B_B92
Regulation Q [Interest Rate Ceilings] 1970-74

TO: Board of Governors

FROM: Division of Research & Statistics
(J. C. Partee)

SUBJECT: Longer-Range Implications of a Suspension of Q Ceilings on Large CD's

Attached is a memorandum, prepared principally by Lyle Gramley, dealing with some of the longer-range effects that might stem from a suspension of Q ceilings on the remaining maturities of large-denomination CD's. It was prepared for the initial discussion of this issue at the Board meeting on Monday, October 19.

Strictly Confidential (F.R.)

October 16, 1970

NOT INTERESTING

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Strictly Confidential (FR) October 16, 1970

Some Longer-range Implications of Suspending
Q Ceilings on Large Denomination CD's

Any assessment of probable future developments associated with suspending Regulation Q ceilings on large denomination CD's is bound to be fraught with uncertainty. The experience of recent years provides some clues as to how banks might react if they were given additional freedom to bid for time deposits, and as to the more general implications for financial market developments that would stem from that freedom. But, to an uncomfortably large degree, judgments must be based on general theoretical reasoning, rather than on empirically tested propositions.

The discussion which follows considers first the potential reversibility of a Board decision to suspend the ceilings on large CD's. It then considers possible structural effects of such an action on the behavior of banks and other participants in financial markets, and attempts to evaluate the workings of monetary controls in the financial environment that would emerge.

Reversibility

For a number of reasons, the Board would not wish to take action putting Q ceilings on a standby basis for large CD's without considering carefully the feasibility of reinstating the ceilings later if that seemed necessary or desirable. Legislative aspects of the problem clearly dictate some consideration of this matter. Temporary legal authority to suspend the ceilings was provided initially in the fall of 1966, and has been extended on three subsequent occasions; the present authority to suspend ceilings expires on March 22, 1971. If the

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provision of the law permitting suspension of the ceilings were not extended, the Board's authority to set interest rate ceilings might possibly revert to the status existing prior to the fall of 1966-- although this among other things, would seem to rule out differentiation by size of deposit for purposes of Regulation Q. At that time, the Board's legal counsel argued that the authority to regulate interest payments on deposits provided in the Banking Act of 1933 did not provide an option to suspend ceilings. Also, it was argued that if the authority were used to set ceiling rates at levels completely out of touch with market rates of interest, the Board might be accused of acting in direct opposition to a statutory mandate.

The merits of that argument would depend, however, on the circumstances surrounding the lapse of the temporary legislation. If the Congress permitted lapse of the temporary legislation because it believed that actions of the regulatory authorities permitting banks to pay whatever interest they desired on large CD's had had adverse effects on sound banking, the Board might well be forced once again to impose effective limits on CD rates. If the lapse occurred under other circumstances, however, the need to impose effective limits on CD rates would be less clear. The possibility that the Board would be compelled subsequently to reinstate effective ceilings on CD rates seems remote, but it cannot be ruled out altogether. (A fuller discussion of these issues is provided in an attached memorandum prepared by Mr. Sanders.)

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In the event that ceilings were suspended and then subsequently reinstated--either to comply with the law or because the Board deemed such action appropriate in the light of economic and financial developments--there would inevitably be some churning in financial markets. However, even if banks had become much more heavily dependent than they are now on the CD market as a source of reserve adjustment and as a means of financing asset expansion, it seems likely that ceilings could be reinstated in a way that would avoid serious initial adjustment problems for banks and the financial markets. For example, the Board could initially reestablish ceiling rates at levels that made CD's competitive throughout the maturity range for all banks actively in the market, and then--if it were deemed appropriate--adjust the ceilings as frequently as necessary to assure banks that an immediate closure of this avenue of reserve adjustment was not contemplated. Such a procedure might entail some increase in the growth rate of CD's in the first few weeks and months following reinstatement of the ceilings, relative to what would have occurred otherwise, as banks sought to prepare themselves for a subsequent squeeze. But this could scarcely be considered a significant loss of monetary control. Thus, from the standpoint of economic issues alone, a suspension of the ceilings now would not appear to make subsequent reinstatement unduly difficult or fraught with problems.

It should be clear, however, that a repositioning of the ceilings after a period of suspension would almost certainly provoke strong adverse reactions in the financial community, unless this action had been forced

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on the Board by the necessity to comply with the law. Our contacts with banks suggest that the recent actions of the Board in suspending Q ceilings on 30-89 day maturities, and in bringing commercial paper issues of bank holding companies and affiliates under Regulation D but not under Regulation Q, have led to widespread expectations that a general move in the direction of providing increased freedom from ceiling rates on deposits is now in process. An additional action by the Board suspending all ceilings on large denomination CD's would seem to confirm these expectations.

It seems likely, therefore, that suspension of the ceilings would lead banks to plan for the future with confident anticipation that reinstatement would not occur. Vigorous protest would have to be expected if ceilings threatening access to the large CD market were subsequently reimposed.

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Structural Changes in Financial Behavior

Structural changes in banking practices would very likely begin to develop rather promptly if suspension of Q ceilings produced a general belief that the Board's action implied an end to the era of CD regulation by interest rate controls. Perhaps the most predictable result relates to bank issues of commercial paper, which already have declined substantially. If banks believed that CD rate ceilings would not be reimposed, there would seem to be only two reasons why bank holding companies and affiliates would continue to issue such obligations. First, commercial paper issues might be regarded as a convenient vehicle for financing the nonbank activities of bank holding companies, particularly since

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there are regulatory limits on the extent to which banks may extend financing to their affiliates. Second, under present law, banks are not permitted to issue time deposits with less than 30 days maturity, but they can issue commercial paper through holding companies and affiliates in this maturity range without running into the prohibition of interest payments on demand deposits. (The Board might wish later to consider regulatory changes to eliminate this anomaly, putting commercial paper and large CD's on a completely equivalent regulatory basis.) Given the high reserve requirements on such funds, the cost to a bank would be high, and its offering rates correspondingly low. Nevertheless, if customer demands for short-term claims at these lower rates existed, banks would no doubt be ready to accommodate them. The volume of such short-term commercial paper outstanding would likely be relatively minor. Apart from these two exceptions, continuance of bank interest in the commercial paper market as a source of funds would be kept alive only by a continuing concern that CD rate ceilings might be reinstated.

Suspension of the ceilings would also provide incentive for an early runoff of liabilities to foreign branches. The incentive would be all the greater, the more confident banks were that reinstatement of the ceilings was an improbable occurrence. In the absence of any other Board action, Euro-dollar borrowings by the U. S. banking community would have to depend predominately on cost considerations.

At current yield spreads, Euro-dollar borrowing is already unattractive even though marginal reserve requirements on these funds are

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now effectively zero for most banks. At prevailing interest rates on newly issued CD's with three months to maturity, reserve requirements on time deposits and the cost of FDIC insurance raise the net cost of such funds by about 40 basis points. The yield spread between CD's and Euro-dollar borrowings presently is greater than this, even in the short-maturity ranges for Eurodollars.

In considering the long-run future of Euro-dollar borrowings, however, it is worth noting that U. S. commercial banks will presumably have a relatively strong interest in keeping their foreign branches alive for the foreseeable future, especially in view of the vehicle that these branches provide for bank participation in lending activities abroad without violating the Voluntary Credit Restraint program. If interest rate spreads were to change significantly, and reduce the cost of Euro-dollars relative to CD issuance, the institutional mechanisms for obtaining funds from the Euro-dollar market would still be in place.

Interest rate spreads will not always remain as unfavorable to Euro-dollar borrowing as they are at the moment--since present yield relationships reflect the continuance of programs of credit restraint in some European countries, while the U. S. is pursuing a policy of moderate monetary expansion. It is conceivable that the timing of cyclical developments here and abroad would, from time to time, give rise to yield spreads favoring Euro-dollar borrowing as opposed to CD issuance. In such periods, Euro-dollar liabilities to foreign branches would rise. Of course, we would not expect to see a repetition of the massive increase of 1969, or even the

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magnitude of growth that took place in 1966.

Increased reliance on the CD market would tend not only to displace nondepositary liabilities as sources of bank reserve adjustment but also to decrease still further the reliance of banks on shifts in asset structure to accommodate changes in the pace of loan demand. This would not be a new development, but an extension of previous trends. Since the early 1960's banks have come to rely more on liability adjustments, and less on shifts in holdings of liquid assets, during periods of cyclical contraction and expansion. This trend would likely be given impetus if the uncertainties associated with the ability to attract funds by bidding for CD's were removed. Specifically, we should probably expect to see less rundown of liquid asset holdings during periods of monetary restraint than we saw in 1966 and 1969, and less subsequent rebuilding than occurred in the intervening years. On average, large banks might choose to hold only a slightly higher percentage of their assets in liquid form than they did at the height of the credit squeeze in 1966 and 1969.

This possibility has implications for the manner in which monetary controls would work if CD ceilings were suspended (to be discussed in the next section). To avoid accumulations and decumulations of liquid assets, banks would have two options: 1) to vary their offering rates on CD's sufficiently to prevent accumulations and subsequent rundowns of liquid asset holdings over the cycle, or 2) to change interest rates, and perhaps other terms, on loans more promptly than they have in the past-- as a means of encouraging more loan financing at banks when economic activ-

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ity is weakening, and of inducing a shift in borrowing to the market when loan demands are strengthening. Presumably, the banks would do some of both, but they probably would rely principally upon variations in CD rates to keep liquid asset holdings at desired levels.

To the extent that banks adjusted their loan rates more promptly, the effects of monetary policy on these interest rates would occur with shorter lags than in the past. This would be of particular significance to business borrowers, whose demands for external financing show strong cyclical fluctuations. Absence of the ceilings would also mean that abrupt changes in bank credit availability to businesses--such as have occurred in the past when CD ceilings were generating severe pressure on the reserve positions of money market banks--would be less likely to occur. As a consequence, nonfinancial businesses might feel somewhat less uncomfortable with the state of their balance sheet liquidity than they do currently. More importantly, however, we might well see a significant reduction in the volume of commercial paper, and especially in the number of issuers, since this source of funds would be a less important alternative to bank credit during periods of severe monetary restraint. Dependence upon longer-term security issues during episodes of tightness in the credit markets might also decline. A reduction in the importance of the commercial paper market as a source of funds to nonfinancial businesses would seem to be a highly desirable development, since this market is susceptible to shocks when individual borrowers are found to be in financial difficulties.

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Effects on Monetary Controls

We turn now more specifically to the implications for monetary controls of a suspension of Q ceilings on large CD's. There appear to be three principal issues to consider. (1) Would the efficacy of monetary restraints be undermined if banks were permitted to bid freely for large CD's? (2) What effects on the distribution of fund flows in financial markets, and on the sectoral distribution of real output, might result? (3) What are the probable implications for the strategy of monetary policy?

There are two principal reasons for concern that removal of Q ceilings on large CD's would undermine the efficacy of monetary policy. First, as the previous discussion indicated, it seems probable that large banks would vary offering rates on CD's substantially as their principal means of adjusting to changing loan demands and to variations in the growth rates of other deposits. These fluctuations in CD rates would, to some extent, induce direct substitution between demand balances and CD's. Additionally, the movements in CD rates would exert an influence on market rates of interest and thereby induce substitution between demand deposits and market securities. It could be argued, therefore, that the relation between the reserve base and the money supply, and also between the reserve base and total bank credit, would be somewhat more variable than if CD rates were fixed. It would still be possible to achieve any desired growth rates of money stock--or, if the System chose, of bank credit--by regulating the growth of total bank reserves. However, the System's ability to maintain

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desired growth rates of money and bank credit might be less precise because of lack of knowledge as to the timing and magnitude of the induced transfers from demand deposits. Also, as discussed more fully in the next section, variations in CD rates would have some influence on rate of monetary expansion needed to achieve any desired growth path of GNP.

The uncertainties of this kind created by variations in CD rates would be similar, in principle, to those encountered in the past during periods immediately following an increase in the Q ceilings on CD's--periods in which very large shifts in financial asset portfolios have occurred. The problems created for monetary policy would thus not be new, and if CD rates were set completely by market forces, they would be mainly transitional in character. As experience was gained with the effects of fluctuating CD rates on the public's desired holdings of demand deposits, adjustments could be made in open-market operations to compensate for the portfolio shifts that occurred. It could therefore be argued that a system of variable CD rates would, over the long run, increase the precision with which the System could control the growth rate of money and bank credit, since it would eliminate the necessity for abrupt changes in CD ceilings and the huge shifts in asset portfolios they produce.

A second source of concern having to do with the efficacy of monetary policy relates to the implications for nonprice credit rationing at banks. As long as the Federal Reserve is able to limit the growth of total bank credit through its control over bank reserves, some sort of

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effective rationing system at banks would have to take place to bring demand for, and supply of, bank loans into balance. As the discussion of the previous section indicates, there is reason to think that greater dependence on the CD market would encourage banks to adopt more frequent changes in the interest rates they charge on business and other loans. It is possible, though not probable, that more flexible policies might also be pursued with regard to nonprice rationing devices. A better case could be made that freer access to loanable funds through the CD market might lead banks to maintain more stable nonprice terms on loans over the cycle, and to accomplish the rationing needed to keep loan demand and supply in balance largely by varying loan rates in step with the cost of CD's.

If the rationing system that developed at banks took the form of greater variations in loan rates and smaller changes in credit availability to particular borrowers, the channels through which monetary restraint operated to affect spending would be altered. If changes in bank credit availability were not as large, variations in credit costs would come to play a more significant role in the monetary process, and there might need to be larger changes in credit availability at the nonbank thrift institutions and in the public credit markets to compensate for the greater stability of nonprice lending terms at banks. Though such changes in the importance of the various channels of transmission of monetary policy might occur, they would not prevent the achievement of any desired degree of aggregate monetary restraint or ease. But they

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would have implications for the effects of monetary policy on the distribution of fund flows in financial markets and on the structure of real output.

Distributional Effects. Less reliance on direct rationing by banks, with greater dependence on fluctuations in interest rates, in the transmission of monetary policy might produce some long-range benefits in terms of improvements in efficiency of resource use. But it would shift the burden of monetary restraint towards sectors in which expenditures are more interest sensitive. The available evidence suggests that this would mean an increased burden on housing and on state and local construction expenditures, with the principal offset a reduction in the degree of restraint imposed on business fixed investment.

Also, wider variations in short-term interest rates over the cycle would serve as the mechanism for producing greater changes in credit availability from nonbank financial institutions, since they would generate larger swings in rates of inflow of consumer-type time and savings deposits to the nonbank thrift institutions, and would also affect the policy loans of life insurance companies. This, too, would tend to accentuate the constriction of mortgage credit and home-building during periods of monetary restraint. This tendency would be dampened, however, if absence of the Q ceilings on large CD's helped to sustain the flow of mortgage lending by commercial banks during periods of monetary restraint.

On balance, probable changes in the sectoral distribution of the effects of monetary restraint on spending might be undesirable in

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terms of social priorities. But there is some reason to think that the sectoral impact of monetary restraint would not differ markedly from what it has been in the recent past. During 1969, large increases in non-deposit liabilities of banks and a substantial increase in the volume of market financing by nonfinancial businesses--especially through commercial paper issues--were important factors in driving up market interest rates, and thereby communicating the effects of monetary restraint to the non-bank intermediaries, to the home-building industry, and to state and local financial markets. Because of these adjustments, nonfinancial businesses were able to increase their share of total funds raised from 40 per cent in 1968 to 54 per cent in 1969--the highest share for any postwar year since 1948. Perhaps the share captured by the nonfinancial business sector in 1969 would have been still larger if banks had been able to bid freely for large denomination CD's. But it seems difficult to sustain an argument that Regulation Q ceilings on large CD's have been a particularly effective device for buffering such areas as home construction and state and local government spending from the effects of monetary restraint.

We believe, therefore, that the Board could suspend the ceilings on large CD's, if it chose to do so, in the expectation that the sectoral effects of monetary restraint without the ceilings would not be greatly affected. But the Board should be prepared to face the possibility that the problems of the nonbank intermediaries and the housing industry during periods of restraint would be increased somewhat, and it

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is a reasonable supposition that other regulatory agencies--and perhaps the Congress--might well express strong views in opposition to a suspension, particularly if such effects began to appear. Also, suspension of ceilings on large CD's would highlight the inequality of treatment of large and small savers, and would augment pressures to provide additional freedom to banks and other thrift institutions to raise rates on consumer-type deposits and shares.

Monetary Policy Strategy. We turn now to consider the implications of a suspension of Q ceilings on large CD's for the strategy of monetary policy. To isolate the effects of suspension from the many other factors that influence the course of monetary policy that the System might choose, we must, of course, assume other things equal. For this purpose, we might suppose that an increase in private spending propensities threatens to raise the growth rate of current dollar GNP above the desired path, and that the System employs monetary restraint to choke off part or all of the potential rise in spending.

The implications of the earlier discussion suggest that to obtain the same degree of monetary restraint without CD ceilings, interest rates might have to rise somewhat more than they otherwise would. Taking into account the response of money demand to interest rates, this would imply a somewhat lower growth rate of the money stock, and for similar reasons, the growth rate of consumer-type time and savings deposits also would be somewhat lower. The growth rate of CD's, on the other hand, would clearly be larger than if effective Regulation Q ceilings were in force. This would tend to offset the slower growth rate of other time

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deposits and of the demand deposit component of the money stock. Indeed, achievement of the same overall degree of monetary restraint would probably be accomplished with a somewhat higher growth rate of bank credit. It cannot be demonstrated conclusively, however, whether the growth rate of bank credit consistent with any given degree of monetary restraint would be higher or lower in the absence of the ceilings.

Stated more generally, suspension of the ceilings would mean that, other things equal, System policy actions might have to produce somewhat larger variations in interest rates over the cycle, and somewhat larger contracyclical variations in the money stock, to achieve a given cyclical change in the degree of monetary restraint. For some time, however, there would be significant uncertainties surrounding the meaning of variations in bank credit. This suggests that the narrowly defined money supply would likely have to become the principal quantitative target for open-market operations, at least until considerable experience had been gained in interpreting changes in bank credit under the new conditions. Additionally, careful attention would need to be given to interest rates and to flows of funds into nonbank intermediaries as complementary indicators of the overall degree of credit restraint.

Looking more generally at the question of suspending Q ceilings on large CD's and its relation to the strategy of monetary policy, it might be questioned whether it would be prudent to relinquish a control device that undoubtedly has had some value in restricting bank credit availability--for all its drawbacks. In this connection, it seems worth

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noting that if the Board decided later that bank bidding for large CD's was having detrimental effects on economic stability, an alternative means of controlling the growth of CD's would be available. This could be done through adjustment of reserve requirements on large CD's, and possibly also on commercial paper issued through affiliates. According to the Board's legal counsel, large-denomination CD's could be singled out as a special class of deposit for purposes of reserve requirements, and the Board could, if it chose, impose reserve requirements in excess of 10 per cent on large-denomination CD's as long as the average reserve requirement on all time and savings deposits did not exceed 10 per cent. (See attached memo.) Given the present distribution of time deposits between large-denomination CD's and other categories, reserve requirements of 100 per cent on large CD's would be legally permissible.

If the Board chose to do so, it could use this power in ways that would affect greatly the incentives of banks to increase their outstanding CD's, but would have relatively small effects on the relation between total bank reserves and deposits, on Federal Reserve management of bank reserves through open-market operations, and on the overall profitability of banking. For example, the Board might impose reserve requirements of (say) 20 per cent on outstanding large-denomination CD's in excess of (say) the average amount outstanding over the previous four weeks. Individual banks choosing to increase their outstanding CD's above the base would be free to do so, provided they were willing to incur the incremental cost. By adjusting the marginal reserve requirement (or the base period) from time to time, the Board could exercise a powerful influence on CD's outstanding while still leaving the individual bank freedom to make adjustments in the light of its own particular circumstances and interest.

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