money

Money never changes; only the pockets it's in. —Gertrude Stein

THE current period of monetary restraint is the fourth such period since 1952. Despite the uniqueness of each tight-money episode, they have possessed a number of common characteristics—for example, a rising structure of interest rates, with new postwar peaks being reached in every case. Of course, the structure of interest rates is only one among many measures of the restrictiveness of monetary policy, but it does reflect the adjustments which the nation's financial system makes to an over-exuberant economy.

The initial point of impact of a restrictive credit policy is the commercial banking system. In response to pressure upon their reserve positions, the banks adjust the composition of their assets and their liabilities. Typically, banks have sold off securities from their investment portfolios to meet at least part of the demand for loans, putting upward pressure on the yields for the types of securities sold. Typically also, rising interest rates have affected the structure of their liabilities and the yields which they must offer to obtain funds.

In analyzing the four tight-money periods, there must be some agreement as to what constitutes monetary restraint and what determines the period of its duration. Money can be defined as "tight" when demands for credit have grown so much more rapidly than the supply of money-to-lend that the financial system encounters difficulty in providing the desired funds. From the standpoint of commercial banks, money is "tight" when their reserves are threatened with depletion. From the standpoint of monetary policy, money is being "tightened" when the Federal Reserve is not supplying reserves to the banking system at a rate commensurate with the rate of growth in demands for bank credit, although this tightening usually appears some time before money can be considered "tight" in the sense defined above.

One measure of tight money that has some usefulness is the "net borrowed reserve" position of the member banks of the Federal Reserve System. When their total borrowings are greater than their total excess reserves, they are said to have "net borrowed reserves." Thus, one definition of a tight-money period is the succession of months in which net borrowed reserves are reported. By this measure, the four periods can be dated July 1952-June 1953, August 1955-December 1957, December 1958-May 1960, and March 1965 to date.

However, this is a qualitative rather than a quantitative definition of tight money, and as such has certain limitations. The degree of monetary restraint may vary considerably over the time when free reserves first become negative and until they become positive again. Further, a given level of net borrowed reserves, say $300 million, is not necessarily identifiable at all times with a consistent degree of restraint. Net free or net borrowed reserves are a residual item, and the reserve base of the member-banking system—that is, total reserves — could be expanding, unchanged, or contracting at different points in time with the identical net borrowed-reserves figure. Nevertheless, the Federal Reserve System utilizes differing levels of net borrowed reserves as one of a number of short-term policy guides in pursuing a policy of monetary restraint, and the financial community generally interprets a deeper level of net borrowed reserves as a move in the direction of tighter money.

Tightness: money supply

Most financial observers during a tight-money period carefully watch the amount of monetary expansion, as measured either by the extension of bank credit or by the increase

in the money supply. The standard textbook description draws a direct casual relation from an increase in bank loans to an increase in the money supply through an expansion of demand deposits, the major part of the money supply. Generally speaking, any increase in bank assets should be reflected in an increase in the money supply. However, a change in the structure of bank deposit liabilities may have different effects upon the money supply as well as upon money "tightness."

A shift from demand to time deposits decreases the money supply (narrowly defined) but it nonetheless increases the banking system's ability to expand bank credit because of the difference in reserve requirements for the two types of deposits. Member-bank time-deposit reserve requirements are now 4 percent for all savings deposits and for time deposits up to $5 million, and 6 percent for time deposits in excess of $5 million; demand-deposit requirements are 16½ percent for city banks and 12 percent for country banks. Every dollar held on deposit with the Federal Reserve Bank will support at least 2½ times as many time deposits as demand deposits.

The ability of commercial banks as a whole to expand their loans during a period of tight money depends importantly upon their success in increasing their time deposits, which increase total bank resources, in contrast to banks' sales of securities. Especially has this been true during the most recent period. To the extent that commercial banks are able to attract and hold time deposits, they may be able to offset some of the pressure exerted on their reserve positions by the Federal Reserve.

Tightness: bank lending

The money supply increased in each of the tight-money periods except 1958-60, but bank credit generally increased at a much faster pace, as did total spending. The faster pace of total spending is traceable, at least in part, to the rise in the rate of turnover of money, while the faster pace of bank credit expansion is traceable, at least in part, to the concurrent leak of funds from the money supply into bank time deposits.

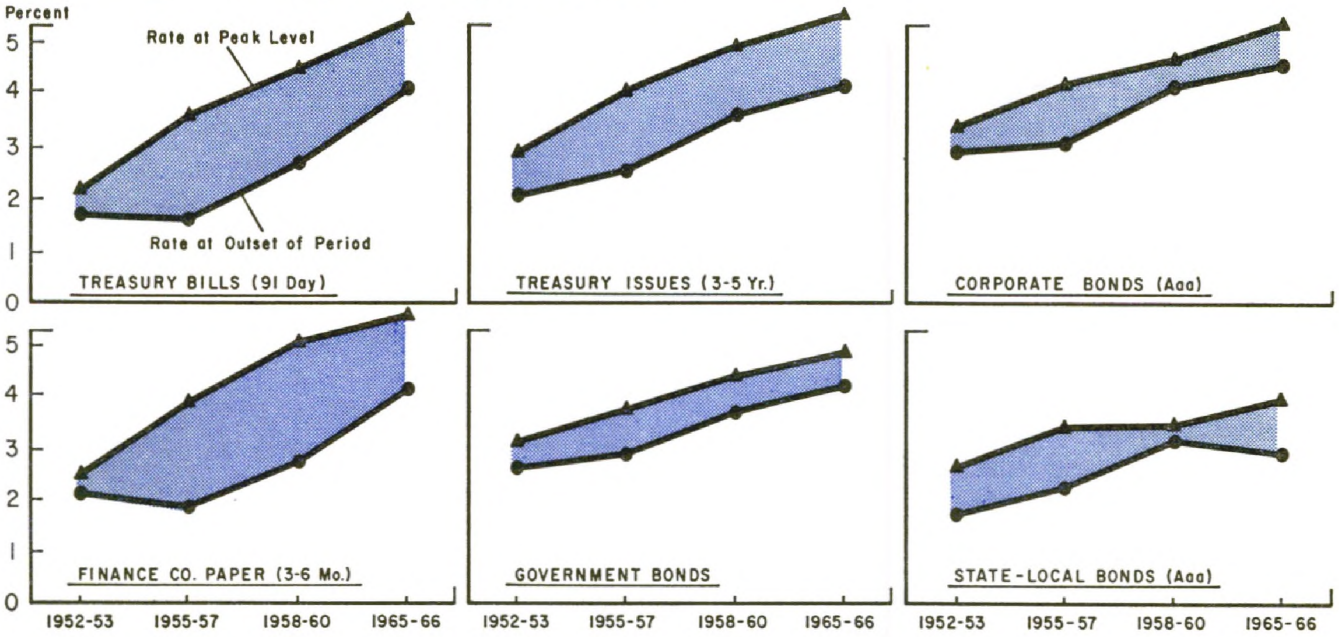
In each tight-money period, while total bank credit was increasing rapidly, the commercial banks shifted the composition of their assets to meet the even greater demand for loans, specifically by selling off U. S. Government securities. However, the commercial banks added to their holdings of other securities (chiefly municipals) in each period except 1958-60. Indeed, in the current period of tight money—except for the last several months—banks acquired more than enough tax-exempt issues to offset their sales of Governments. In 1958-60, the commercial banks made substantial inroads upon their holdings of both Governments and tax-exempt securities to meet loan demands, which increased slightly faster than in 1955-57.

Tightness: interest rates

Interest rates, being quite responsive to changes in money-market pressures of supply and demand, have shown fairly substantial increases in all maturity ranges during these tight-money periods. The rise in rates has not been uniform, however, and short-term and intermediate rates have generally risen much more than long-term rates. Moreover, the highest levels of rates have generally occurred two to six months before the end of each tight-money period. The shift from deep levels of net borrowed reserves to net free reserves may be gradual, as it was in 1960 when net borrowed reserves moved from $375 million in January to a plus figure in June. In such a situation, less pressure develops on bank reserves and the money markets, and interest rates recede from their peaks, even before the tight-money period comes to an end in terms of zero-level net borrowed reserves.

Long-term rates came under considerable pressure in the 1955-57 period, as average yields on outstanding corporate and municipal issues rose by more than a full percentage

Interest rates reach progressively higher levels
in each tight-money period of postwar era



point at their peaks. In the 1958-60 period the pressure was felt most heavily in the short- and intermediate-maturity ranges; market yields on Treasury bonds rose above the 4¼-percent statutory limit on new issues of long-term Governments, and the Treasury thus was forced to conduct its refinancing operations in shorter-term maturities.

In the current period, interest rates in all ranges of the maturity spectrum have exceeded the highs reached in previous postwar periods of monetary restraint. In the third quarter of 1966, new issues in the corporate market were priced to yield well above 5½ percent. The Treasury-bill rate broke through the 5-percent level, and a note and certificate offered in the August-November Treasury refunding carried coupons of 5¼ percent. The offering yield on one Federal Agency issue was 6.25 percent, and others were priced at a 6.20-percent yield. In September and October, on the other hand, interest rates fell back somewhat from the highs reached in August.

The present vigorous and extended boom in business spending for plant and equipment has resulted in a high volume of business borrowing from banks and record flotations of corporate issues in the capital market. In the first half of 1966, these factors helped keep the Treasury-bill rate well below other money-market rates—largely because of the existence of a strong demand for temporary investment of the receipts of corporate and municipal capital-market flotations. The Federal Reserve System was also a large net buyer, purchasing nearly $900 million of Government securities in the course of its open-market operations during this period.

Tightness: depositary-type savings

Flows of depositary-type savings—including savings and time deposits held at commercial banks, mutual savings banks, and savings-and-loan associations—have played an increasingly important role in tight-money periods. In 1958-60 the increase in total savings-type deposits was rather small in comparison with the gains in the 1955-57 and 1965-66 periods. Moreover, the relative positions of the commercial banks and the S&L's in the savings competition were almost reversed in the two most recent periods. To date in this period, commercial banks have garnered

roughly two-thirds of the total increase in savings-type deposits at all types of savings institutions, and the S&L share has correspondingly declined.

This commercial-bank success has been due mainly to the shift in the interest-rate advantage away from savings-and-loan associations. The gross differential between yields on S&L savings accounts and yields on bank time-and-savings accounts has narrowed considerably over the postwar period, declining from about 1.6 percent to less than 0.5 percent between 1952 and 1965. The one exception to this trend was the 1958-60 period, when the yield differential and the trend of deposit flows worked to the advantage of the S&L's.

In the 1958-60 period, the total reserves of the banking system declined very sharply and the money supply (seasonally adjusted) actually decreased. In that period, moreover, the commercial banks lost out rather badly in the competition for savings. This may well have made the central-bank pressure upon reserves even tighter; to the extent that the commercial banks did not maintain their relative share of the savings flow, they had to make greater inroads upon their security holdings in order to obtain loanable funds.

By contrast, in 1965-66 the commercial banks enjoyed such a large share of the increase in savings that they were able to make substantial net additions to their holdings of tax-exempt securities — substantial enough to more than offset their sales of Governments — even while meeting an exceptionally strong demand for loans. However, the current tight-money period is not yet over, and later developments may be somewhat different.

In the competition for savings, of course, there are other outlets for the short-term investment of funds besides the three major types of savings institutions. If money-market rates rise above the rates offered by the savings institutions, funds may flow away from, or out of, the savings institutions.

This phenomenon occurred, to some extent, in the 1958-60 period, when the market yield on Treasury bills rose to a high of 4.66 percent and finance-company paper earned the investor over 5 percent. Yields on intermediate Treasury issues also rose well above the average interest return on savings-type deposits. (A five-year Treasury note issued in August 1959 with a 5-percent coupon came to be known in the market as the "magic five," for the response that it evoked among individual investors.) This situation was repeated in the third quarter of 1966; in that period, yields on finance-company paper climbed above the 5½-percent ceiling on interest payable on commercial-bank time deposits, and selected U. S. Treasury bonds and Federal Agency issues in the intermediate-maturity range yielded about 6-percent on an investment basis.

The implications for commercial banks and other savings institutions are quite clear. Although commercial banks have been highly successful in the intramural competition for funds among savings institutions in the present tight-money period, this advantage is of

FACTORS AFFECTING THE MONEY SUPPLY

(billions of dollars)

	1952-53	1955-57	1958-60	1965-66
Change in bank credit	+3.5	+ 9.7	+ 5.2	+35.7
Loans	+5.6	+16.0	+16.7	+32.8
U.S. Governments	—2.3	— 7.4	—10.8	— 5.0
Other securities	+0.2	+ 1.1	— 0.7	+ 7.9
Plus: Change in time deposits	—3.1	— 8.1	— 2.2	—26.8
Plus: Change in other net factors	+3.0	— 0.5	— 3.6	— 0.4
Equals: Change in money supply	+3.6	+ 1.1	— 0.6	+ 8.5

Note: For time-deposit change, minus sign indicates increase. Four periods are dated July 1952 - June 1953, August 1955-December 1957, December 1958-May 1960, and March 1965-September 1966. Source: Board of Governors of the Federal Reserve System.

rather limited value when the yields on money- and capital-market instruments rise above the highest rate that the savings institutions can pay. A slackening in the net inflow of time-and-savings deposits to commercial banks would require that the banks make stronger efforts to sell off securities in order to accommodate the demand for loans. To the extent that the banks must place a greater reliance upon this source of loanable funds, the net expansion of bank credit will be smaller and the money supply will increase at a slower rate.

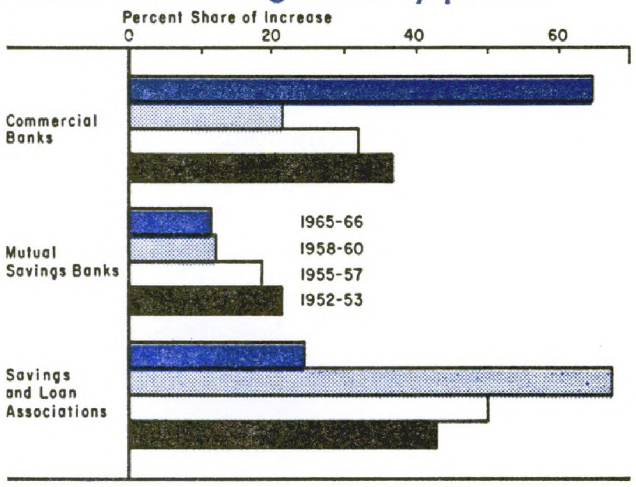
Current period: policy

The present tight-money period may, for the sake of convenience, be divided into three parts. These are most readily defined in terms of policy actions taken by the Federal Reserve System. First, and most significant perhaps, was the change in monetary policy from ease to what might be described as mild restraint. This took place in March 1965, when the member-banking system first began to register net borrowed reserves on a continuing basis. The change was accomplished entirely through the use of open-market operations, as the Federal Reserve supplied reserves to the banking system in lesser amounts than needed to meet the demand for bank credit.

The second phase began in early December 1965, when the discount rate was raised from 4 percent to 4½ percent. Over the next six months monetary policy became progressively more restrictive. During this time, moreover, the commercial banks raised their prime rate three times—from 4½ percent to 5 percent, thence to 5½ percent, and thence to 5¾ percent. (This August, it went to 6 percent.)

The third and latest phase of the current tight-money period covers July through September 1966. In this interval the Federal Reserve took a variety of actions designed to implement and reinforce its policy of monetary

Commercial banks gain lion's share of funds in this tight-money period



restraint. To discourage the dependence of the banking system upon large-denomination negotiable time certificates of deposit, the reserve requirement against time-and-savings deposits of over $5 million was raised twice, first from 4 percent to 5 percent and then to a maximum of 6 percent in August.

Regulation D was amended to define short-term promissory notes of banks and similar instruments as deposits, thereby requiring a reserve against such instruments, and Regulation Q was amended, first to reduce the maximum interest payable on multiple-maturity time deposits, and then to set a 5-percent ceiling on interest payable on both certificates of deposit and other time deposits of less than $100,000 issued or received after September 26. At the same time, the Federal Home Loan Bank Board prescribed maximum dividend rates for savings-and-loan associations on passbook accounts and certificate or "bonus" accounts. These actions were taken with a view to ending the competition for funds among savings institutions.

On September 1, the Federal Reserve System circulated a letter to member banks suggesting that a further expansion of loans—and of business loans in particular—at recent rates of increase was likely to lead to an inflationary rate of total spending. It also suggested that

banks should refrain where feasible from liquidating municipal securities and similar types of assets to meet the surging demand for business loans, since this could put upward pressure on interest rates in other credit markets. While offering longer accommodation at the discount window for banks requiring the additional time to make their adjustments through business-loan curtailment, the System reiterated its traditional policy of accommodating seasonal, short-term, and emergency borrowing in the traditional manner.

The Federal Reserve has now used all of its instruments of general monetary control in the present tight-money period. Reserve requirements have been used as a restrictive measure for the first time since 1951. Admittedly, this weapon has been applied only to time deposits—but this is understandable, in view of the large increases in time-and-savings deposits at the commercial banks, where they have become the major source of loanable funds.

The discount rate has been raised only once in this tight-money period, compared with seven increases in the 1955-57 and five increases in the 1958-60 periods. This does not mean that the discount mechanism has played a secondary role in current monetary policy, but rather that less reliance on the level of the discount rate itself has been required.

Open-market operations have continued to represent the major avenue for implementing policy on a day-to-day basis to allow for growth and to cushion the heavier impact of other policy tools. And the control of commercial-bank time-deposit rates through Regulation Q has played an important role.

Current period: tightness

The policy of monetary restraint obviously contributed to the tightness that was evident in the money and capital markets in the third quarter of 1966. However, it would be giving monetary policy too much credit to say that it bore the sole responsibility for this tightness. The sharp rise in interest rates that took place during that period owed a great deal to various market factors.

On the savings side, commercial-bank time deposits increased at only a 10-percent annual rate in January-September 1966—as against 16 percent in the comparable 1965 period—although the banks continued to gain the largest part of inflows to savings institutions. This slowdown in deposit inflow is attributable in part to a lower rate of saving out of disposable income and in part to the competition from short-term investments; the latter now offer a higher yield than bank time deposits, which are restrained by Regulation Q ceilings.

In spite of a slackening in the growth of bank reserves—down from a 4.7-percent annual growth rate in the first three quarters of 1965 to a 2.6-percent rate in the same period of 1966—business borrowings from commercial banks increased at an annual rate of over 18 percent during this 1966 period and thereby put considerable pressure on the commercial-banking system. The business-loan expansion recently decelerated, especially in September, when the annual growth rate dropped to 4.6 percent.

However, the demands for credit have not been confined to the banks. Corporate offerings in the capital market were more than one-fourth larger in the first nine months of 1966 than in January-September 1965. The capital market flotations of state and local governments rose by nearly 9 percent in the same period.

Thus, a combination of factors—a strong demand for funds pushing against a supply of savings that was not growing apace, along with a monetary policy designed to limit the increase in bank reserves—was responsible for pushing interest rates to such record levels during this most recent tight-money episode.

—Herbert Runyon