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MONETARY POLICY AND DEPOSIT INSTITUTIONS

Remarks of

SHERMAN J. MAISEL

Member
Board of Governors
of the
Federal Reserve System

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I am pleased at this opportunity to speak with an executive group of the Savings and Loan League. We have many mutual problems. Recently all financial institutions have faced new situations. The rapidity of change in money markets, in interest rates, and in the relationship among financial institutions has been record breaking. Understanding and prescription have not kept pace with events.

Slowing the Growth in Demand

Our primary national economic problem, which only a year ago was still that of insuring a steady expansion of demand, has reversed to where, at least temporarily, the primary problem is that of restraining the growth in private demand so as to ease the pressure on capacity and prices.

The basic cause for this turnabout is no secret. It springs primarily from the additional spending needed for the war in Vietnam. The added war expenditures, directly through Government purchases and indirectly through related business spending for additional plant and equipment, plus higher consumer incomes and expenditures, have raised total demand faster than our ability to expand the supply of goods and services. The clearest signs of pressure on real resources have appeared in the higher utilization rate for plant and equipment and lower unemployment. There also have been rapid shifts in the supply and demand situation for many sensitive commodities.

These increased expenditures and market pressures have resulted in more rapid and more significant price increases than had been recorded in any of the previous seven years. In addition, on the balance of payments front, where formerly we had been achieving an impressive reduction in our deficit, signs of a renewed deterioration have since appeared.

The Methods for Slowing Demand

To restrain demand growth, two major policy approaches have been available. The first, the simplest, and the most direct, would have been through fiscal measures. A tax increase would have narrowed the increase in demand at once. Furthermore, it could have been tailored fairly precisely to cut back directly the most disturbing demand--the over-rapid expansion of investment in plant and equipment.

The second, slower, and more indirect, method of moderating demand increases was through the use of restrictive monetary policy. As a result of higher interest rates and lower credit availability, some prospective buyers who can borrow only at higher rates and in curtailed amounts cut back on their purchases of goods and equipment. If monetary policy alone is used to slow the growth in demand, the degree of sensitivity of purchases to changed credit conditions will determine how much credit expansion must be slowed and interest rates raised.

Most American economists have stressed the fact that attempts to curtail powerful increases in demand through monetary restraint are likely to generate serious stresses both on the general structure of our monetary institutions and upon industries and individuals with more than an average dependence on credit markets. For this reason, they have advocated primary reliance upon the use of flexible fiscal policy. Earlier this year economists were nearly unanimous in their attempts to convince the business and political world of the desirability of a tax increase.

<u>The Dilemmas of Financial Institutions</u>

In periods such as the present when the expansion of demand must be slowed, financial institutions may find their short- and long-run goals in sharp conflict. Their traditional policies and beliefs may appear self-defeating.

Financial institutions recognize their major stake in the attempt to hold demand within the limits set by the feasible growth in supply in order to halt inflation. Thrift institutions, particularly, know that if they are to exist and remain viable, the value of savings in real terms must be maintained. No savings institution offering fixed-value claims can be successful in a truly inflationary economy.

Mortgage lenders have an additional concern. They have lived directly with one inflationary influence on the economy. Price increases in new construction as well as for existing dwellings have been strong. While the causes of this specific inflation are extremely complex, aggressive merchandising of easy credit has certainly not restrained it.

Thrift institutions also have properly been major supporters of our competitive enterprise system and of the advantages of increased individual saving. Our extraordinary growth in wealth and income has been built upon the free and competitive channeling of individual savings to borrowers who can make the most efficient use of these sums. Our whole financial structure is based on the belief that most decisions as to whom to lend to and what rates are to be paid are best handled by competitive institutions and not the Government.

Dilemmas arise because the advantages institutions gain in fighting inflation may be offset by potential individual costs. Tight money seemed fine to lenders when it meant they could charge more. It seems less desirable to them when all of their increased income and perhaps more has to be paid out to the owners of savings. When savings flows are expanding less rapidly, operational efficiency must be improved. There is a wider gap between the men and the boys. Poor management is less likely to be bailed out of mistakes in lending by an inflationary rise in prices.

In times like these, managements also have temptations to resist. While the number of good loans rises and the quality of credit improves, the fringe of marginal borrowers offers still higher rates. Since this group normally operates almost entirely with an institution's rather than their own money, they can always promise higher and higher fees. In periods when income and profit margins are under pressure, it may be harder to resist the pressure to "go for broke" and in the process wind up merely "going broke"!

Lenders by nature also hate to turn down business. Financial institutions have properly stressed their services to borrowers. Major efforts have been made to cultivate firms that can generate loan volume. It is always unpleasant in periods of tight money to have to refuse loans to customers assiduously wooed in the past. Managements tend, too, to overstress the cost of losses of customers to competitors. They fail to recognize that all financial institutions must turn away borrowers.

Finally, there is a legitimate concern over an undesirable ratcheting upward of interest rates. If a sufficient number of institutions misjudge the market and rates rise more than necessary, there may be problems in bringing them down. In the past, deposit rates have tended to be inflexible in both directions.

The dilemma is sharpened because restricted growth in credit, traditionally and apparently in this period, falls disproportionately on the housebuilding industry. Even while pointing to the growth in overall construction and the failure of housebuilding to solve its internal price problems, most observers, I believe, would think it a detriment and not a gain to the economy if the level of housing starts falls much below the current level. It is cold comfort to point out that the current problems of housebuilding compare closely with those of previous tight money periods and were predicted well in advance.

Recent Financial Events

What has been happening among financial institutions? I think most are surprised to learn that despite all the talk about "tight" money the creation of money and credit since December 5 has been at a record-breaking pace. From December 1 to June 30, the money supply increased at an annual rate of 5.9 per cent. This is far faster than in any prior postwar year. Credit made available through financial markets also set a record. Bank credit did not expand as rapidly, but still its rate of increase exceeded the preceding six years.

While some criticize the Federal Reserve for being "too tight," others criticize it for an overly rapid increase in bank credit. Critics of the latter sort contrast this record-breaking growth in credit and ask how it can be reconciled with our goal of slowing down the expansion in real demand. People also wonder why with this sharp expansion of credit there has been such a rapid rise in interest rates and in the pressure felt by all financial institutions.

The explanation is that interest rates result from the conjunction of the supply and demand curves. While the supply of credit has risen, it has done so less rapidly than demand. Credit applications from potential borrowers, whether to hoard for the future, to speculate, or for legitimate credit needs, have shot up. Their demands could not be matched with the expanded supply except with higher interest rates and the direct rationing of availability by lenders.

We also have experienced a traditional shift from saving through deposit institutions to direct purchases in financial markets. This has slowed, but far from halted, the growth in deposits. Look at Chart I (attached). This relates the growth of deposits in thrift institutions to the spread between the deposit rates and the market rate for intermediate Government bonds. Clearly savers are intelligent. A very significant proportion of them--perhaps now more than ever--shop for their best return. The rate at which they expand deposits depends on the rate offered in comparison with money market instruments. Thus far this year because of the high demand in money and capital markets and the rising rates paid there, savers have put a far larger share of their savings directly into credit instruments instead of into deposits.

The Survey of Bank Time Deposits

We know that over time savers have also become more selective in their choices of deposit instruments. Again this is logical. The postwar period has witnessed a rapid expansion in the number of families with fairly sizable amounts of savings and a more sophisticated approach to investment. The greater coverage of the financial press, the increase in investment services, the growth of financial trustees, the awareness that interest rates are news, all reflect the fact that most savings are not in the hands of depositors with small knowledge or means. Rather they are concentrated sufficiently so that even minor variations in rates can make sizable differences in responses.

The growing sophistication of savers is demonstrated both by flow of funds figures showing an increased movement of individual savings to the money markets and by the recent Federal Reserve survey of member banks' experience with time deposits covering the period from December through mid-May.

What were some of the survey's results? Excluding time deposits held by governments and the large negotiable CD's, passbook savings still made up about three-quarters of the remaining total of time deposits held by individuals, partnerships, and corporations. On the other hand, by far the fastest growing kind of time deposit was the consumer type (savings certificates and bonds, and certificates of deposit under $100,000). The total of sums held in savings passbooks at member banks actually fell during this period at an annual rate of 4 per cent.

The survey also seems to say that banks are using consumer-type instruments in an attempt to hold funds which would otherwise be lost to the money market or other institutions. A tremendous variety in rates, type, size, and maturities exists. The range of instruments mirrors the type of reactions one would expect of a competitive system given the variety of differences in geography, size, and needs which exist among our financial institutions.

Rates paid reflect the different market situations faced by each bank. Thus almost all banks competing in the money market for corporate or public funds were paying the maximum rate of 5-1/2 per cent on certificates of deposits of $100 thousand or over. In contrast among the banks competing for consumer CD's fewer than 3 per cent, or 191, were issuing any CD's carrying interest rates over 5 per cent. The highest rate paid by the average bank was still less than 4-1/2 per cent.

High rates on consumer-type time deposits were concentrated primarily among banks in New York and California where the competition from the money market, the stock market, and other institutions is greatest. These higher rates served primarily to stem losses. As a general rule banks with the highest rates achieved less than average gains in their total consumer-type deposits. Given the demand for funds and the rates on market instruments, they had to run very fast in order not to lose ground. Banks as a whole were gaining time deposits at about 55 per cent of last year's rate.

The survey also showed that the instruments that have received the widest publicity--notably "savings bonds"--were still minor parts of the total. This over-estimate of the actuality of these instruments is, I know, a phenomenon with which you in the savings and loan industry are all too familiar, because of the tendency of people to read the dividend rates advertised by a few savings and loans in the financial press and the New York papers and to jump to the conclusion that these are representative of the rates that all savings and loan associations could pay. For example, though commercial bank savings bonds have probably attracted more attention than any other instrument, the fact remains that as of May 11 they were issued by only 162 member banks. Half of the banks had not raised their rates since December 3. Only 8 banks paid more than 5 per cent interest on these bonds and only 1/2 of 1 per cent of all member banks issued any bonds of this kind at rates over 4.5 per cent.

Similarly, many have mistakenly assumed that most banks were raising minimum maturities and sizes in this period. In fact the opposite is true. Most banks made no change in the conditions attached to their instruments. Of those that altered their terms, considerably more lengthened the minimum period required for money on deposit than shortened it. Similarly more banks raised the minimum acceptable than reduced it.

The Dilemmas of the Regulatory Agencies

The dilemmas faced by financial institutions have created related ones for the regulatory agencies. The desirable goals to be sought in this period have been numerous and at times conflicting. They include, among other things:

(1) Moderation of the rate of credit expansion to that which will support a maximum growth in real output and continued improvement in unemployment without inflation;

(2) Improvement in the rate of individual savings so more real income is available for eager investors;

(3) Supporting the growth of the competitive enterprise system;

(4) Recognizing the institutional problems of rapid change and attempting to ameliorate its hardships;

(5) A distribution of the credit supply that does not unduly penalize any sector.

It was in the pursuit of these and other longstanding goals, and in the light of the survey and other information becoming available, that the Federal Reserve Board acted two weeks ago to raise reserve requirements on time deposits other than savings. As is usual we were criticized both for doing too much and too little. What were a few of the things that had to be considered?

It was clear that the ceiling on large CD's could not be rolled back without drastically curtailing the credit lifeline of millions of borrowers. Between $15 and $20 billions are outstanding in time deposits paying over 5 per cent. Almost all this money could easily flee to other instruments. No one can say with assurance what the results of such a rollback would have been, but clearly the market for mortgages, construction loans, state and local bonds, and similar items held by banks would have suffered tremendous shocks.

On the other hand, it also appeared that several of the goals I have just listed would be furthered by a moderate increase in reserve requirements with a maintenance of the existing rate ceilings. This would serve directly to slow the expansion of credit. This action would raise somewhat the cost of money obtained through CD's. It would call into question the overly glib assumption that banks could continue to expand their assets without limit by purchasing liquidity through the issuance of CD's. They would be more likely to adjust their operations to the fact of a ceiling on Q which no longer would give much headroom in competition with the money market. Each of these effects would aid in the creation of a sounder background against which lenders could determine the necessity of each potential loan.

The problem of the consumer-type CD was still more difficult to resolve effectively. Here the legal powers available to the Board were limited. Gestures could have been made by limiting the terms of one or two particular types of time deposits. Most outstandings, however, are indistinguishable except in amount or by type of holder from the vast majority of market CD's. But the Board lacks legal authority to use either amount or type of holder as a basis of distinction for regulatory purposes.

Furthermore, the survey suggests that the majority of banks seem to be following a logical path in attempting to shape their savings instruments to the needs of their customers. They are offering savers different rates depending on savers' willingness to trade off convenience, liquidity, risk, and marketability for interest income. While some banks seemed not to be following a prudent course, the facts convinced many that the costs, with existing powers, of attempting to curb the few were greater than the threat the few carried to a continuing sound financial system.

Although the present situation does not appear unreasonable, it may not be stable. The rates offered on savings could escalate to a point that would create hardships for some institutions. Since banks are fairly flexible in their portfolios, most problems would be faced by other types of institutions. For this reason, I was rather surprised to see that spokesmen for the savings and loan industry at the recent Congressional hearings did not agree with the Administration that the three regulatory agencies ought to have standby powers to impose interest and dividend rate ceilings on deposits. It seemed to me that a bill which gave the Federal Reserve and the FDIC authority to set interest ceilings on deposits differentiated by size (say, $100,000) and gave authority to the FHLBB to impose similar ceilings would be a useful weapon to hold in reserve in the present period.

The decision to leave rates paid to the enterprise system and the management ability of financial institutions is obviously not a universally popular one. We certainly were urged strongly to impose controls and ceilings that could only have had a very drastic effect on all financial institutions. A law or regulation which is likely to lead to a sudden contraction in credit is unlikely to help anyone. I think you would all be amazed at the number of letters and calls we have received urging us in effect not simply to slow down the rate of credit growth but to force a contraction by reducing the ceiling banks could pay on their time deposits far below rates available in the money market or abroad. I am certain that few realized the amounts involved, the costs that would be engendered for major parts of the country and the economy, plus the dangers of cumulative contractions that might follow from their seemingly simple policy suggestions.

How these proposals were to help reach our economic goals and make more savings available to meet borrowing demand was not clear. Many seemed to argue that savers will put as much or more money into financial institutions at lower than at higher rates; This argument is hard to follow. The contrary argument, that lower rates for deposits would only cause more funds to go to the money market seems more logical. Deposit institutions, to hold their share for their borrowers, must pay a rate competitive with the market. They can minimize their costs by shaping their response to the variety of savers' needs. Even so it is entirely possible that some with even the best of current management may suffer losses in profits. This is the cost of past overly exuberant action by individual institutions and the present too great a dependence on higher interest rates to curtail demand.

The Future

One needs a particularly clear crystal ball to predict the future in a period of such rapid change. It is always possible that war expenditures will drop, taxes will be raised, business capital and investment will be curtailed, or that consumers will suddenly begin to spend less and save more. Any of these movements if sufficiently large would reduce the demand for credit so much that even with normal rates of growth in the credit supply pressures on interest rates and specific credit markets would be reduced.

On the other hand, if some or all of these forces fail to reverse recent trends, then the continued pressures of demand upon a credit supply expanding at only normal rates will not allow the situation to ease. Financial institutions will continue to face unpleasant choices. The costs and dangers of further rate escalation will have to be weighed against the advantages in adjusting lending operations to the slower growth in total available deposits. At the same time banks will have to work harder at allocating their funds among their potential borrowers. The problem of balancing national and community needs against short-term profit possibilities will be greater.

Other deposit institutions will face similar problems. They will have to rethink their rate and lending strategies. At the same time they will have to continue to evaluate risks carefully. One should expect that in a period marked by improving loan quality lenders would upgrade not lower the quality of their portfolios.

I believe that all lending institutions and the Government will have to give special consideration to the housebuilding industry. In recent years, lenders have channeled more of their funds to land speculation, commercial and industrial properties, and the refinancing of existing structures. A failure to reverse these trends sharply at this time would be a major disservice to the country.

At the same time, I feel that the conduits set up to allow housebuilding to tap the financial markets more directly in times of tighter money should be expanded and the flow through them increased. These conduits include the special assistance programs of FNMA and the advances for expansion of the FHLB System. Unless lenders do shift more of their funds to housebuilding and unless the governmental programs are enlarged, housing starts may well decline to an undesirable level.

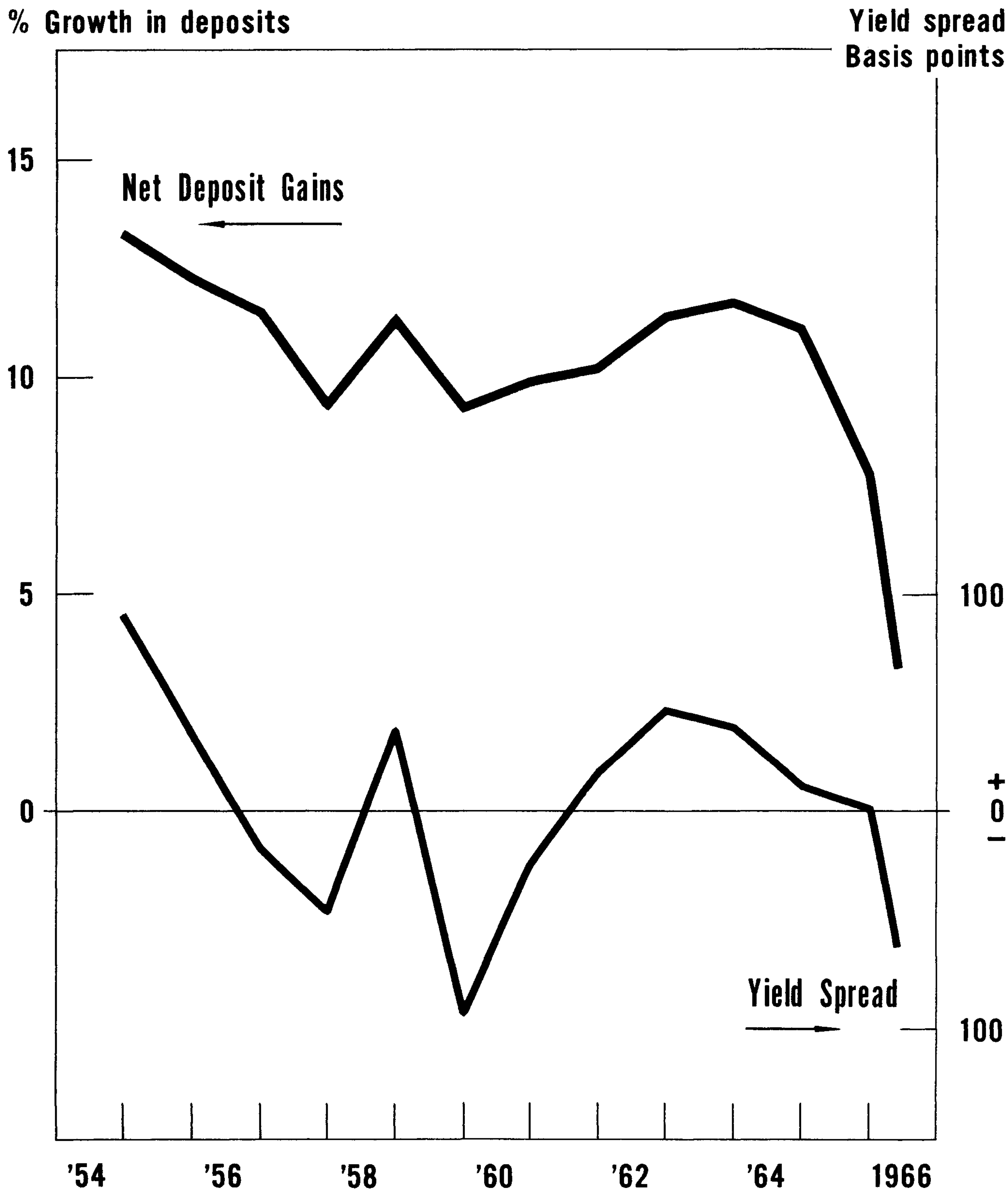
When the history of this period is examined, I think that all those concerned with the financial world will have learned many things. Of utmost importance will be a wider understanding of the relationship between monetary and fiscal policy. Talking to economists, I find they express great disappointment in what they consider a failure of financial leaders to play a constructive role in shaping community and political views in the past six months. Instead of leading the discussion and fight for more flexible taxes to offset the pressures on financial institutions, financial men have put their effort into seeking new governmental controls. The unfortunate part is that, while higher taxes would have eased their difficulties immediately, the suggested controls seemed to promise more harm than good.

One of the great advantages of conferences such as this is that they enable each to examine more carefully the assumptions upon which he has acted. I hope each of you will have time to re-examine the relationship of flexible fiscal policy to the operations of your and other financial industries. What would your and the country's situation be if there existed a broader understanding of a system which depended for stability on flexible taxes rather than on higher interest rates and tighter money?

I think we also will have to rethink the problem of institutions borrowing short and lending long. Clearly one cause of our difficulties is the uneven time distribution in individual firms of portfolios and deposits. If their average length was closer together or if the portfolios had more instruments with adjustable rates, some of our current problems would not have arisen.

In any case, I think, or fear, we most all agree that these are most interesting times for those concerned with financial markets. Many of us may well wish this were less true.

ANNUAL RATE OF CHANGE IN NET DEPOSITS AT MUTUAL SAVINGS BANKS AND SAVINGS AND LOAN ASSOCIATIONS RELATED TO YIELD SPREAD,* 1954-1966



* Average interest/dividend rates paid less average yield on 3-5 year intermediate Treasury bonds.