Statement of George W. Mitchell, Member,
Board of Governors of the Federal Reserve System

For the Committee on Banking and Currency
of the House of Representatives
May 24, 1966

I would like to briefly state my basic reasons for believing that the Board's position with respect to Regulation Q ceilings is appropriate at this time. In doing so I want to make clear that I do not project this view into a future in which conditions may be changed or changing.

I start with the proposition that the broad subject with which this hearing is concerned is a flesh-and-blood problem, and I would like to recall my diagnosis of its potential in a speech I delivered several months ago, and has previously been referred to by Mr. Strunk.

At that time I considered in what respects contemporary credit developments might, from either the over-all or the structural view, become a cause for concern. My choice of something to worry about, which may yet turn out to be a real menace to our credit structure, was not that we had too much debt in the aggregate or in broad economic sectors; nor was it the level of credit quality which could be safely serviced by an expanding economy. Rather, it was the growing business of borrowing short and lending long--the transformation of liquid claims into long-term credits by depository intermediaries.

Back on October 22, 1965, I pointed out that for the saver and investor these intermediaries were offering the best of all possible worlds. Thus the investor had a highly competitive return on his funds, and yet by prevailing practice he was always instantly able to convert his deposit into direct expenditure or direct investment if market conditions open up more exciting earning opportunities. The channelling of these flows into long-term instruments has also provided more ample funds for use by corporations, individuals and the various units of government. And financial intermediaries themselves by lengthening their portfolios and broadening their range of assets have been able to live well off an increasingly slender interest rate differential.

"In surveying these uniformly pleasing results, however," I noted, "that the question naturally arises whether they have been obtained by risking serious destabilizing repercussions in the future. Certainly while banks and other savings institutions have been expanding the volume of liquid claims in the hands of the public, they have been assembling in their own hands an entirely different time profile of matching assets. Not only are their loans and investments far less liquid than the claims against them as has always been true; they are far less liquid than they were five or ten years ago."

I went on in that speech to point especially to the liquidity risks attaching to CD issuance, but my remarks could equally well have been punctuated by illustrative references to the risks inherent in the passbook share accounts of savings and loan associations.

"In considering the vulnerability of depository institutions to savings outflows," I said, "the potentially disruptive contingency--and the one that is most likely to create a challenge to monetary policy--lies in the possibility of relatively sudden shifts of funds from 'time' deposits to direct investment in equity or credit markets. In this respect, negotiable certificates of deposit constitute the most vulnerable segment of the total since they are directly competitive with the full range of money market instruments and are held by corporations and other institutions likely to respond quickly to relatively small shifts in yield differentials. Indeed, the most immediate and direct constraint on monetary policy posed by the new profile of bank liabilities may lie in the need to weigh carefully the impact of specific actions on such differentials.

"More broadly, those charged with formulating monetary policy must recognize that the process of transforming liquid savings into long-term instruments does lack some of the automatic checks and balances inherent in a single contract between the original saver and the ultimate borrower. A widespread shift by depositors to other forms of asset holdings--say a move by corporate holders of negotiable CD's into market instruments or by individual savers into common stocks--might force readjustments in bank assets that would have serious repercussions on those credit markets in which banks are inactive and into which it may be difficult to entice other investors without significantly higher yield incentives.

"This would be particularly likely in markets such as those for municipal bonds and mortgages where bank participation has increased sharply in recent years. It might well occur whether the readjustment undertaken by banks losing time deposits was confined to reduced takings of new issues or extended to actual liquidation from existing portfolios."

These comments foretold a contingency which began to come into being with the December, 1965, tightening in monetary policy and the subsequent rise in market interest rates. A major asset adjustment that would have been required of banks (and an unexpected impact on their customers) was partially eased by a change in Regulation Q. This change permitted banks to offer higher rates for what amounted to about 14 per cent of their total deposits. So far as the larger banks were concerned, it enabled them to be more competitive with the security markets. So far as the smaller banks were concerned, it enabled them to be more competitive for local pools of funds.

But in both instances the banks were also competing with each other and, more fatefully, with themselves. They had in passbook savings about $90 billion on which the ceiling was not changed. To a considerable extent they found promoting CD and open book accounts at 4-1/2, 5, or 5-1/2 per cent attracted large transfers from their own lower-rate passbook savings accounts and thus only raised the price on funds they already had. This redundancy of cost had a substantial moderating influence on their competitive drive.

Furthermore, even with these higher deposit rates banks have not been able to fully offset the lure of high-yield market instruments for their customers; the most that banks altogether have been able to do is to keep up a positive net inflow of time deposits, but with a growth rate far below last year--a third less in January-April than in the comparable period of a year ago. Savings and loan association and mutual savings bank net inflows have also been dropping--to a rate only half that of 1965. Thus, all financial intermediaries have been feeling the tug of higher market rates of interest. Meanwhile the share of credit demands met through direct flows of savings to the market has risen sharply as savers by-passed banks <u>and</u> other intermediaries and put more of their funds directly into securities. Last year the banking system was able to accommodate two-fifths of the credit used by individuals, businesses and governments; in the first quarter of this year, the banking system's contribution fell to only about one-quarter of the total.

What does this background of fact and principle signify for how we should approach today's problem?

I think it is clear that we all have a common goal of maintaining the stability of our financial institutions and of providing savers with the best yields and the greatest liquidity consistent with that stability. I would add that near-instant liquidity of time deposits at banks or savings and loan associations is a privilege that must not be too widely shared. It can hardly be shared at all with any very large number of that kind of depositors whose withdrawals are stimulated by rate incentives. A predictable, even though large, turnover in savings accounts is one thing, and well within financial managements' capabilities--a concentrated mass withdrawal to take advantage of rising yields is an entirely different matter and much more difficult to deal with. This is one reason for the Federal Reserve rules that today deny passbook accounts to business corporations and to State and local governments, two type of depositors who are exceptionally sensitive to rate differentials.

Today many depository institutions are recognizing the destabilizing threat of rate changes, and they are trying to stratify their depositors, according to sensitivity to yield differentials on the one hand and to desire for liquidity on the other. Those that are sensitive to higher yields are being locked in with varying maturity arrangements; this is a major virtue of the certificate of deposit. Those that are more liquidity-conscious are being offered lower yields in passbook-type accounts.

The rates, terms, and conditions offered vary widely from place to place in the nation, reflecting the great variety of economic and financial circumstances and the differing judgments of thousands of financial managements. In the process several new mutations of deposit instruments have taken place. A few such mutations may be bad, or at least nonprofitable in the longer run, but I regard as constructive those savings contracts that compel the holder to accept some meaningfull restraints (maturity or otherwise) on his ability to demand cash from his depositary institution and then pay that holder well for his giving up of liquidity. And for this reason, denouncing longer-maturity, higher-yielding CD's just because they are of small denomination strikes me as antithetic, not only to equity but also financial stability.

In a problem as complicated as this one, it is possible to mistake surface symptoms for underlying causes of disequilibrium. The result of an erroneous analysis may be to damage our financial intermediary system, reduce the benefits of a competitive financial system, or to thwart the effectiveness of monetary action, the major instrument of public policy being used to counter emergent inflationary pressures at this juncture.

Bank and savings and loan competition has been vigorous for several years now. But it moved into the acute stage when monetary restraint reached its current levels and it became obvious that the aggregate of credit would not be large enough to go around. The problem, in my view, is linked directly to the way in which we are dealing with overheating, or the threat of overheating, in our economy. Were we using fiscal policy to counter these pressures, I doubt the issue we are considering today would even have arisen, greater reliance upon fiscal restraint would probably not have produced the monetary stringency we now see around us or may be expecting. Our problem is clearly worse, however, because financial intermediaries have implicitly promised more liquidity, yield and accommodation to their customers than they can readily deliver.

Admittedly, there is room for differences of view on what, if anything, should be done now. In seeking solutions, we must keep in mind that there are both short- and long-run problems involved, cyclical as well as secular developments with which to cope. In the short run, we have to quell the hysteria and break the paralysis that seem to be gripping some participants in and observers of the financial scene. The financial structure is essentially resilient and well managed, and there exist governmental mechanisms established for the very purpose of easing adjustments that must come in the wake of shifts in demands for goods and for financial services. While not denying that a problem exists for all financial intermediaries--as a result of the Government's reliance on monetary policy as the main tool of economic restraint--the situation hardly warrants the crisis atmosphere that has developed in some quarters, or the over-reaction by portfolio managers which threatens to curtail housing activity unnecessarily sharply.

What is important is to be sure that in dealing with the short-run problem, we do not adopt solutions that in the long run will hurt more than help. I believe the best and most lasting solution lies in permitting intermediaries, savers, borrowers, and the market to work out their own overheating, in our economy. Were we using fiscal policy to counter these pressures, I doubt the issue we are considering today would even have arisen, greater reliance upon fiscal restraint would probably not have produced the monetary stringency we now see around us or may be expecting. Our problem is clearly worse, however, because financial intermediaries have implicitly promised more liquidity, yield and accommodation to their customers than they can readily deliver.

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What is important is to be sure that in dealing with the short-run problem, we do not adopt solutions that in the long run will hurt more than help. I believe the best and most lasting solution lies in permitting intermediaries, savers, borrowers, and the market to work out their own salvation. Most of them are doing well enough now and others are taking constructive corrective measures. If governmental actions are needed, they should be actions designed to remove restrictions and inhibitions, rather than those which hamper adjustment to evolving economic needs.

I would like to add a postscript to my statement, with respect to the impact of monetary conditions of recent years on the smaller banks of the nation and, by inference, on the effect of restricting their use of CD's and open book accounts. Unfortunately, our statistical knowledge of how small banks are faring depends upon Call Report data which are not very current. From data for June 30, 1965, the latest information we have, I think it clear that small banks were holding their share of the market for demand deposits, losing out on passbook savings, gaining slightly on CD's and open book accounts held by State and local governments and gaining well on CD's and open book accounts held by individuals, partnerships and corporations.

Using June 30, 1961 as a comparison year, defining small banks by the total of their deposits in each of these categories, and choosing deposit levels in each case to set off 75 per cent of the 13,543 banks in the nation, these are the results:

(1) Banks with demand deposits of less than $5,110,000 had 11.6 per cent of the demand deposit market in 1961 -- 11.5 per cent in 1965.

(2) Banks with less than $3,250,000 in passbook savings had 13.0 per cent of that market in 1961 -- and dropped to 10.9 per cent in 1965.

(3) Banks with less than $1,310,000 in CD and open book accounts to individuals, partnerships and corporations had 7.1 per cent of that market in 1961 and gained to 11.9 per cent of it by June 30, 1965.

These data are now almost a year old and what the statistics for June 30, 1966 would show is partly a matter of conjecture--my conjecture would be the smallest 75 per cent of the banks are still holding their own on demand deposits, still losing on passbook savings and more dependent than ever on the small CD and open book account to hold their share of the time deposit market.