For release on
Saturday, May 13, 1967
at 11:00 a.m., EDT

Living with Monetary Management

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at the

Annual Stockholders Meeting

of the

Federal Home Loan Bank of Greensboro

Washington, D. C.

May 13, 1967

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Financial institutions--commercial banks, savings and loan associations, mutual savings banks and credit unions--in recent decades have been developing and exploiting one of the most useful financial techniques of the century:--intermediation, the art of borrowing short and lending long.

Though it looks like alchemy and depends to a degree on financial intuition for its profitable use, the transformation of funds serving real liquidity needs for depositors into long-term loan commitments for borrowers is not only practicable but is also a sound operation. Both experience and statistical analysis can be used to show that exposure to the liquidity demands of small and medium-sized depositors is, under most circumstances, modest in proportion and predictable in timing and, therefore, manageable. The stability of these hoards of funds in the aggregate is dependable, though to a lesser degree than the stability of demand deposits at commercial banks.

Commercial banking learned long ago that money claims (withdrawals) against demand deposits simply roll around the community from one account to another and if a bank could attract a balanced panel of depositors from various economic and geographic sectors in its service area it could count on surprising stability in the aggregate of its demand deposits. In actual practice, this stability was further reinforced by a banking tradition of conservative financial management and by public concern for the safety and availability of depositors' funds. Banks, therefore, often held large stocks of short-term and marketable assets as buffers against potential and even hypothetical deposit drains.

As the U.S. financial economy grew in stability and strength after the banking reforms of the 1930's, experience with somewhat less liquid claims--time deposits and share accounts--encouraged intermediaries to work greater and greater transformations of liquidity promises and attractive yields into long-term loans against which they extended commitments. Without a doubt this process has made saving easier and more profitable, and it has accommodated the interest and convenience of much broader groups of savers and investors. It has had an equally beneficent effect on users of loan funds who have had the benefit of a more competitive environment and in many cases access to credit resources heretofore not available.

Increasingly, intermediation became the best of all possible worlds for everyone--the intermediary, the saver, and the borrower. But, like all good things, some institutions tried to over-extend their capabilities by simultaneously promising instantaneous, unlimited liquidity to depositors under all circumstances, and assured credit availability to borrowers. These promises, good in ordinary times, became onerous and hard to meet in the months of monetary restraint last year. In some instances, losses and dislocations were severe.

Subsequently, apprehension about the stability of the whole intermediation process has arisen. Today intermediaries are re-examining more carefully and deliberately than ever before the basis of this operation and what they need to do to avert or lessen the strains that might arise in future periods of monetary restraint and sharply rising interest rates.

Several things could be done and a few, in my view, should be done. Let me sketch briefly some of the possibilities.

One view, more implicit than explicit in the monetary debates of 1966, is that monetary restraint should be abandoned as a tool of economic policy. This course of action appears in several guises--one academic observer, for example, believes that the money supply should be increased at an agreed-on, uniform rate, month in and month out, regardless of the level or change in interest rates or credit availability; because, he argues, neither the Federal Reserve nor anyone else is well enough informed on the linkages and lags in monetary action to prescribe a policy of deliberate monetary influence on the economic environment. Discretionary monetary management, in his view, is usually destabilizing. This argument seems to contain the assumption that the private economy is self-stabilizing--a premise that is hardly borne out by the history of business cycles prior to Keynesian economic policies. And if it was self-correcting, it was only at the cost of such "corrections" as the Great Depression.

Giving up discretionary monetary management for domestic objectives has also been urged at times by those who believe that, when domestic and balance of payments considerations give off conflicting signals to monetary policy, the balance of payments signal should prevail. They propose, in other words, that U.S. monetary policies should always adapt to those of the other industrial nations of the world. It is not at all fanciful that we will one day cede monetary sovereignty to a world-wide monetary authority, but I doubt that we shall be prepared for many steps in that direction except as existing extensive barriers to trade and migration are contemporaneously dismantled or relaxed and fiscal policies are also coordinated.

In 1966 many people objected to rapidly rising interest rates and a lessened rate of credit growth in the United States because of the immobilizing effect on their ability to sell existing assets, or to secure the funds to create more assets--in short, they objected to the impact of monetary action per se. What this position ignores is that the failure to restrain excess demand by monetary and/or fiscal policy will also limit the ability to satisfy demands--but the restraint will come from inflation.

I do not believe it would be wise to give up monetary tools as active instruments of government policy until it has been demonstrated that fiscal policy can go it alone as a stabilization device. As useful and promising as it is, fiscal policy needs more time to develop as a flexible and timely instrument. It is, of course, possible that for increasingly long periods of time monetary policy will be able to perform its function of serving the evident needs of the community without being forced into a vigorous reflationary or deflationary posture. This has been its role during most of the Sixties. Nonetheless, for the foreseeable future, we are likely to have occasional fluctuations in the economy and I believe intermediaries should expect in these periods to see changes in the monetary climate and be prepared to live with them. A change in the rules of this game is not likely to solve their problem.

In the past few months, intermediaries have been building their liquidity resources--repaying debt, liquidating outstanding commitments, and acquiring short-dated assets. These policies have been made possible by the large inflow of funds from savers, by investors turning away from market instruments toward depository institutions, and by a less than aggressive expansion of new loans and commitments.

This combination of policies and the patterns of interest rates and credit flows are consistent with the aftermath one would expect from a period of credit stringency. But they are becoming less and less consistent with, and appropriate to, the fundamental function and rationale of financial intermediaries. While this is an appropriate time for reappraisal of intermediation, the reappraisal should not be an excuse for drifting into a liquidity trance with its immobilizing effects on the traditional loan customers of intermediaries.

In the current reappraisal of the intermediation process, then, and the steps that might be taken to avoid or lessen such difficulties as occurred in 1966, I would hope that you felt considerable urgency to get on with your regular business of lending and responding to the current financial environment.

As an outside observer, may I offer a few suggestions or comments on the longer-run problem, recognizing your superior expertise and close knowledge of this branch of the intermediation business. They have to do with (1) a realistic objective in coping with monetary restraint; (2) possible alteration in your asset structure; and (3) changes in your liability structure and commitments on liquidity and credit availability.

It is quite apparent that intermediaries are giving a good bit of thought to outmaneuvering monetary restraint in the future while accepting the evident blessings of monetary ease. But, in my judgment, periods of conspicuous ease and vigorous restraint may well be of shorter duration in the future and may be supplanted by longer and longer periods when monetary policies have nominal effect on intermediation. If so, I wonder if this effort to outmaneuver monetary restraint is worthwhile.

In the past 14 years, monetary restraint of an intensity sufficient to affect the operations of intermediaries in any degree has been in effect for a total period of no more than 36 months and only on three different occasions: early fall of 1956 through October 1957; January 1959 to January 1960; December 1965 through November of 1966. Looking ahead, it would be easier to try to spot these events in the offing, even putting up with a recognition lag of two or three months, and then to adjust operations to the central bank's interest, rather than to attempt to over-ride, outmaneuver, or insulate your operations from a public policy of restraint.

True, some moderation in monetary impact on your business may be possible, practicable, and desirable. But avoidance in toto is only likely to lead to the use of different methods and tools by the monetary authorities should the need for them be apparent. I suggest, therefore, that when the economic climate gets steamy and the central bank has begun to reflect that fact in its policies, it is better for the intermediaries as a whole, and ordinarily individually, to pass along the restraint in charges and availability rather than trying to follow a "business as usual" policy.

Diversification of investment opportunities for mutual savings banks and savings and loan associations is frequently mentioned as providing more flexibility in adjusting to a decline in savings inflows and an increase in outflows. It is true that lending shorter on a broader spectrum of assets could help to improve portfolio flexibility. Earnings could respond more readily to rapid changes in general credit conditions and lenders could have a broader range of investment choice at times of savings abundance. It is true, too, that lending shorter could allow thrift institutions to operate more as one-stop service outlets for their many customers.

But the advantages of this kind of approach seem to me rather marginal. Investment flexibility could be sacrificed--not enhanced--if needs to service existing customers preclude on-again off-again operations. I question whether any significant sectors of consumer, agriculture, or business customers today are as easy to put off as are mortgage borrowers once they have become regular customers. Aside from builders, in fact, few mortgage borrowers become customers of one particular lender more than once in a lifetime. Most household heads take on a new mortgage loan relatively few times from any lender as they pass through the family cycle. In this sense, you may already have the most readily interruptible credit service being offered.

Admittedly, the grass is greener on the other side of the asset fence, and there are undoubtedly some potential sectors of unsatisfied credit demand in the United States, even at current rates and terms. But none stand out as large or as available on a stop-and-go basis as mortgage lending. And most sectors are already deeply penetrated by existing lenders with considerable expertise, ready to capitalize on the trend toward a checkless credit-card society.

Another investment possibility is to include more short-term marketable securities in your portfolio. Greater liquidity is indeed a worthwhile objective to a limited degree, and especially for intermediaries that traditionally specialize in borrowing short and lending long. But in the short run, of course, excessive liquidity can be gained only at the immediate expense of earnings which may or may not be improved over the longer run. Short-dated assets are more profitable only when long yields are trailing an upward trend in short rates--and perhaps not even then at the prices you pay for money. However, your timing has to be good to make this game pay in the short run--certain it is that the differential in yields between short and long debt today makes the former a pretty expensive loss leader. This is not to deny--let me emphasize--that a better cushion of liquid assets may not be desirable as a structural matter or may not improve long-run earning potentials.

Let me turn to the liability management side of the ledger, for this aspect of the problem seems to me to offer a greater promise of success, enabling you to use your particular expertise in attracting and retaining savings flows and pools. A longer structured set of liabilities can, of course, provide a better balance for the maturity range of assets, and can bring the turnover of liabilities closer in line with the turnover of assets. This, in turn, can help to minimize operational needs for liquidity.

It is well known that many medium-sized regular savers as well as owners of somewhat larger deposit accumulations, or even debt instruments, are not particularly sensitive to favorable yield differentials on market instruments. For some, in fact, liquidity is so important that the alternative to a time or share account is a demand deposit. For still others, there is no established or familiar pattern of direct investment and no promotion of such an alternative. Thus, there is a great deal of relative stability in regular savings accounts.

Larger and more sophisticated investors have also become customers of financial intermediaries because they have found that the investment convenience and yields offered often constitute a better package than they can put together themselves by dealing directly in market instruments. Most of these customers, however, are highly rate conscious, and many are acutely responsive to expectational influences in financial markets. To give them what is in effect costless instant liquidity is to incur exposure to sudden and large withdrawals that are disruptive to the practical operation of most intermediaries. Such depositors can only be made a useful source of funds if their rate sensitivity can be curbed through restrictions on withdrawals, through incentives not to withdraw, or can be satisfied by maintaining a close linkage between market rates and depository yields.

The large commercial banks have used several credit instruments to compete aggressively with market yields for a small but often significant part of their total resources. Negotiable certificates of deposit, Euro-dollars, Federal Funds, repurchase agreements, subordinated notes, and (in a negative sense) dealer loans have all been more or less competitive with market instruments.

In the aggregate, these devices have seldom provided more than five per cent of total commercial bank resources. But the importance to individual institutions, and in the aggregate of day-to-day, week-to-week, or month-to-month change, has, of course, been much greater.

On a limited scale, therefore, some instrument or group of instruments that enable an intermediary to pull funds out of the market--even at a possible loss in the short run--adds a degree of flexibility in periods of monetary restraint. And it is at the margin where flexibility counts most under these conditions.

What does experience tell us about the erosion in intermediaries' liability structure due to monetary restraint in recent years? No doubt your first-hand experience in 1966 tells you plenty--and rather than summarize something that you could describe better and with more feeling than I, it seemed to me it would be useful to cite some statistics from the experience of commercial banks in this period, recognizing that ratios of withdrawals to savings balances for commercial banks tend to run substantially higher than those for savings and loan associations.

For my convenience and because of the great detail in which the data are compiled, let me refer to time and savings deposit figures collected by the Federal Reserve Bank of Chicago for 450 commercial banks in 50 Midwest urban and metropolitan areas since the mid-1950's. These data are available for regular passbook savings and, after 1958, for passbook savings plus time certificates of deposit held by individuals (consumer-type CD's). Both rates of inflow and outflow are available, but I will be referring only to the statistic used to measure the rate of withdrawal or "turnover." This withdrawal rate pertains to gross withdrawals during the period--month, quarter, or year--divided by average daily balances in the corresponding period. It contrasts with the measure widely used by savings and loan associations, which relates gross savings withdrawals to total gross savings receipts.

From 1959 through 1966, the withdrawal rate on consumer-type time and savings accounts at this group of banks averaged .52; i.e., gross withdrawals in two years were roughly equivalent to the average balance for the period. This relationship also held true for passbook accounts alone. The surprising thing, however, is the stability in this rate over a period which included changes in time deposit ceilings and changes in the differential between passbook and CD ceilings. In three years--1959, 1961, 1962--the rate was .52; in 1963 and 1964 it was .47; in 1960 it was .50; in 1961 it was .51 and in 1966 it was .63.

If we average rates of outflow in the years 1961-1965 as not being significantly affected by monetary posture one way or the other, we come up with a rate of .50 to match against .63 for 1966 and .52 in 1959 and .50 in 1960. These overall averages suggest monetary restraint could have affected the outflow rate by no more than about 4 per cent in 1959 but by as much as 25 per cent in 1966. Incidentally, similar computations for insured savings and loan associations in the Chicago Federal Home Loan Bank District show that monetary restraint could have affected the outflow rate for these institutions by about 3 per cent in 1959 and by about 15 per cent last year.

For commercial banks, local competitive conditions and practices in the Midwest have had a marked effect on the level of withdrawal rates in various localities. If the data are disaggregated so as to show changes taking place in the major metropolitan area of each State (Chicago, Detroit, Milwaukee, Indianapolis and Des Moines) and in all of the other urban areas combined for each State, the results are reasonably consistent with expectations. Michigan rates are high--about .65--and rose most sharply--about one-third--in 1966. Rates in smaller cities of Iowa, Indiana and Wisconsin were lower (.40-.45) and rose least--under 10 per cent. In Chicago, Milwaukee and Des Moines rates increased about 20 per cent, from levels of less than .50.

These data imply that, in many geographic areas, attention obviously needs to be given to the structuring of liabilities of savings-type institutions so as to curb or offset withdrawals from interest-sensitive accounts. In these Midwestern States, 60 to 75 per cent of passbook savings are, according to the FDIC's 1966 Survey of Deposits, in individual accounts of less than $10,000 each. The average size of these accounts is less than $900. Another 20 to 30 per cent of passbook savings are in accounts of between $10,000 and $25,000 each. While our withdrawal data do not pinpoint the accounts from which the 1966 acceleration in withdrawals emanated, much of the increased outflow must have come from these larger accounts.

The practice of making immediate payment on request for time deposits or share accounts, despite legal notice requirements, works out well as long as the amount and timing of withdrawals can be anticipated and allowed for. But periods of monetary restraint present special problems; at such times, in the interest of stability of financial institutions, further disabilities may need to be brought into play on withdrawals made for rate advantages. Rules imposing a greater loss of interest for certain types of withdrawals, further extended maturities on deposits or share accounts, and a more careful internal appraisal of depositors' withdrawal propensities are some of the techniques that should be explored in assessing the limits of intermediation for our depositary institutions. Perhaps such exploration would lead to policies circumscribing intermediaries' growth--curbing advertising claims of instant liquidity, higher yields and assurances of ever-ready credit while tranquilizing institutional exuberance and overconfidence--but I have a feeling that for the institutions involved these results could be all to the good.