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IN RECORDS SECTION
JUN 28 1963

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

June 27, 1963.

TO: Federal Open Market Committee

FROM: Mr. Sherman

For your information, there is enclosed a copy of the text of a statement on liquidity and monetary policy presented by Mr. Young at the O.E.C.D. meeting of Working Party No. 3 held in Paris on June 19, 1963, together with the charts referred to in the statement.

Merritt Sherman, Assistant Secretary,
Federal Open Market Committee.

Enclosure.

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June 19, 1963

JUN 28 1963

LIQUIDITY AND MONETARY POLICY

INTRODUCTION

This presentation is designed to examine recent changes in liquidity in the United States economy. You have before you a set of charts depicting liquid assets and related variables over the past decade or so. I shall ask you to follow the presentation by examining these charts with me as I go along.

As we do this, we may succeed in throwing some light on the process that generated recent changes in liquid assets, on the forms in which they occurred, and on the effects on balance sheet structures of the major economic sectors in the U. S. economy. We shall conclude with some observations regarding the recent and prospective posture of monetary policy.

OVER-ALL LIQUIDITY

CHART I - LIQUID ASSETS AND GNP

Chart I shows that over the past two years the private sectors of the economy--consumers, nonfinancial businesses, State and local governments--have added substantially to their holdings of money, savings accounts, and short-term U. S. Government securities. The increase in their liquid assets is notable partly because of its size--some $65 billion or 16 per cent in two years--and partly because it exceeded the rise in economic activity as measured by GNP. In previous postwar cyclical upswings, liquid asset holdings have generally increased less rapidly than activity,

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so that a decline in the ratio of liquid assets to gross national product has resulted. In this cycle, however, the ratio declined briefly and then turned up again, attaining by the end of last year roughly the same level as at the cyclical trough in early 1961.

This contracyclical rise in liquidity raises questions as to both its internal and its balance of payments effects. But before answers can be attempted, there is need first to examine the spending and saving patterns of key sectors of the economy--consumers and corporations--and the inflows to and investments of the key financial sector--the commercial banking system. This is what my charts, for the most part, endeavor to do.

CONSUMER SECTOR

CHARTS II AND III - CONSUMER SPENDING AND BORROWING

Let us consider first the pattern of consumer spending and saving. The major components of each, for the past decade and a half, are traced in Chart II. The upper panel shows how narrowly the spending by U. S. consumers for nondurable goods and services has fluctuated in relation to income. Cyclical swings are shown to have ranged roughly between 75 and 78 per cent of income. Cyclical swings in spending for tangible assets (the second panel from the top) have clearly had much greater amplitude. In the present cycle, however, spending for tangibles over all, at least until this spring, has shown very small and irregular cyclical advance.

Let us look next at consumer borrowing to finance spending. As the bottom panel of Chart II shows, this has averaged a little

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better than 5 per cent of income, and typically in each cyclical upswing there is a rise in borrowing. In Chart III, where borrowing is related to spending for tangible assets, one is struck by the apparent heavy reliance that consumers have placed in the present cycle on debt financing of such assets.

In Chart II again, the second line from the bottom traces consumer acquisitions of financial assets in relation to income. Reflecting the fact that consumer current consumption has not been exceptionally high in this cycle, while spending for durable items has been relatively low and extensively financed from borrowed funds, this ratio last year reached a peak level for the postwar period. (Since year-end, the ratio has apparently fallen off a little.)

CHART IV - CONSUMER LIQUID ASSETS

The next chart, Chart IV, breaks out consumer acquisitions of liquid assets from their acquisitions of all financial assets. The key point is the dramatic rise in consumer acquisitions of liquid assets in this latest cyclical upswing. In earlier periods of a rising ratio of financial saving, the rise reflected especially acquisitions of securities. It may be noted that the increase in total financial assets of consumers was much less striking than that in liquid assets.

CHART V - YIELD SPREADS

One of the explanations for the differing behavior of consumers in acquiring financial assets in the present cycle as compared with earlier cycles is to be found in Chart V. In earlier

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upswings, interest rates on market securities rose substantially relative to rates on time and savings deposits. From stage to stage, in 1961 and 1962, deposit rates were stepped up, while market rates on securities were stable or declining. Thus, apart from other influences at work, consumers have had a greater inducement to acquire those types of financial assets that are ordinarily classified as liquid.

CHART VI - LIQUID ASSETS UP MORE THAN DEBTS

With consumer debt and financial assets both rising substantially in this latest cyclical upswing, Chart VI provides an answer to the question whether consumer financial positions over all were deteriorating or strengthening. The answer is clearly on the strengthening side, at least in the aggregate for the consumer sector. While short- and long-term debts of consumers rose by $34 billion over the two-year period from early 1961 through 1962, consumer holdings of liquid assets alone rose $47 billion. It may be added that very little of the increase in consumer liquid assets was in immediately spendable cash; consumer money holdings rose by only $4 billion.

CHART VII - SHORT-TERM AND MORTGAGE DEBT

The composition of the recent increase in consumer debt is made clear in Chart VII. Short-term debt did little better than to keep pace with income, while the rise in mortgage debt outstripped income as it had in earlier cyclical periods.

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CHARTS VII-A AND VII-B - ASSETS AND DEBT BY INCOME AND AGE GROUP

We now look at the available evidence from consumer surveys on the increase in liquid assets and debt among broad income and age groupings, shown in Charts VII-A and VII-B. These cross-sectional data indicate that between early 1959 and early 1962, increased liquid asset holdings (Chart VII-A) were concentrated mainly among older families in the lower and middle income groups. But, as Chart VII-B shows, the largest increases in debt were among upper income families. These indications have a bearing on the question whether the rise in savings and time deposit holdings of individuals represents, in fact, cash held temporarily idle pending some investment action or large personal outlay, or whether it represents longer term savings accounts. We think that they suggest the latter, in view of the average age of those accounting for most of the increase in assets.

CORPORATE SECTOR

CHART VIII - CORPORATE SPENDING AND BORROWING

We turn next to a set of charts relating to nonfinancial corporations. The developments in this sector have some important similarities with the consumer sector and some important differences. As to similarities, the business sector has applied in this cycle a smaller proportion of available funds to the acquisition of capital assets than in comparable phases of other postwar cycles, as may be seen from the top line of Chart VIII. But borrowing did not rise much in relation to retained funds (bottom line) and there

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was no large rise in the acquisition of financial assets (middle line) in relation to internal funds.

CHART IX - CORPORATE BORROWING

While corporate business borrowing did not rise much in relation to retained earnings in the present cycle, it did rise moderately in relation to expenditures on tangible or capital items, as is shown in Chart IX. The rise, however, was less noteworthy than for the consumer sector, and the ratio has turned down a little in early 1963.

CHART X - CORPORATE LIABILITIES AND LIQUID ASSETS

Considering the widely reported increase in the volume of corporate internal funds in this cycle, the picture of the developing liquidity position of U. S. nonfinancial corporations, shown in Chart X, comes as somewhat of a surprise. Corporations have added strikingly in the present cycle to their accounts receivable--in this way extending credit to one another, to unincorporated business, and to consumers, accentuating a trend that traces back to 1954. In the present cyclical expansion, moreover, the rise in accounts receivable has further encroached on total current assets, with the result that there has been little increase in liquid assets. With current liabilities also rising at a rapid pace, the ratio of corporate liquid assets to total current liabilities has fallen to the lowest level of the postwar period and preliminary data for the first quarter show a further reduction. Incidentally, this general pattern of financial change holds for most industries and major size groups of business.

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CHART XI - CORPORATE LIQUID ASSET HOLDINGS IN RELATION TO CORPORATE INCOME

In this chart we measure corporate liquidity in relation to the flow of income rather than, as in the last chart, in relation to the stock of liabilities. Corporate liquidity in relation to corporate-generated GNP has also shown a decline over the past decade and this decline, as Chart XI illustrates, has been extended in this cyclical upswing. This ratio has now arrived at a level significantly lower than at the beginning of the 1956-57 business capital investment bulge.

Another point to be noted is that the corporate response to the rise in short-term interest rates in this cycle has been principally reflected in a shift in the composition of liquid asset holdings. Thus, the ratio of cash to corporate activity has declined, while holdings of interest-bearing liquidity instruments have increased since 1961.

One element in this increased holding of liquidity instruments merits special comment. Negotiable time certificates of deposit, first introduced by banks in mid-1961, now amount, after a burst of popularity early in 1962, to $7 billion or so. The availability of this instrument has provided the U. S. financial community with an instrument competitive with the Euro-dollar market. Without its existence and the interest rates offered by it, the outflow of U. S. short-term funds into international markets in 1962 might have been much greater.

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Altogether, the picture of corporate liquidity depicted in this and the previous chart suggests some interesting portents for the future. If the U. S. economy begins to experience an upsurge in business capital investment--both for larger inventory holdings and for larger plant and equipment acquisition--a stage may not be far distant that will feature strongly expanding business credit demands at banks and through market flotations.

THE BANKING SYSTEM

CHART XII - BANKS SHIFT THEIR PORTFOLIO COMPOSITION

Our next three charts relate to the banking system. Chart XII shows that, while the first response of banks to recovery from recession was an increase in the share of their portfolios made up of Governments, this response was soon succeeded by one entailing a declining share of Governments and a rising share composed of mortgages and municipal securities. Consistent with our earlier observations regarding borrowing by consumers and corporations in the current cyclical expansion, we see that the proportion of consumer and business loans about held steady--in other words, about kept pace with the expansion in total deposits. Most recently the banks have again been operating to enlarge the share of Governments in their portfolios.

CHART XIII - TIME AND SAVINGS ACCOUNTS

The rise in time and savings accounts at U. S. commercial banks since the recession low of 1961, amounting to about $28 billion, or 37 per cent, has been the outstanding feature of U. S. banking

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developments. Over the same period, expansion of demand deposits has amounted to only $5 billion, or 4-1/2 per cent. Thus, there has been an accelerated shift in the composition of deposits, extending a trend going back for a decade, as Chart XIII shows.

This shift in deposit composition, accentuated by higher time deposit rates at banks, put banks under pressure to seek assets yielding enough to pay the higher interest costs. They naturally sought these assets in the market sectors most active in generating new debt claims--the mortgage and municipal securities markets. The instruments of these markets have long maturities, and the banks have justified their acquisitions of them on the hypothesis--supported to be sure by some evidence--that the rise in time deposits has represented real "long-term" savings. However, with the proportion of consumer, farm and business short- and intermediate-term loans holding constant, with the proportion of mortgages and other securities rising, and with the average maturity of the Government portfolio somewhat extended, the whole development has resulted in some erosion in the liquidity position of the banks. This does not mean that erosion has been serious, but merely that individual banks in large numbers have put themselves in a position of greater dependency on borrowing reserve funds from the central bank in the event that conditions of credit availability in the U. S. money market should change.

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CHART XIV - NET FREE RESERVE POSITION

The last chart of the group shows the net free reserve position of the banks over the past decade. This particular figure is sometimes used as a measure of the liquidity position of our banks but it is no more such a measure than the Euro-dollar position of Continental banks is a measure of their liquidity. The figure is merely a measure reflecting the net unlent and uninvested funds of banks at a given point in time. It is seldom a large figure-- a half billion dollars being in experience almost an outside margin. Our city banks, which consistently operate with well sharpened pencils, almost never share in it on the positive side to any significant degree. And from week to week, the figure, whatever its amount, never represents funds in the hands of the same group of banks; the ownership of the funds represented is constantly shifting.

As can be seen from Chart XIV, the net free reserve position of the banks in the economic cycles preceding this one featured a conspicuous swing from recession to cyclical peak, mirrowing the cyclical course of U. S. monetary policy. The normal propensity of U. S. banks is to rely on reserves acquired outright rather than obtained by borrowing or discounting. From time to time, individual banks may borrow reserves from the central bank in making reserve adjustments but when this is done the indebted banks are under obligation to free themselves from discount debt at a relatively early date. Consistent with this pattern, the U. S. central bank

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makes a practice of providing at its initiative the reserves needed by the banking system for its ordinary growth. However, when credit demands at banks are strong, the banking system will usually find it expedient to supplement reserve funds supplied at the central bank's initiative (through open market operations) with funds they take the initiative in borrowing from the central bank. When this happens, the banking system's free reserve position will decline.

In the present cycle, and reflecting the slack in credit demands in relation to resource use and also the lagging expansion of the money supply, it has been possible to proceed thus far without the same swing in the banks' free reserve position as in past cycles. The main reason is that, with U. S. economic growth lagging and with a margin of underutilized resources persisting, the monetary authorities have felt that the pressure on bank credit expansion emanating from a persisting large free reserve position was appropriate and desirable.

Late last year, as the pace of demand deposit expansion increased appreciably and as payments flows internationally turned more adverse, the Federal Reserve reduced somewhat the pace at which it was supplying reserves to the banking system for purposes of domestic stimulus. This was reflected, given other conditions, in some decline in the net free reserve position. With the indications of resumed expansion in domestic economic activity this spring and with the payments position internationally showing little, if any improvement, the Federal Reserve has recently retarded further the

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pace of its provision of reserves and the banks have been obliged to support their lending and investing with an increased volume of discounting at the Reserve Banks. U. S. credit conditions are now less easy than they were. Indeed System policy has been described by the financial press as having shifted from a moderately stimulative posture to one that is neutral to moderately stimulative.

CHART XV - COMPARATIVE MONETARY DEVELOPMENTS

To set expansion in U. S. monetary liquidity in perspective, there is one final chart worth brief attention. Chart XV compares over the period since convertibility the expansion in the supply of total U.S. money and quasi-money--as defined by the IMF--with that experienced by principal continental countries. If you have gotten an exaggerated impression of the monetary expansion in the U. S. in consequence of the monetary ease that has been pursued during this economic cycle, these charts should serve to deflate a little the exaggeration. Compared with the increase in monetary liquidity of important European economies, that occurring in the U. S. has been modest indeed--and modest enough to keep our price level stable if not modest enough to preclude any spill-over into international markets.

CONCLUSION

To recapitulate the facts and relationships we have reviewed:

(1) Capital spending by both consumers and corporations has increased little in relation to incomes in the past two years of cyclical expansion. This accounts in large measure for the continued slack in the economy;

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(2) Consumers and to a lesser degree corporations have chosen to finance a sizable share of the cyclical expansion of their capital outlays by borrowing.

(3) Borrowing by consumers in this period has been exceeded, on the asset side of their balance sheets, by acquisition of financial assets, mainly in the form of "liquid" claims on financial institutions.

(4) The relationship between market and deposit interest rates has helped to induce consumers to take a substantial share of their increased financial assets in the form of claims on financial institutions. This is in contrast with past cyclical upswings when their increased financial assets took much more the form of direct acquisitions of securities.

(5) Corporations in this cyclical expansion have used their growing financial surpluses principally to extend credit to customers and suppliers rather than accumulating larger holdings of Government securities. As a consequence, corporate liquidity has fallen to the lowest level of the postwar period.

(6) For commercial banks, the postwar trend in deposit composition toward a larger share of time and savings and a smaller share of demand deposits has accelerated since the recession low of 1961. At the same time, bank portfolios have come to include a larger share of longer term and a smaller share of liquid assets. Thus, banks are now more highly dependent on reserves supplied by the central bank to meet expanding borrowing demands in the period ahead.

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(7) Finally, it is easy to exaggerate the increase in liquidity that has occurred in the U. S. economy. By comparison with Continental Europe, the increase in U. S. monetary liquidity has been quite moderate.

In my personal judgment, it would be a grievous mistake to conclude from developments in the consumer and corporate sectors that less bank credit availability in the past year or two would merely have resulted in a smaller accumulation of both debt and financial assets by consumers and corporations, leaving capital spending untouched. If bank credit had been less available and interest rates higher, capital spending would doubtless have been even less expansionary than it was. Considering the delicate and uncertain balance of expansionary forces and U. S. margins of unused capacity and manpower, the result might well have been a full-scale and deflationary recession in the U. S. rather than a slow expansion. This consideration has had a major influence on U. S. monetary policy.

At the same time, the monetary authorities have been continually aware of and responsive to the exigencies of the balance of payments. By acting to maintain a competitive level of short-term rates, they have foregone additional monetary expansion at a time when the economy needed monetary stimulus and have probably limited the reduction in long-term rates. Despite their downtilt, long-term rates remained at very high levels by historical standards. This restraint in the use of monetary measures in an economy suffering from unemployment and excess capacity has subjected the Federal

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Reserve to vigorous criticism at home and has, in fact, been the occasion for a significant division of judgment within the Federal Reserve System.

As we wrestle with these divergent pulls as between domestic and balance of payments considerations, we can perhaps take some comfort from the fact that adjustments toward payments equilibrium are in process. As pointed out in the very stimulating Annual Report of the Netherlands Bank, cost and price movements in Europe and the United States have been responding as they should to the balance of payments disequilibrium.

The major question now is, should monetary policies in the U. S. and Europe be utilized more actively as a means of reducing the capital flow across the Atlantic Ocean.

In its Annual Report for 1962, the Bundesbank indicates that further monetary action to bring down interest rates in Europe cannot reasonably be expected, for it might threaten internal stability. This is precisely our problem, with the signs reversed.

Apart from the question whether a narrowing of interest rate differentials between the U. S. and Europe would in fact dampen the private capital flow--and the Bundesbank Report acknowledges the doubts that exist on this question--a major tightening of U. S. monetary policy designed to raise interest rates significantly would, as I have said, have threatened the stability of our economy.

If there is any single misconception in Europe regarding the U. S. financial mechanism, it is the notion that interest rates

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can be raised, regardless of domestic economic circumstances, in order to deal with the private capital outflow. In the U. S., perhaps more than in many European countries, interest rates can be influenced only by forces that directly affect the supply of and demand for funds. Unless demands are vigorous, rates can be raised only by reducing the supply of bank credit--possibly to the point of deflationary contraction in the volume of cash balances.

Firm action to reduce the internal supply of loanable funds in order to make foreign lending less attractive in the past year or two could have had an adverse effect on domestic spending, and if undertaken through a crash program would have had serious repercussions on the domestic economy and in turn on the international economy. Surely a better way to reduce foreign lending is to foster domestic expansion so that the attraction of U. S. funds for external placement would be significantly reduced.

Recently, economic developments in the U. S. have been encouraging. If resurgence of expansive tendencies really carries through, impelled in part by tax reduction, gradual reduction in U. S. credit availability would be possible. In their duty to resist possible future speculative tendencies and keep U. S. industry competitive internationally, the U. S. monetary authorities may be expected to pursue policies less conducive to credit ease than in the last year. Some adaptation in policy toward less ease occurred near the close of last year, and further adaptation has taken place recently. Whether and when still further steps will be

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taken is at this point in time uncertain. Given our balance of payments problem, there would be no hesitancy in taking additional steps, if domestic activity was showing strong upward momentum, but we are too wary of economic forecasting to predict such strength now. And even if further steps were appropriate and feasible, we would certainly not want to predict that European and other foreign borrowers, given the state of capital market facilities and interest rate levels abroad, would find themselves unable or unwilling to compete for funds in U. S. markets. Of course, the practical problem is seldom to exclude any class of borrowers en masse, but only to exclude those who are in some sense marginal. Thus, we might hope for some contraction in the outflow of U. S. capital.

There is one special point of emphasis to be mentioned in conclusion. In my personal judgment, the monetary policy rein in the U. S. is probably more taut now than at the comparable stage of any earlier postwar cyclical expansion. There has recently been another pull on these reins by the Federal Reserve, reflected in a further decline in free reserves and some further reduction in money market ease. The Federal Reserve feeling is that it is operating in close contact with the market and that it need go through no special effort to make the market responsive to any change in its policy.

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Chart I

LIQUID ASSET HOLDINGS rose somewhat faster than GNP in 1962

Ratio scale
Billions of dollars

700

600

500

400

300

GNP

TOTAL LIQUID ASSETS

Per cent

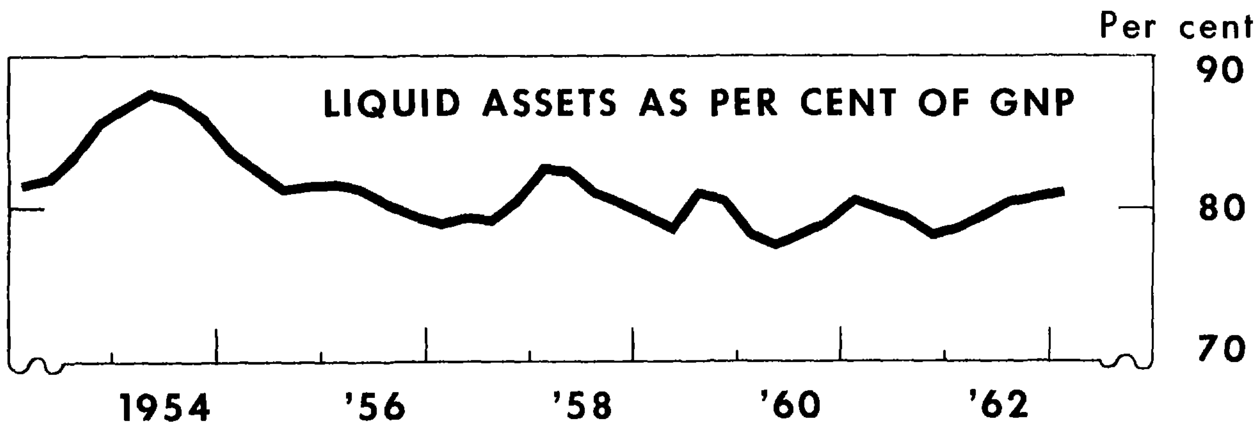

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Chart II

CONSUMER SPENDING less for physical assets, more for financial assets

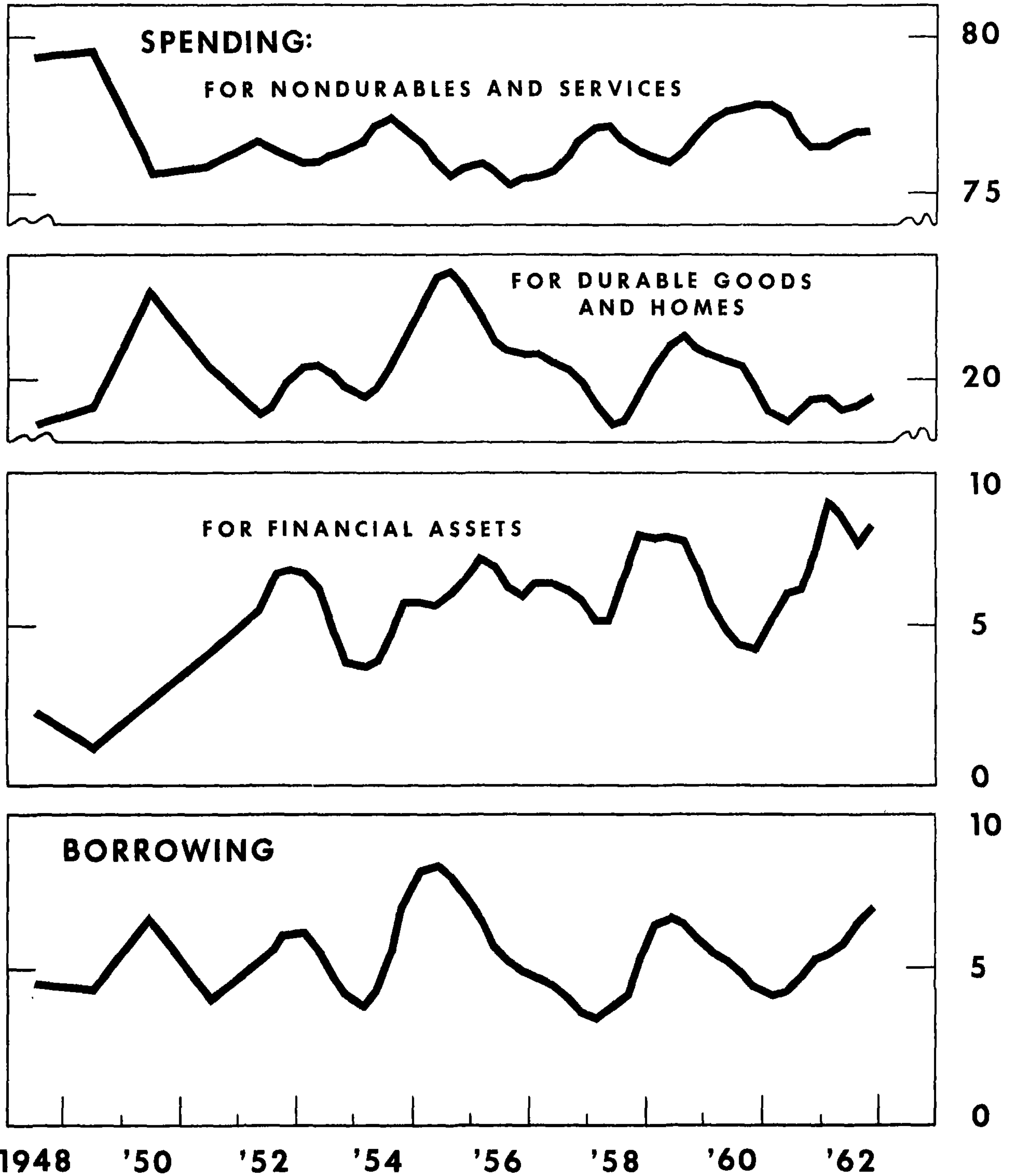

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Chart III

CONSUMER BORROWING high relative to spending

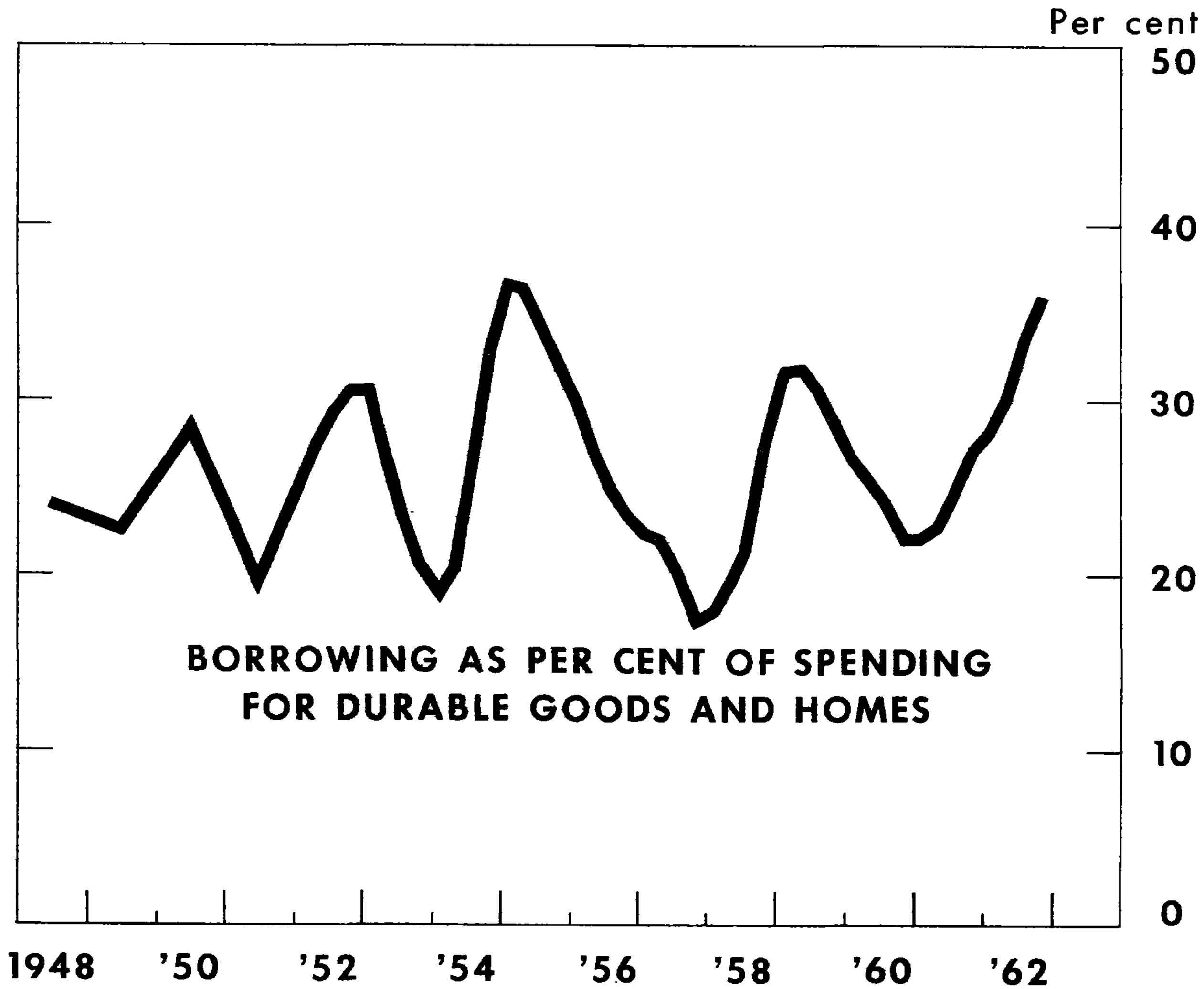

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Chart IV

CONSUMERS have been acquiring mainly liquid assets

Per cent of disposable income

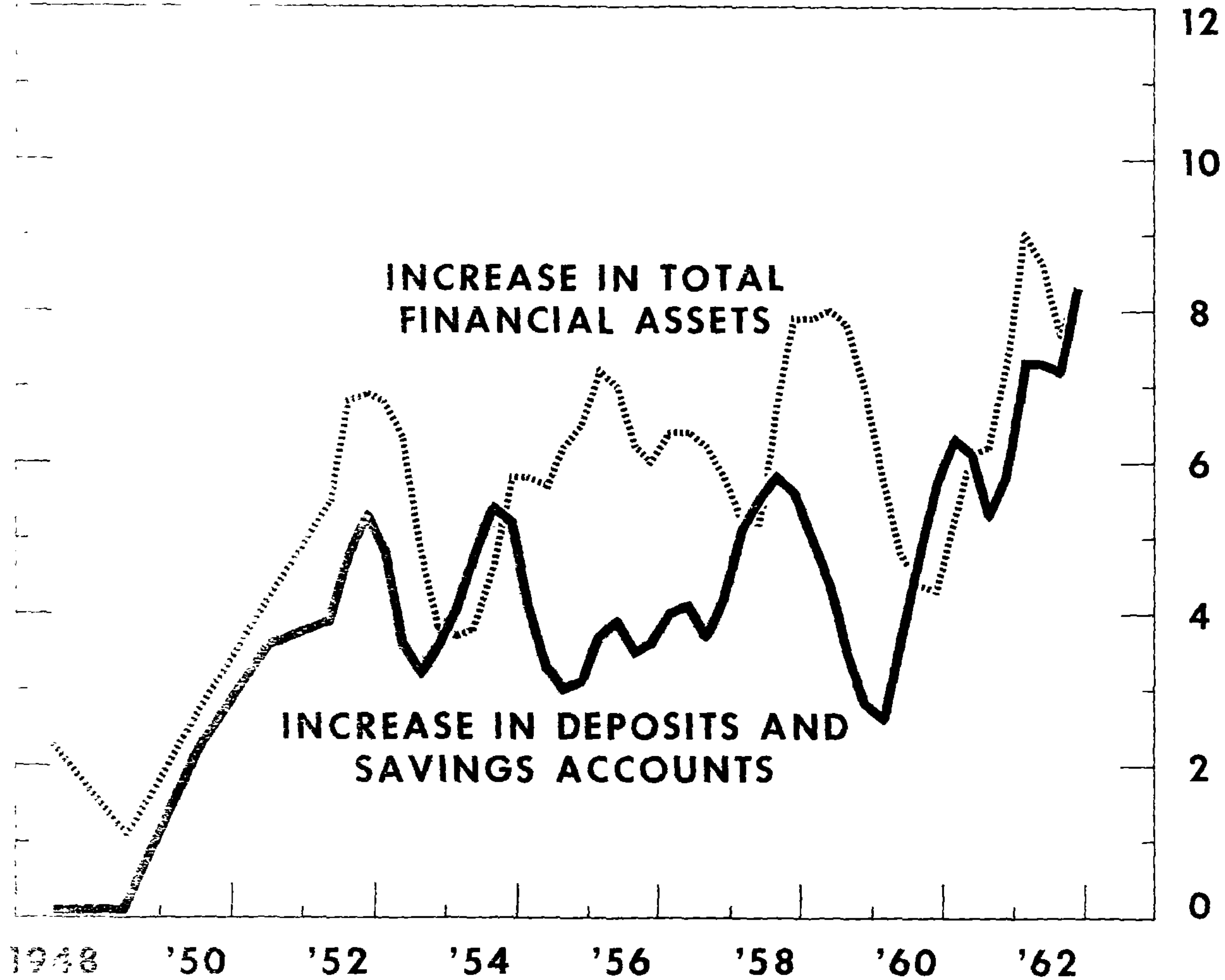

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Chart V

YIELD SPREAD less favorable to consumer investment in securities

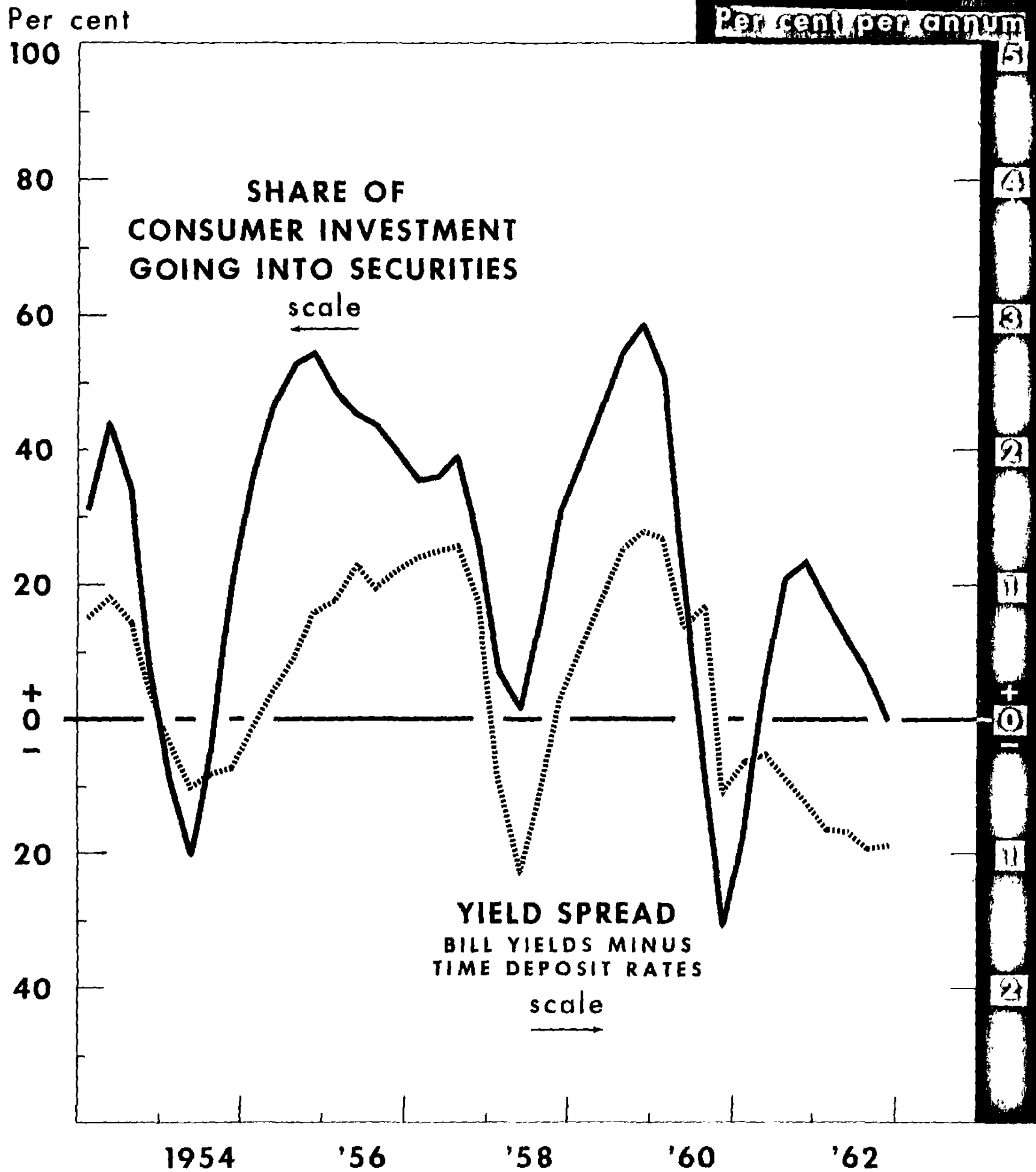

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Chart VI

LIQUID ASSETS up much more than debt in latest expansion

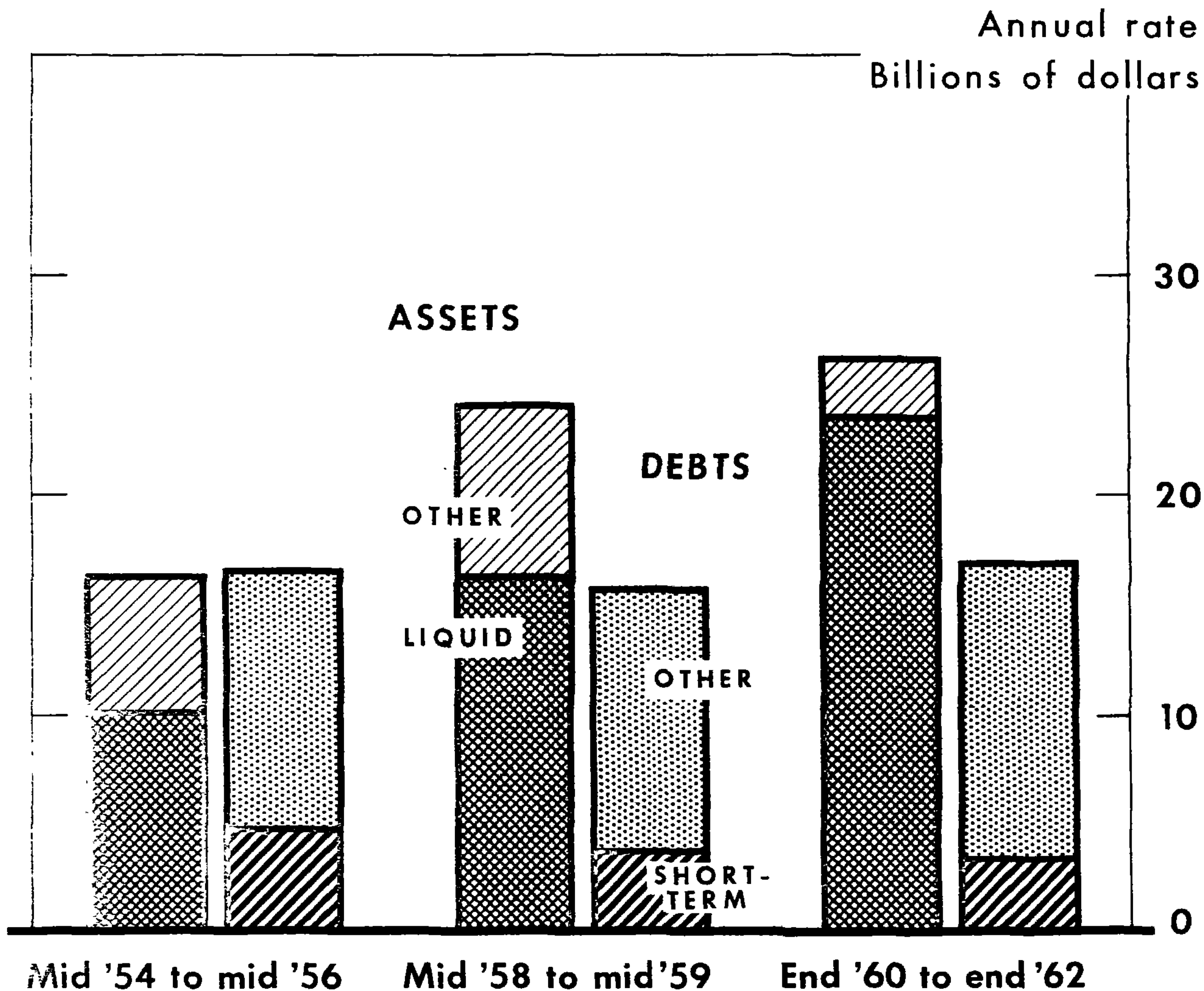

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Chart VII

SHORT-TERM DEBT keeps pace with income but MORTGAGE DEBT rises faster in 1961-62

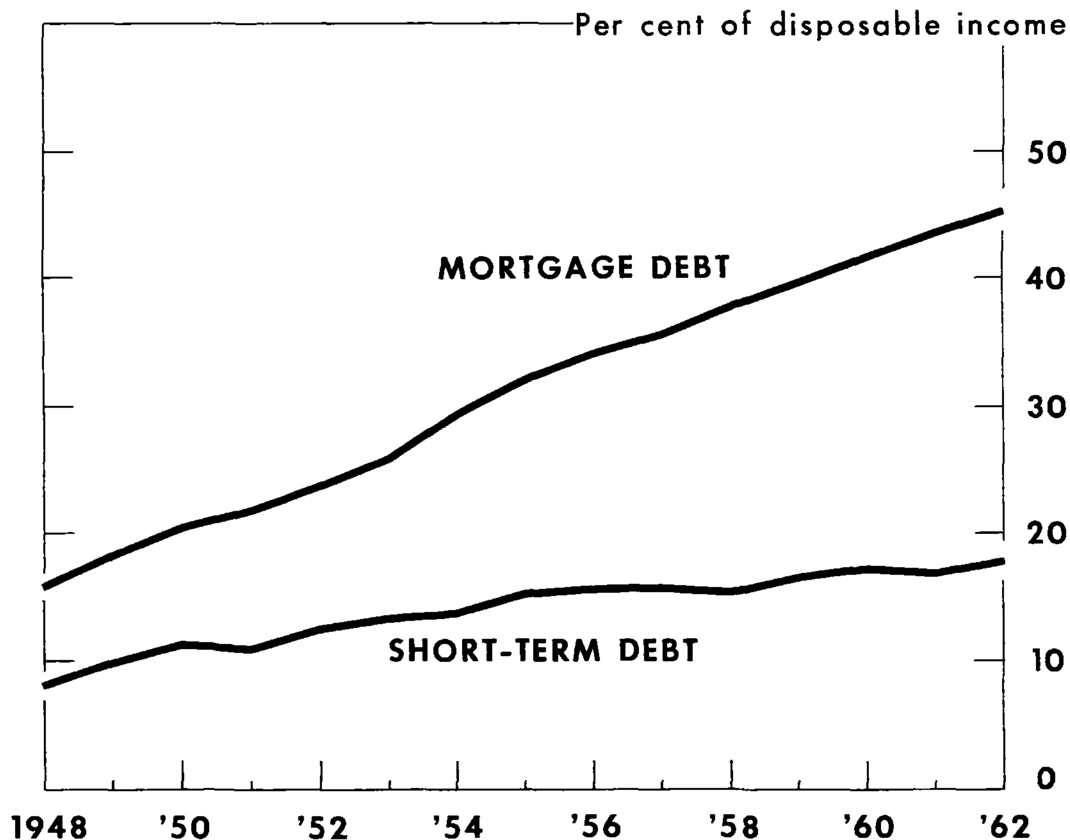

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Chart VII A

OLDER FAMILIES report largest liquid asset increases among lower and middle income groups

AVERAGE LIQUID ASSET HOLDINGS
EARLY 1959 AND EARLY 1962

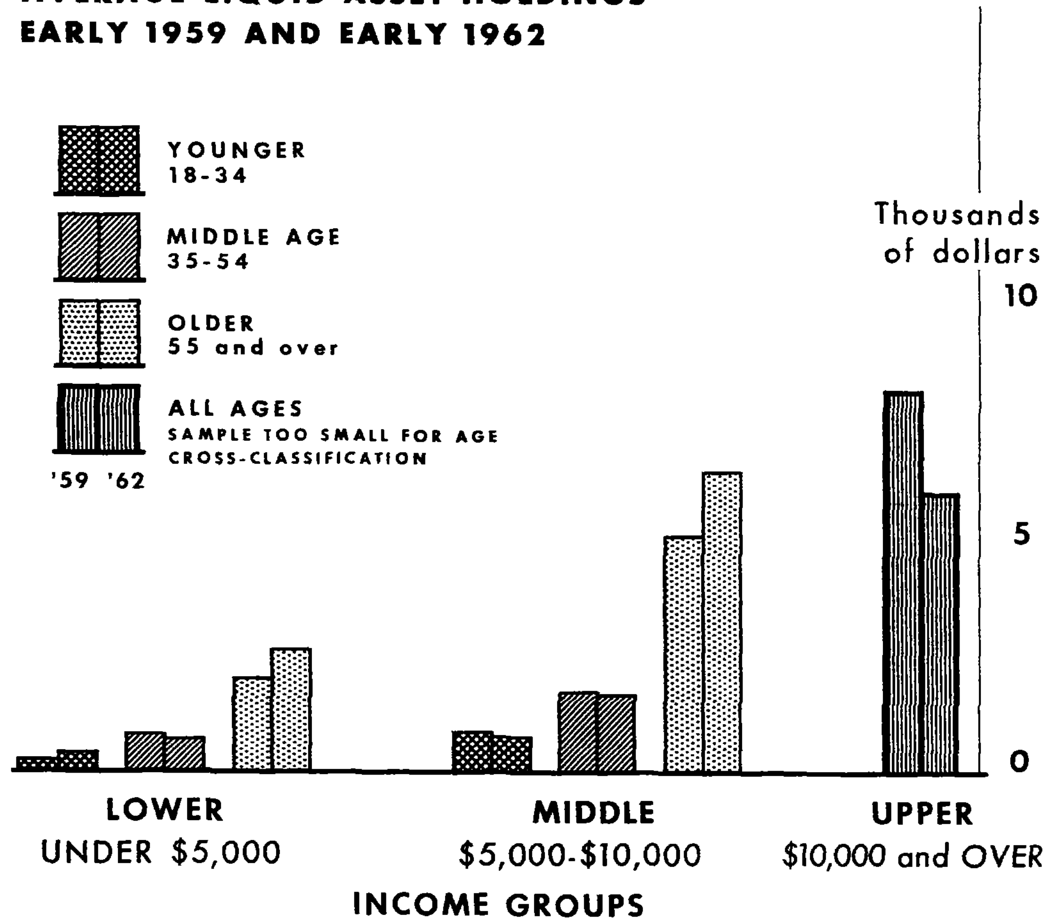

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Chart VII B

LARGEST DEBT INCREASES reported by upper income families

AVERAGE INSTALMENT AND MORTGAGE DEBT EARLY 1959 AND EARLY 1962

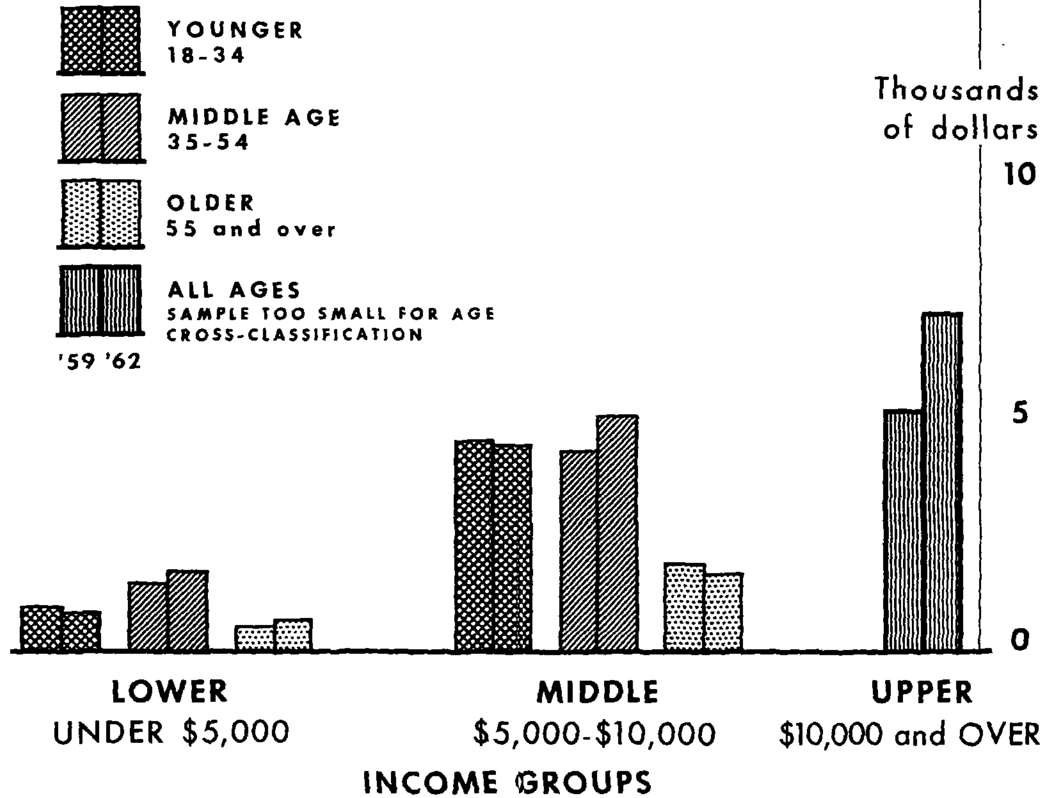

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Chart VIII

CORPORATIONS, like consumers, spent relatively less on capital assets in 1961-62 than in previous recoveries

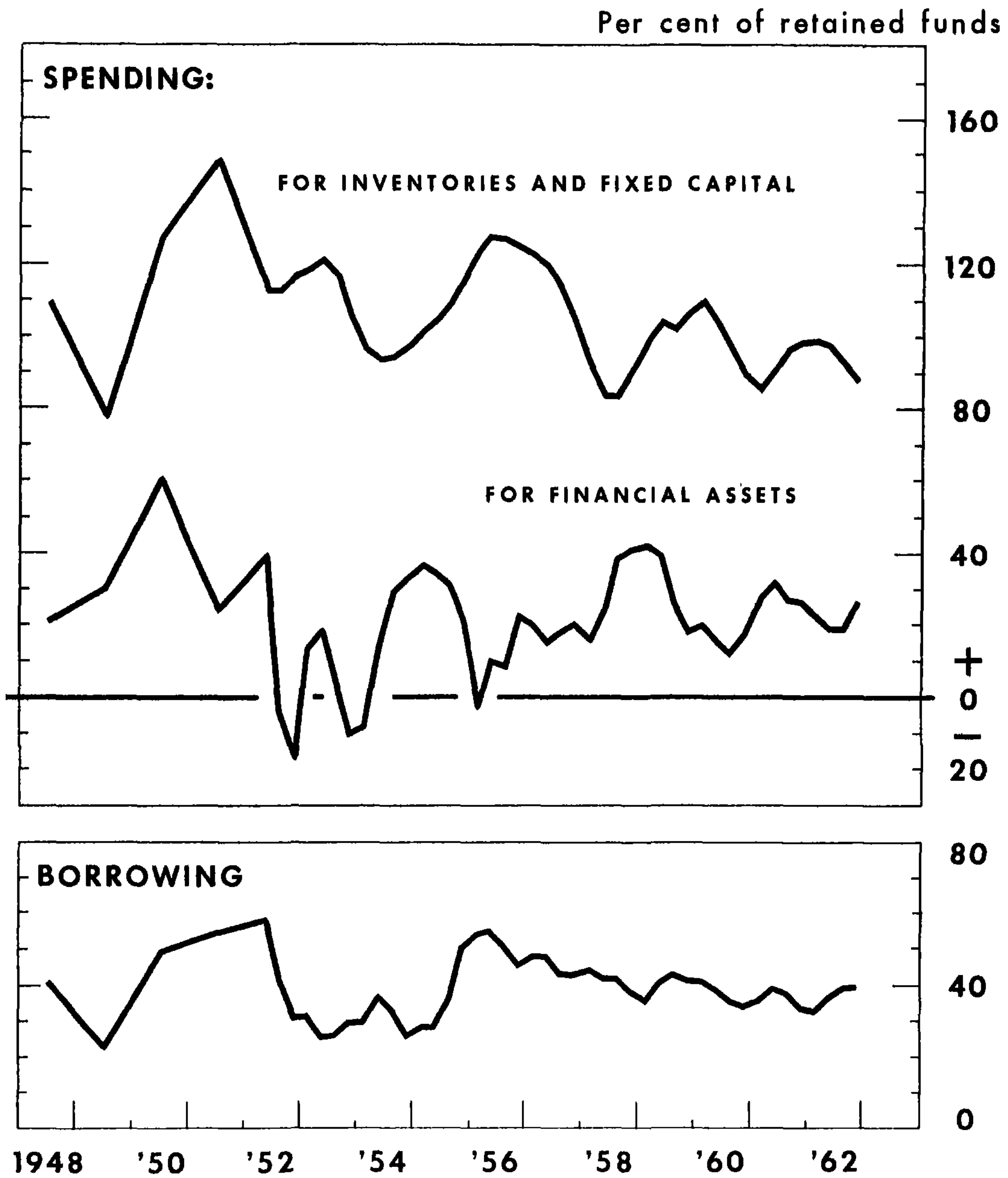

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Chart IX

CORPORATE BORROWING also rises relative to capital spending

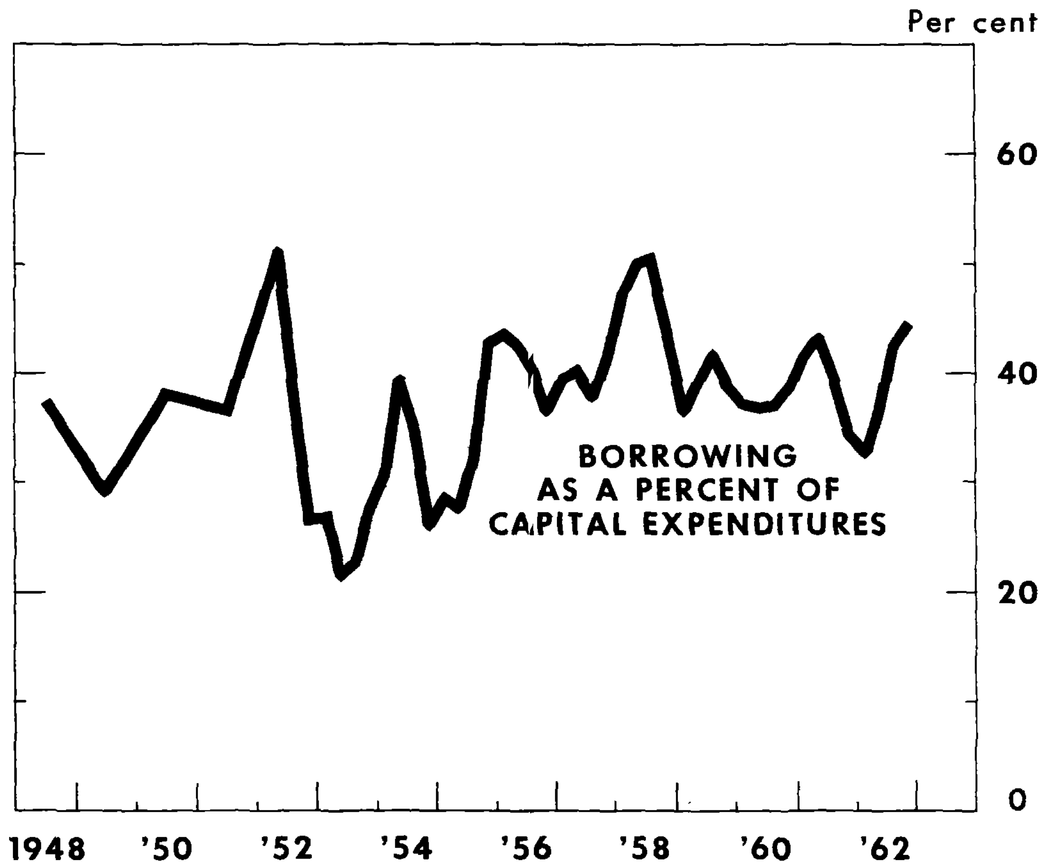

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Chart X

CORPORATE LIABILITIES continue to rise but liquid asset holdings are little changed

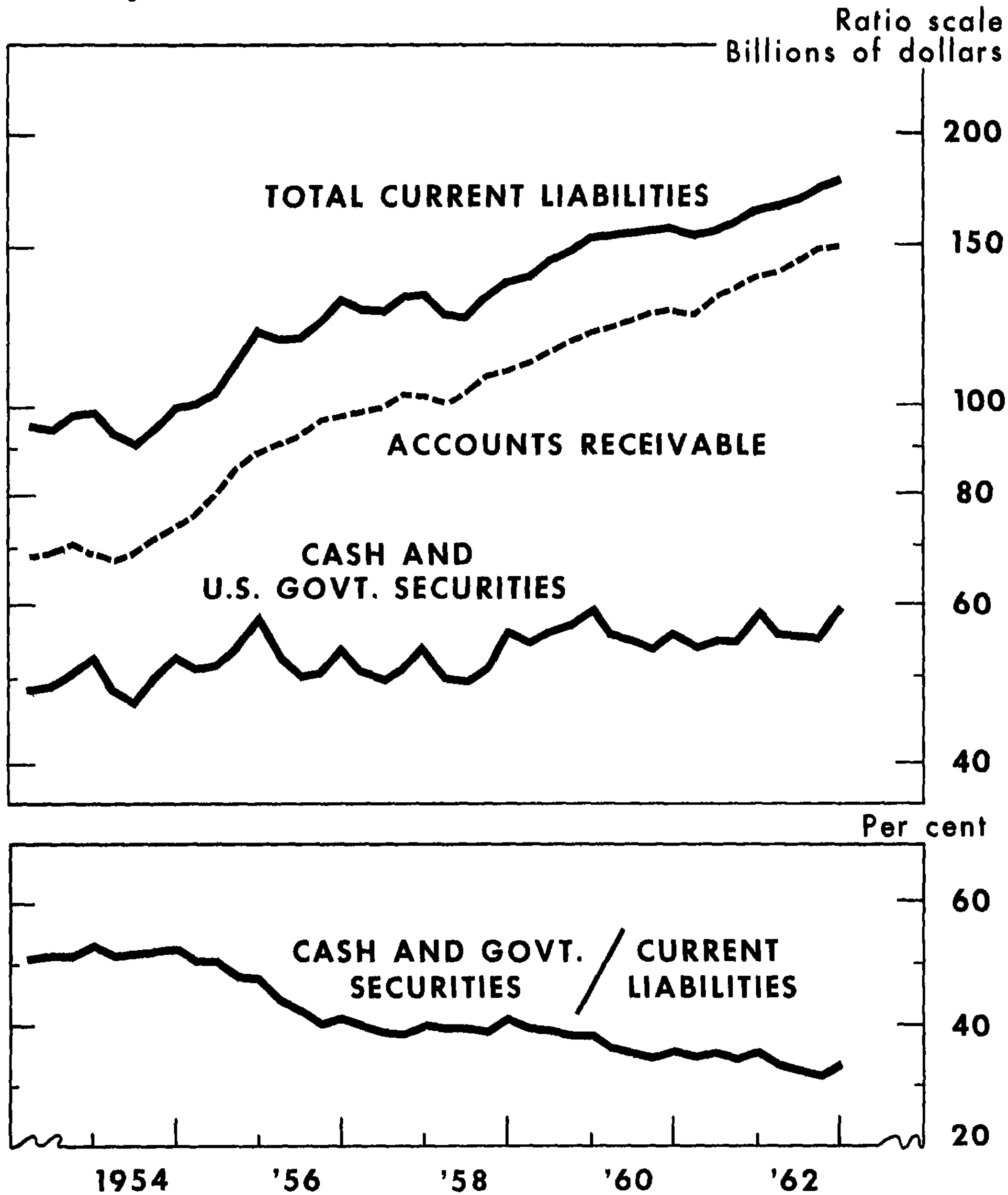

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Chart XI

CORPORATE CASH HOLDINGS decline relative to corporate activity

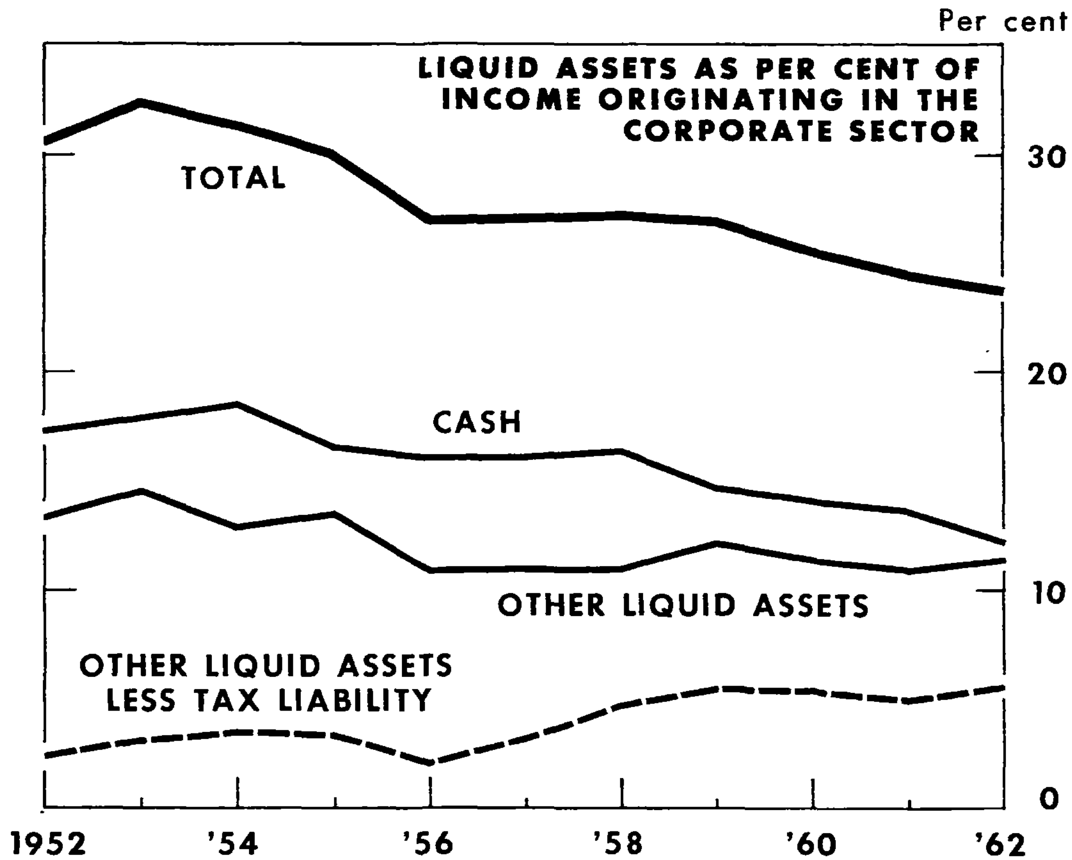

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Chart XII

Banks shift PORTFOLIO COMPOSITION favoring mortgages and municipal securities

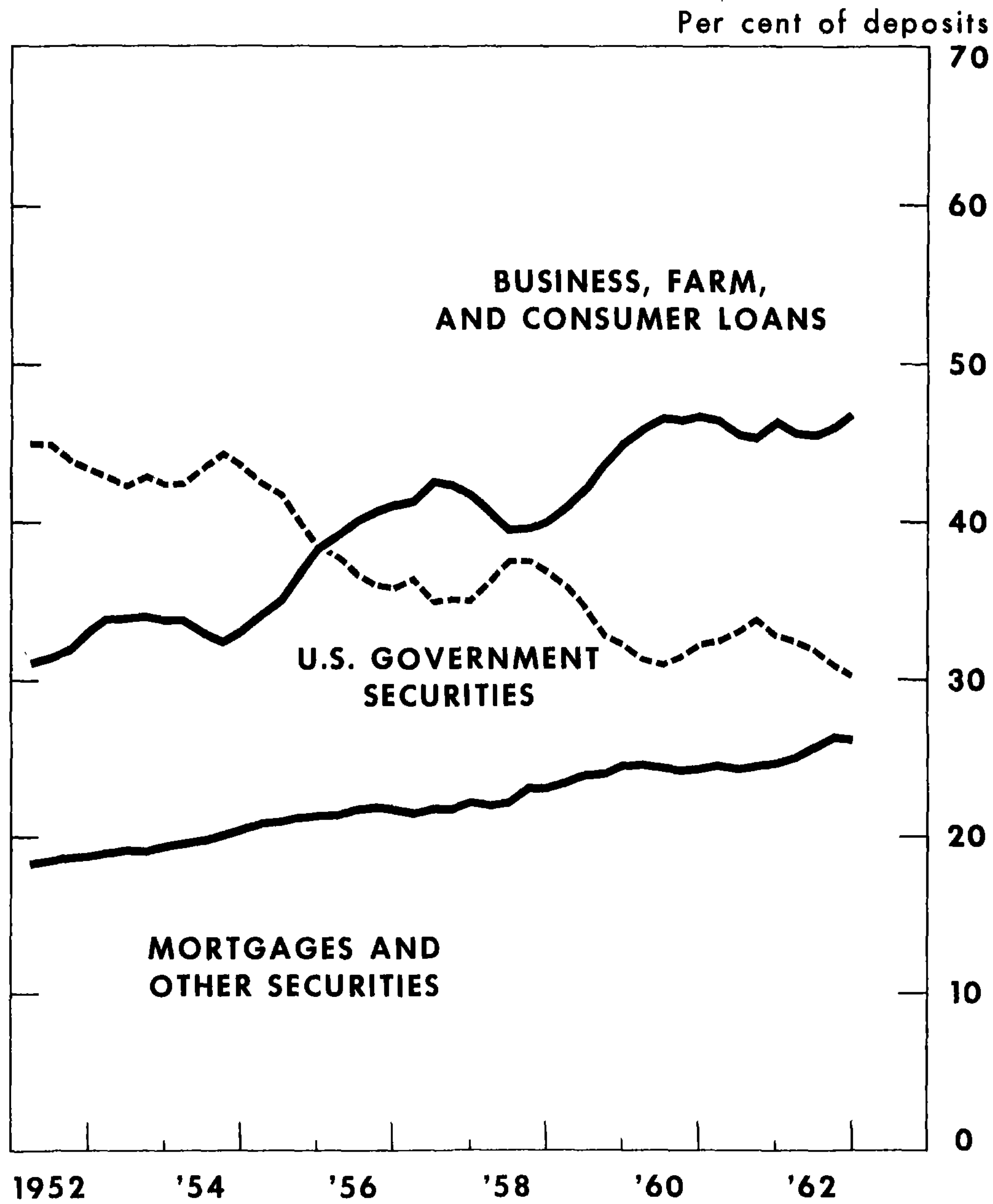

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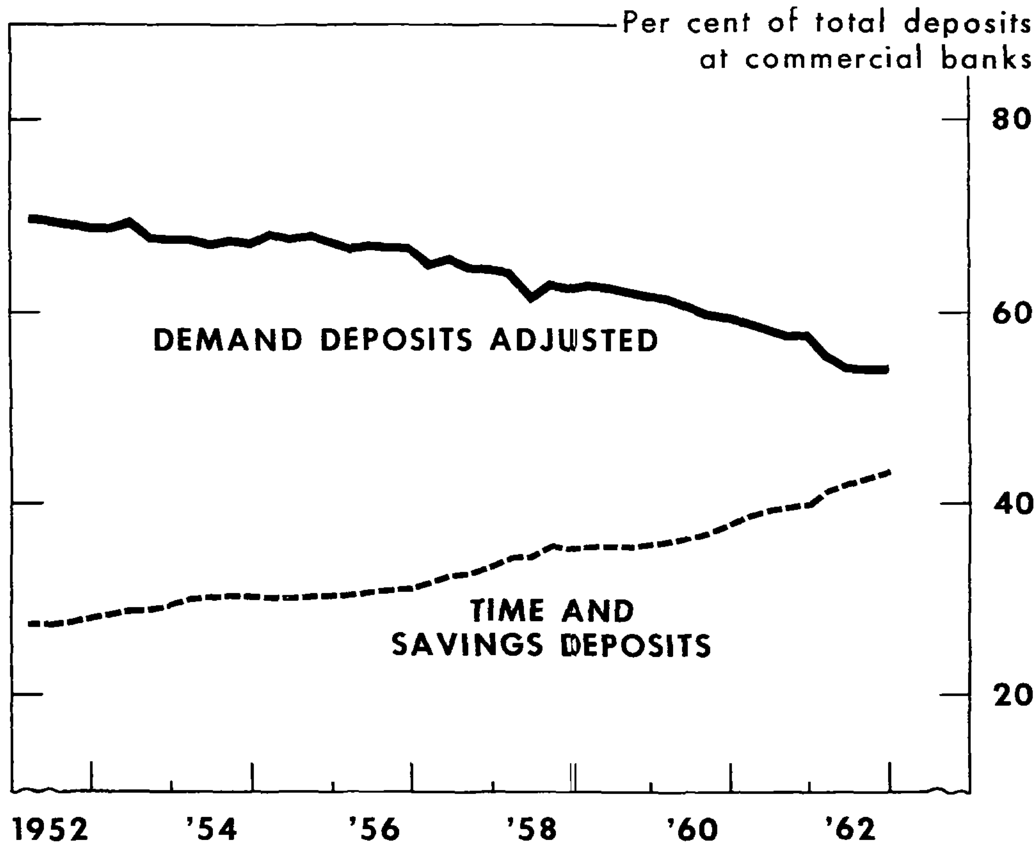
Chart XIII

TIME AND SAVINGS ACCOUNTS are a rapidly growing share of total bank deposits



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JUN 28 1963

Chart XIV

FREE RESERVES reduced in 1963

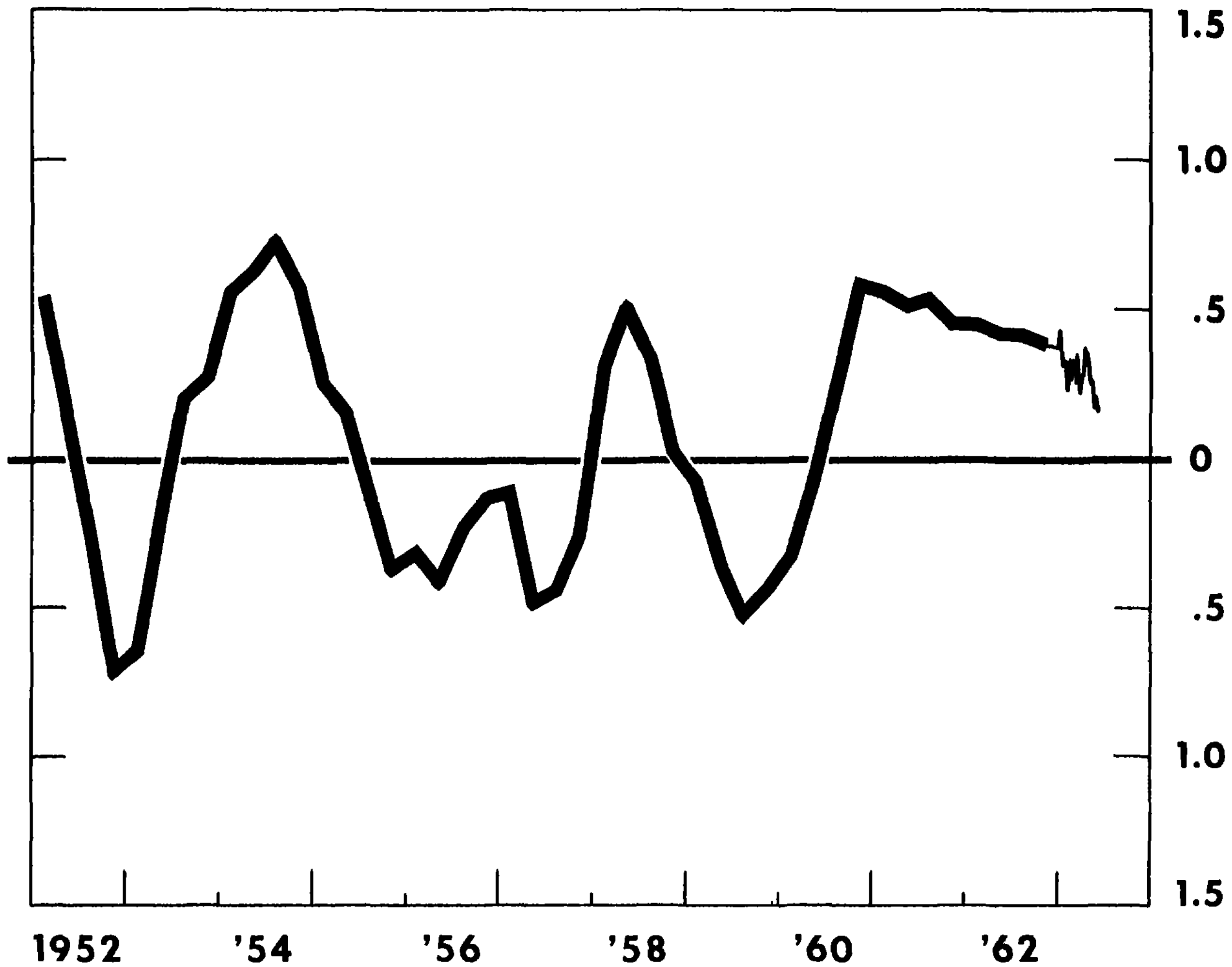

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Chart XV

MONEY AND QUASI-MONEY grew less in the U.S.