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NEW STANDARDS FOR CREDIT AND MONETARY POLICY

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New Standards for Credit and Monetary Policy

Innovations in commercial banking in recent years have been numerous and significant. Many of the changes were overdue or inevitable in light of the Nation's economic development. Several have implications for monetary and credit policy because the banking system is the primary transmission link for the Federal Reserve's monetary and credit actions.

At least three such facets of postwar banking developments emerging in the Sixties appear to foretell significant trends in the Seventies. These are: (1) changes in commercial banking structure and function; (2) the introduction of new and varied intermediation instruments of both a deposit and non-deposit character; (3) the progress toward computerizing monetary transactions.

My comments on new standards for credit and monetary policy are organized around these unfolding developments in commercial banking because they will condition to a considerable degree the efficiency and effectiveness of alternative monetary techniques and devices.

Banking Structure and Function

It was becoming more and more apparent in the Fifties and early Sixties that banking's growth was being constrained by geographical confinement of major conventional types of banking activity. Stunting the growth potential has been accomplished by

limiting the economies of scale realizable in a modern corporate organization. For banking these economies and efficiencies are significant in such diverse areas as data processing, capital adequacy, resource allocation, management succession, portfolio management and planning.

Banking organizations today ordinarily compete in the provision of most traditional money, saving, and loan services only in areas around their banking office locations. There are exceptions, of course. Banks are continuously active in the impersonal money and capital markets. They also provide services to remote corporate and individual customers whose balances are large enough to justify a competitive effort. But, by and large, most banks grow in the number of customers services either by extending their service areas or as the communities around their existing locations grow. And a community might, in these terms, be a neighborhood, a city, a county or a group of counties. If growth in a community is slow relative to that in the Nation, its banks are also faced with relative sluggish growth prospects. As the higher rates of population and industrial growth in the past 20 years have been in the South and West, banks in those regions have had the greater growth potentials. The established financial institutions in the East and mid-West, on the other hand, have had to develop new activities, markets, and sources of funds in order to show significant rates of growth.

Aggressive banking organizations of sufficient size to exploit economies of scale have extended their operations and competitive positions in many ways. Some results of their efforts are manifest in the accelerated growth of holding companies with one or more banks, in relaxed branching restrictions and quickened merger activity in a few States; in the development of new lending and borrowing services; and in the expansion, mainly through subsidiaries and affiliates, into related and financial services such as equipment leasing, mortgage servicing, data processing, insurance, factoring, international finance, and mutual funds.

Some of the thrust of these developments can be seen in the comparative statistics over the past decade. There has been a decline in unit banking, a drastic shift in the balance in the dual banking system and an erosive change in the influence of correspondent banking connections. The main fact though is that bankings' structural horizons are changing in ways that will be more apparent in the statistics of the Seventies.

For the banks that are participating, the extension in markets has been both geographical and in broadened services. In general, the competitive effects of these trends on both bank and non-bank competition has been salutory although there is much apprehension evident in the congressional deliberations on the one-bank holding company bill that larger banks will, by these means, become too dominant in too many markets.

The implications for credit policy are that as banking organizations become more diversified in form, function, and geographical extent they become more resourceful in coping with regulatory constraints and more protean in their resistive capacities. Shaping the resource-gathering and credit-granting activities of banking conglomerates through interest rate ceilings, reserve requirements and other regulatory restraints might be likened to punching a bag of sand into an erect position. Many doubt it is possible, necessary or even desirable to do so.

Most sectors of the U.S. financial structure are less hampered by regulation affecting credit conditions than banks, but the banking sector has been so pervasive in its influence on other financial institutions and market participants that it has had the capacity to pass on or "lay off" restraint. This action is not costless so far as the bank and its customers are concerned. But a bank can, for a market determined price, sell assets, borrow money or attract deposits and use these resources to meet its loan and investment commitments. This ability to transmit restraint to the market and other intermediaries has meant there has been no real difficulty in making public credit and monetary policies work even though many institutions and their customers are not directly touched by Federal Reserve policies.

Recent trends toward conglomerate corporate complexity indicate the possibility of stripping some activities and functions away from the banks proper and lodging them in subsidiaries,

affiliates, joint ventures or trusteed stock arrangements. These moves would, at least temporarily, frustrate regulatory constraints and might serve other corporate objectives but they would, if thought to be running counter to the overall public interest, invite further regulatory complications. As long as financial conglomeration is really peripheral to a banking system which retains credit market shares in the neighborhood of those realized in the late 1960's there seems to me to be little cause for concern on the score of credit and monetary control in the functional and structural developments under way today.

Time Deposits and Liability Management

A drastic decline in the major component of money--demand deposits--has occurred in the Fifties and Sixties. Such deposits have long been regarded as the life blood of commercial banking; they have also been the source of predictable stability in loanable resources. In mid-1947 the net contribution of such deposits to commercial banking's resources was equivalent to 37 per cent of the then current GNP; in mid-1957 to 25 per cent; in mid-1969 to 17 per cent.

Banking had a response to the 50 per cent decline relative to GNP in check book or non-interest bearing bank money. It was the development and promotion of a variety of interest-bearing deposits and other liability instruments. The long-established passbook accounts were glamorized and their rates made more competitive.

Negotiable and non-negotiable certificates of deposit were tailored in size, maturity, rate and name. In a variety of forms they have been suited to the needs and convenience of the banks' regular customers as well as customers of other intermediaries. These certificates have also appealed to large numbers of money market participants.

In the aggregate these measures worked to extend banking's share of credit markets from roughly 20 per cent in the late Fifties to around 40 per cent in the late Sixties. Within banking, the relative roles of demand and time deposits in providing loanable resources have shifted from a 2.4 to 1.0 relationship in 1947 to a .8 to 1.0 relationship in 1969.

Experience with monetary restraint in 1966 showed banks how regulatory ceilings on rates of interest for deposits might become a threat to their capacity to retain contact with the sources for funds they had developed in the early Sixties. In consequence, new channels of communication with markets were developed in the form of non-deposit liabilities which were subject neither to interest rate ceilings nor reserve requirements. Among the devices used, Euro-dollar borrowings, repurchase agreements, and commercial paper sales by holding company affiliates and banking subsidiaries have been the most important or promising.

As banks extended in scope and magnitude their access to money and credit markets earlier this year, apprehension that such

techniques would undermine the force of monetary restraint grew despite the magnitude of the decline in deposit flows.

On July 24 the Board of Governors restricted the use of repurchase agreements by commercial banks. This was done by making the bank liabilities on such agreements deposit liabilities provided the agreements had been entered into with nonbanks and on assets other than Treasury securities and agency issues. The purpose of the regulation was to prevent banks from borrowing on their portfolios of loans, mortgages, and municipal securities and thus obtaining funds for other lending and investment or to meet liquidity needs. The constraint of Regulation Q ceilings applied to such transactions as it would to time deposits generally.

This action had the effect not only of limiting the banking system's access to money and credit markets but also of downgrading mortgages and municipal securities as liquidity assets relative to Treasury and agency issues.

On August 13 marginal reserve requirements were imposed on Euro-dollar borrowings and the sale of outstanding loans to foreign branches. A regulation imposing interest rate ceilings on commercial paper sold by banking affiliates has been proposed by the Board.

Without doubt regulatory policies have been aimed at insulating the banking system from money and credit markets. This has been done with rate ceilings, regulations curbing banks' ability to substitute other liabilities for deposits, and restrictions on contingent sales

of assets. In total, these measures have limited the banking system's ability to lend to its customers, a fact that is abundantly clear from the magnitude of the decline in market shares of funds going to banks in 1966 and 1969. The same rate ceilings have hampered the savings and loans and the mutual savings banks in serving their customers, too, although their plight in 1969 has been ameliorated by the operations of FNMA and the lending policies of the FHLB Board.

The policy of reinforcing monetary restraint by constraining banking's access to money and credit markets may be more controversial than its practical significance in the present situation warrants. But for the long run it clearly raises important issues relating to financial structure and the role of credit policy.

As seen by their proponents today, regulatory constraints have forced a sharp contraction in the rate of bank and other intermediary lending and investment. The rational for this approach is that Q ceilings, by limiting bank access to funds, have led to greater restraint on business loans than would otherwise have occurred--a desirable distributional effect on credit availability in view of the role of business investment in generating excess demand and inflation. Furthermore, since intermediaries are more efficient in their credit allocative function than direct lenders and markets, the reduction of intermediation is seen as the quickest and surest way to slow and restrict the availability of credit and thus to bring about the modification of spending and investment decisions.

All of those borrowers who are exclusively dependent on intermediaries encounter credit restraint even though they may be preferred customers.

The main argument against sealing off the intermediaries from markets is that the effectiveness of restraint is not significantly diluted as a result of its being shifted by a bank intermediary to the market or another intermediary, however different the incidence. As banks disperse monetary restraint, and they cannot disperse all of it, they force borrowers other than their customers to pay higher prices for credit and to face uncertain availability. Their action in selling assets, raising interest rates paid for funds, entering into repurchase agreements of assets and the like, does not result in much diminution of over-all restraint. Even if intermediaries were given unlimited access to money and credit markets they would themselves be increasingly restrained by the market environment they would be creating. The argument continues that the channeling and confinement of restraint to intermediaries and their customers results in the unnecessary dislocation of credit patterns, in inequities in the distribution of credit and inefficiencies in the operation of the financial system.

The differential effect of forcing intermediaries to contract their lending operations has the most certain and serious effect on smaller customers who do not have significant access to capital and credit markets. Shutting off or restricting the flow of bank credit to large corporate borrowers only means they become

more dependent on markets. And since such borrowers are better able than most others to obtain funds in the market using such non-depository credit instruments as commercial paper, some have argued that corporate borrowers were more favorably situated with respect to credit availability as a result of bank disintermediation.

While I am persuaded that intermediaries should have had more ready access to markets, the contrary position is not without merit from a pragmatic short-run standpoint. However, I believe the real problem is not one of making monetary and credit restraint effective in some given interval but the longer run effect of such tactics on the process of intermediation and the institutions providing this service.

A significant change in the financial environment during the Sixties has been the greatly expanded role for intermediation. Liquidity services have been shifted on a large scale to intermediaries or specialized intermediary devices. There has been a resulting relative decline in demand deposits and non-intermediary holdings of non-intermediary debts. If long-run policies are adopted to cut off their access to markets intermediaries will be greatly handicapped fulfilling their liquidity function. In this view, they are more in need, from a public policy standpoint, of being assisted in dispersing restraint than being constrained from doing so.

Looking beyond the current period and its requirement of monetary restraint, therefore, I believe the view that banks

should be barred from access to financial markets by regulations of one type or another presents neither a stable solution to the problem nor one that is in our long-run interest. It is unstable in the sense that the banking system can develop quite an array of alternative techniques for maintaining contact with sources of funds and users. While it may be true that commercial banking "cannot fight city hall" very effectively in the short run, given time it can develop flexible instruments and durable relationships to break down most of the barriers regulators can think up. And if it cannot and the belief prevails that banking must in the public interest be isolated from financial markets, many of commercial banking's present-day functions will be scattered to other intermediaries and financial agencies.

But, it seems to me, this, in addition to being undesirable, is entirely unnecessary to the objective of monetary restraint. If, in fact, it should be determined that monetary restraint ought to be aimed at selected types of institutions or specific uses of credit, it would be better to impose differential reserve requirements on all such institutions and assets. While I believe we need not shrink from being concerned with the social objectives served by the economy's use of credit, I question whether this period of monetary restraint is one in which to launch such a policy explicitly or by indirection.

We would improve the effectiveness of the linkages by which monetary restraint is transmitted if we could develop techniques

for bringing commitments to lend under pressure more promptly. No reasonable application of monetary restraint is intended to bring about "fails" on prior commitments. The process is aimed rather at prospective spending and investing decisions. The tardy response to monetary restraint in 1969 can be traced to the weakness of its initial impact on commitment policy of lending institutions.

Computerizing and Scheduling Monetary Transactions

I noted earlier the decline over the past twenty years, in relative terms, of the demand deposit component of the money stock. A similar decline has occurred in currency. Coin usage, on the other hand, has stepped up about 25 per cent in the same period, primarily as a result of requirements for meter hoards.

Money serves two basic functions: as a transaction tool and a source of liquidity. Technological changes in the past decade have greatly extended money's efficiency as a transactor and greatly reduced its relative attractiveness as a liquidity source.

The relative decline in currency can be linked to the expansion in consumer checking accounts, charge accounts, and credit cards. Non-cash sales make up over two-thirds of the transactions of many of our largest retailers. Convenience credit is widely available via vendors' credit facilities and, more recently, through bank, oil company, and travel and entertainment cards. It has been estimated that by late 1970 at least 50 million bank

credit cards will have been issued. There are 75 million charge accounts in use today.

The most striking decline in holdings of demand deposits has occurred in business accounts. These are no higher today than they were in the early Fifties. Actually corporate demand balances today probably reflect more than anything else compensating balance requirements for check processing, loan and other banking services. Theoretically, a skilled money-managing, computer-equipped treasurer, unhampered by compensating balance requirements, could manage his firm's checking account so that toward each day's end he would know if he had a balance large enough to cover the transaction costs for an overnight investment. And if he had, his resultant late-day investment action might, under certain circumstances, indirectly turn out in effect to be lending that residual in his account to his own bank. Electronic facilities for check processing will make possible much closer management of cash positions, particularly if scheduled credit transfers become commonplace.

The best information we have on the ownership of the demand deposit component of the money supply indicates that households own about $70-75 billion, nonfinancial businesses $45 billion, financial business $15 billion, and State and local goverment $13 billion. About $4 billion is in foreign accounts. It is safe to say that all professionally-managed accounts are at or near minima established by banking rules or practices.

Households are managing their money position more closely, too--many use a fee-no-minimum balance-type account. Individuals have become increasingly sensitive to interest costs and interest yields. Their response to the promotional efforts on the advantages of time and savings accounts has been to progressively reduce demand balances to the minimum levels consistent with the timing of income receipts. Such attitudes are evident in the average holdings in household checking accounts. According to mid-1968 data, the latest we have, there were 79+ million demand deposit accounts. Most of these were for households but businesses, governments and nonprofit organizations were included. Sixty-four million accounts had balances of less than $1,000 and the average holding was $240! Not much leeway there.

Computer facilities becoming available will enable households to schedule regular periodic payments through pre-authorization arrangements even more precisely in relation to the timing of their salary and wage credits. This will bring within their reach still more of the money economies that corporate treasurers present enjoy.

The reduced relative attractiveness of money--currency or demand deposits--as a source of liquidity arises chiefly from the competition of near monies--mainly savings and time deposits in commercial and mutual savings banks and savings and loan associations, but including short dated Government debt and money market paper. Since these interest-bearing deposits or paper have instant

liquidity or conveniently scheduled maturities they can serve as both liquidity reserves and earning assets.

The relevance of these facts on deposit trends and prospects is to the controversy over the use of money supply as a guide for monetary policy makers or as an indicator of their actions. In recent years rates of change in various financial aggregates have been increasingly recognized for their analytical value in both of these roles.

The Federal Open Market Committee has, since 1966 and regularly beginning in 1968, used an aggregate called the "bank credit proxy" to quantify intervention limits on expansion or contraction arising out of a directive couched in terms of money market conditions and interest rates.

The primary instructions to the Manager are for "no change," "firmer," or "easier" posture supplemented by specified ranges in marginal reserve measures and short-term interest rates. This pattern is internally consistent, so far as can be foretold, with a projected range for the "credit proxy." But if the proxy begins to move outside of its range this fact begins to modify the Manager's reserve supplying actions.

Our experience using aggregative measures as supplementary operating guides has not been spectacularly successful but it has been good enough to encourage further development and use. Since the only measurable monetary action the Committee can take is to alter the amount of reserves supplied to the banking system, it is

necessary to estimate how quickly a change in reserve injection will affect changes in various aggregative measures. The relationships are far from stable and the results have been necessarily approximate and subject to significant errors.

The Joint Economic Committee of the Congress in recent years has urged greater attention to a particular monetary aggregate--M_1, the narrowly defined money supply. In its 1969 report is said:

> "Over the long run, the increase in the money supply should be roughly at the same rate as the growth of U.S. productive capacity. As indicated by this committee in its report, the expansion of the money supply should be somewhat above the long-run real growth rate during periods of high unemployment and excess capacity. On the other hand, monetary expansion should be below real growth in periods of inflation. We recommended a rate of increase ranging from 2 percent to 6 percent. The principle of harmony between the rate of growth of the money supply and the rate of growth of the economy has been recommended by the committee for many years....."

> "As long as inflation continues at a high rate, the pace of expansion in the money supply should remain near the lower end of the range suggested; that is, near 2 percent per annum."

By the Committee's standards the Federal Reserve may or may not be in the ball park. For 1969 as a whole (up to December) money supply rose at a 2.8 per cent rate but the growth in the first half was 4.3 per cent and in the past five months was 1.1 per cent.

There is no doubt, in my opinion, that financial aggregates will steadily become more useful in guiding policy makers and the judgments of those who are searching for clues to policy changes. But I believe we are a long way from being able to specify a particular aggregate as a "North Star" for monetary navigation. Nor would I expect that in our researches we will be able to find for our constantly changing environment a single aggregate--monetary or credit--of predictable durability and reliability.

On the other hand, if the analytical insights that can be gained from the study of the Flow of Funds were available on a more current basis our reliance on changes in credit aggregates would be significantly extended.

The most popular of all the aggregates--M_1--seems, given present technological and institutional trends to have the shortest life expectancy. Its significance for policy is being chipped away, on the one hand, by steadily increasing variety and attractiveness of near monies and, on the other, by the long continued and prospective further rise in velocity made possible by computer and communications technology. Turnover (velocity) in demand deposits has been increasing steadily: it more than doubled in the 1960's and has increased 7 per cent so far this year.

The technological obsolescing of M_1 does not mean that money supply is dead or only alive in St. Louis. If it were to be rid of its transaction component and become primarily a liquidity measure its meaning and interpretation would be in the tradition of M_2 and M_3, and, in my judgment, this would add significantly to its stature as an important financial aggregate.