For release at 10:30 a.m.
Pacific Standard Time
December 28, 1966

Interest Rates Versus Interest Ceilings in the Allocation of Credit Flows

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at the

Annual Meeting of the

American Finance Association

San Francisco, California

December 28, 1966

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There is no need for me to assert or emphasize on this occasion the importance of the role of prices and free markets in the allocation of financial resources. Academic training or professional indoctrination, if not prejudice, has given all of us a well-established and relatively similar orthodoxy. There is also a derivative consensus on the impropriety of price ceilings or floors, whether statutorily or collusively reached; still it is this latter orthodoxy that I want to explore in a special context today.

That special context is a period of monetary restraint such as we have had in 1966. Even though we grant that ceilings are inappropriate in periods of monetary neutrality, ease or moderate restraint, may there not be some degree of monetary restraint that creates conditions under which one can argue that ceilings have an appropriate role to play in protecting our financial institutions and relationships?

To start with, I want to make sure that we do not share the popular degree of naivete about the nature of rate constraints on the financial markets. The shelters or barriers that collusionists or law makers erect are always leaky under any significant pressure--and the greater the pressure the less effective they eventually become. Given both time and the financial incentives, these constraints affect less and less of the flow of funds.

However, in the meantime, or at times, statutory and institutional constraints on the flow of funds have significant allocative effects. Usury laws and statutory interest rate ceilings are prime examples of the ambivalence of limitations on credit terms. A usury statute may force a borrower into a more costly credit market or into a loan repayment or discount plan with effective rates well beyond the usury rate. It may act as a floor instead of the intended ceiling, or it may bar practical access to credit at all. These and other possibilities indicate the caution needed to evaluate the short-run protection afforded to borrowers by usury statutes as well as the longer run changes they induce by promoting or restricting institutional access to a given market.

Similarly, the constrictiveness of regulatory rate ceilings has stimulated some aggressive banks to probe the inherent fungibility of time money and, in doing so, achieve a precedent-breaking enlargement of the Federal funds market, a large-scale domestic use of the Euro-dollar market, and a surprising degree of moral suasion on their negotiable CD customers.

The prime rate, a widely respected floor and ceiling for the "better" loan customers of commercial banks, is another frequently cited example of an artificial rate barrier. Its allocative effects on bank and nonbank sources of funds are muted because "better" customers must be defined and that process introduces some flexibility in eligibility for the rate; additional variance in the rate itself is achieved through the discriminating enforcement of compensating balance requirements on various customers.

A final example may make still clearer the importance of avoiding a doctrinaire position in these matters. It is generally known that the statutes of the United States legally prohibit banks from paying interest on demand deposits. In the words of the Federal Reserve Act, "No member bank shall, directly or indirectly, by any device whatsoever, pay interest on any deposit which is payable on demand...." But it is equally well known that in substance, a return is being paid on demand deposits in the form of bank services, and that these services are being measured more and more precisely as account balance equivalents by the electronic capacity for accounting minutia now beoming available. The legal prohibition, then, may limit the return paid on demand deposits to the cost of services that a demand depositor can demand, but that is all it does. And in these times, I should add, there is also an implicit loan commitment fee sense that is, in effect, earned by demand deposits; namely, the value attributable to the access to bank credit that goes with a prized demand deposit (one which the customer maintains well above service requirements over the years). This "right to accommodation" is not inconsiderable whenever the customer asks for credit in a period of really "tight" money. Thus, even though they are handicapped by a nominal interest rate ceiling of zero per cent banks are able to create powerful incentives among their customers to hold substantial sums in demand deposit accounts.

In light of the protean character of rate ceilings and floors, I believe we must guard against over-emphasizing their role in an analysis of financial allocation and in our proposals for reform. We should also be taking a close look at the public and private institutional factors, including tax differentials and subsidies, which probably have a more basic and enduring influence on financial resource allocation than all the rate barriers and shelters combined.

With this slightly disparaging introduction to implications of the title of this speech, let me develop the substance of my remarks by refreshing your recollection of recent developments in financial intermediation.

All would agree, I believe, that intermediation has been a major factor in financial developments in the post-World War II years. It has great advantages for the institutions involved and their potential customers on both sides, i.e., those from whom they borrow funds and those to whom they lend. These advantages are those of investment specialization and efficiency, of enhanced liquidity for depositors, of a broader availability of credit to smaller borrowers, and a generally more competitive environment all around.

The nonbank financial intermediaries recognized and exploited these advantages in the immediate postwar period. From 1947 to 1956, the savings and loan associations, mutual savings banks and credit unions grew over four times as rapidly as banks, and 70 per cent more than the rise in GNP in current dollars. To be sure, part of the explanation for the slower growth of the banking system was the reduced (2.3 per cent) annual growth rate in demand deposits, reflecting excess liquidity inherited from the war and the recurrent need to temper inflation by restrictive monetary policy actions.

It was clear to many bankers at the time that they were losing out in the competition for consumer savings as the deposits and shares of nonbank institutions gained increasing acceptance among households. These competing institutions were demonstrating that it was possible to buy money from supposedly interest-insensate consumers. To make matters worse for banks, many business customers, attracted by rising market yields, were turning more and more to market instruments as a repository for their liquid funds, and their deposits at banks showed little growth. Finally, with their deposit growth limited, their customers' loan demands growing, and their portfolio of liquid assets gradually becoming a smaller share of their total assets, banks, by the mid-1950's, were coming under increasing pressure to find funds.

The increase in Regulation Q ceilings at the beginning of 1957 afforded banks additional leeway to compete for time and saving funds. I say additional leeway because many banks were not using what leeway they had and were reluctant to see more added. Others, however, made effective use of the opportunity. In the next five years total interest-bearing deposits of banks expanded at an average annual rate of about 10 per cent, or about twice the pace of the preceding decade. In these years, from 1957 through 1961, the public's greater relative share of financial asset acquisitions in the form of bank time deposits was associated with smaller accumulations of demand deposits and a small decline in their relative purchase of market instruments. Claims on nonbank depository institutions, however, continued to rise as a relative share of total financial asset purchases. Banks' share of total credit flows rose to over one-fourth--up from slightly over one-fifth for the period 1947 through 1956. Nonbank depository institutions increased their share about the same--from less than one-fifth to about one-fourth, and nonbank nondepository institutions and direct market financing, especially the latter, had declining shares of total credit flows.

A more dramatic shift in financial flows occurred in the 1960's. Four increases in Regulation Q ceilings from 1962 through 1965 permitted banks to continue to attract time and savings deposits. The decision in early 1961 of major money market banks to issue large denomination negotiable CD's to business, State and local governments and others, broadened the area of bank competition for funds and signalled the beginning of intensive efforts by banks to attract more interest-sensitive deposits. And, I might point out, more than permissiveness and increased aggressiveness was at work here. A kind of Schumpeterian competition was also a major factor: many banks were forced to break away from past norms not only to meet nonbank competition but also to react in kind to the efforts of other banks to buy funds.

The net result was a further acceleration in time and savings deposit inflows at banks to an average annual rate of 15 per cent from 1962 through 1965, with banks all over the country and of all sizes sharing in this greater growth. In this period there was a sharp decline in the pace of public purchases of credit market instruments. And as time passed, and banks designed still more attractive consumer deposit forms, nonbank depository claims also began to decline as a share of financial asset purchases. These shifts in competitive positions were reflected in steadily growing credit flows to banks. Over one-third of total credit came from banks for the entire period 1962 through 1965, and in 1965 the bank proportion reached 40 per cent. Nonbank depository institutions maintained their one-fourth share of credit flows initially, but by 1965 their market position had declined to one-fifth. Public purchases of open market instruments declined to 10 per cent of total credit flows--down from a high of 23 per cent in the earlier postwar period.

But these changes in credit flows were not simply a mere diversion of funds from one channel to another. Two other major phenomena were contemporaneously involved.

First, the rate of expansion of total financial asset acquisitions of the public accelerated sharply. In the consumer sector, for example, total financial asset purchases rose from slightly over 5 per cent of income from 1957 through 1961, to over 7 per cent of income from 1962 through 1965. This development was the result of a complex series of shifts in financial and real flows, including a much higher level of borrowing--especially in the mortgage market. Generally easy conditions in this market in 1962-65 encouraged a higher turnover rate of existing houses and probably a net withdrawal of equity from the housing market. Mortgage borrowing relative to new housing expenditures rose from 61 per cent in 1957-61 to 81 per cent in 1962-65. It was the competitive return on deposits and shares at intermediaries that made it relatively inexpensive for consumers to retain liquid assets while borrowing to finance expenditures. And it was the seeking of investment outlets by financial institutions that made borrowing terms more attractive. Thus, the result was that a higher level of liquid asset acquisition by the public had a counterpart in a higher level of borrowing.

The second major change from 1962 to 1965 was in the composition of lending. With greater inflows--at higher cost--certain intermediaries shifted their lending patterns. Banks in particular stepped up their purchases of mortgages and municipals, taking one-fifth of the former market and three-fourths of the latter market in this period. Moreover, businesses sharply reduced their use of credit market instruments to finance their greatly increased borrowing and turned increasingly to mortgages and bank loans.

These shifts in borrowing and lending patterns, in turn, had three major results for financial markets. First, the increased bank purchases of long-term assets, the larger demand for mortgages by all financial institutions, and the reduced financing by businesses in the open market, were all major factors in the unusual stability of long-term rates from 1961 through mid-1965. Second, the enlarged availability of mortgage financing had its counterpart in the expanded volume of multi-family and commercial construction, as well as the rise in residential construction. Third, the high level of efficiency of financial intermediation meant that many borrowers--whose capital market alternatives are limited--were able to obtain financing in amounts that would not otherwise have been available.

All of these developments, I believe, on balance made an important contribution to national economic welfare in the years beginning in 1961 through mid-1965--helping to foster needed growth in economic activity, fuller employment of our resources, more efficient and competitive provision of financial services and yet with reasonable price stability and some degree of financial restraint exercised on our continuing balance of payments deficit.

However, the economic objectives and policy prescriptions that were suitable to the first five years of this decade were rendered inappropriate by events over the course of the past year or so.

During 1965 prices began to rise more quickly, economic activity accelerated with the rise in defense expenditures, and credit demands expanded at a rapid pace. The increasing credit demands and growing inflationary pressures called for a progressively more restrictive stance of monetary policy. All these forces in interaction led to a sharp increase in market interest rates in 1966 to levels far above previous postwar highs. These higher market rates, in turn, outstripped the rates that financial institutions were able and willing to pay on their deposit-type claims and thus reduced their rate of growth.

Taking advantage of the higher ceilings on time deposits established in late 1965, banks moved up their deposit rates still further and, accordingly, their inflows of interest-bearing deposits declined only modestly in the first eight months of 1966. In this period, such deposits expanded at an 11 per cent rate, compared to the 15 per cent average of the previous four years. Savings and loans and mutual savings bank inflows, which had decelerated each year since 1963, rose only 3 per cent in the first three quarters of 1966--a rate of expansion below the interest accretion on their shares and deposits. Since these institutions tend to specialize in mortgages, mortgage credit availability was sharply reduced and both real estate activity and expenditures for new housing declined.

The large relative growth of "consumer-type" time deposits at banks may have suggested that the loss of funds of nonbank institutions was due to bank competition but the substantially offsetting decline in commercial bank passbook savings indicated that the banks' "consumer-type" CD's were highly competitive with their own savings accounts.[1/] Meanwhile, the sharply increased pace of public purchases of market securities indicated that the market was a major competitor for bank and nonbank intermediaries alike.

1/ See following table

Time and Savings Deposits at Weekly Reporting Banks
(In billions of dollars)

Item	Level Dec. 30, 1964	Change from Dec. 30, 1964 to Dec. 8, 1965	Change from Dec. 29, 1965 to Dec. 7, 1966[1/]
Total time and savings deposits	66.9	11.0	3.3
Negotiable CD's in denominations of $100,000 and over	12.6	3.9	-1.1
State and local, foreign government, and official institutions, etc.[2/]	9.8	1.3	.1
Sub-total	22.4	5.2	-1.0
Consumer-type time deposits[3/]	3.8	1.4	8.0
Savings deposits	40.7	4.4	-3.7
Sub-total	44.5	5.8	4.3

1/ Changes in 1966 have been adjusted to eliminate the effect of (1) the redefinition of time deposits in June to exclude hypothecated deposits (2) the weekly reporting panel change in July.

2/ Includes U.S. Government, and financial institutions.

3/ Time deposits of individuals, partnerships, and corporations (IPC) less all negotiable CD's in denominations of $100,000 and over. Therefore, the changes reflect the deduction of CD's issued to all ownership categories, and not just those issued to IPC groups. "Consumer-type time deposits" include small holdings of time deposits by partnerships and corporations.

After mid-1966, several developments began also to limit expansion of time deposits at banks. The most important of these was the continued rise in market yields which made bank deposits relatively less attractive because ceiling rates on negotiable CD's were not advanced to keep pace.

The Federal Reserve policies on ceilings in this period deserve comment. System policy toward time deposits in general and ceiling rates in particular was guided by two developments in 1966. First was the aforementioned effect of policy moves on nonbank institutions and the housing market. In order to ameliorate these conditions, the Board, in July, lowered the ceiling rate on the so-called multiple maturity time deposits in order to reduce the attractiveness of such deposits relative to nonbank claims. In late September, pursuant to new legislative authority, the Board further reduced the ceiling rate on time deposits of less than $100,000 from 5-1/2 to 5 per cent. At the same time the Federal Deposit Insurance Corporation and the Federal Home Loan Bank established ceiling rates for mutual savings banks and savings and loan associations.

The other development influencing System policy on time deposits was the very rapid increase in business loans in the first half of 1966. Such loans expanded at an annual rate in excess of 20 per cent--more than in 1965--in the first seven months of 1966 and, in the summer, were accelerating despite reduced reserve availability. These loans, which were contributing to the capital goods boom from which so much of the inflationary pressures were emanating, were being financed from time deposit growth, as well as from liquidation or curtailment of other elements in bank portfolios. To attack the problem from the time deposit side, reserve requirements on time deposits at individual member banks in excess of $5 million were raised from 4 to 6 per cent in July and September.

But more importantly, ceiling rates on time deposits in denominations above $100,000 were not raised as market yields increased. At first, banks were forced to issue shorter term negotiable CD's, but by mid-August negotiable CD outflows began and by the end of November amounted to $3.0 billion. With other forms of time deposits also under pressure, inflows of interest-bearing deposits at banks from August through November decelerated to a 1 per cent rate, and in October banks suffered an outflow of time deposits for the first time since 1960.

Reduced time deposit inflows, given banking conventions on the primacy of business loans at prime rates, were not enough to ameliorate the problem, and could have led to sharp reductions in bank credit other than business loans. Thus, on September 1, the presidents of the Reserve Banks wrote to all member banks calling upon them to rely more on curtailment of business loans in adjusting to liquidity pressures--including time deposit outflows--

and less on other portfolio items. The letter indicated that Federal Reserve discount facilities would be available for extended use to help banks accomplish this objective.

The net result of all of these actions--or failure to act differently--in the first three quarters of 1966 has been a sharp reversal of the pattern of flows developed in 1962-65. Bank credit expansion has dropped from 40 per cent of total funds raised in 1965 to 20 per cent over the first three quarters, and 6 per cent in the third quarter. Nonbank depositary institutions also accounted for a smaller share of credit flows--11 per cent for the first three quarters as compared to 20 per cent in 1965. The public, in turn, has supplied over one-third of total funds raised by its direct purchases of securities, up from 10 per cent in 1965.

The disintermediation of credit flows this year has moderated the pace of total financial asset accumulation by reversing the consequences of the earlier increased intermediation. Mainly it has rechanneled financial flows and altered borrowing patterns and credit availability. The reduced inflows to nonbank institutions has resulted in a decline in mortgage borrowing since most prospective mortgage borrowers have only limited alternatives in financing outside of institutional lenders. Many business borrowers also have found their ability to substitute market borrowing for bank credit limited by their size. Other borrowers who can qualify for market financing have found it an imperfect substitute for bank credit. Issues of market securities are less flexible, have higher interest rates and transactions costs, and have longer institutional lags than would be the case with a loan at a bank. Thus, the diversion of funds to market instruments from claims on banks and other financial institutions--accompanied by rising yields and reduced credit availability--has been a major transmission mechanism for monetary restraint.

What will financial historians learn from the intermediation trends of the past year as they view them against the financial and economic background of the postwar period? Certainly these trends will appear to have had a dominant influence on both the amount of credit and the channels of credit flow in recent years, and particularly in 1966. While one does not write history as it unfolds, contemporaries' understanding of the past and expectations of the future are germane to any subsequent appraisal. It seems to me that the salient points for evaluating credit and banking policy are about as follows:

1. The tools available for a policy of monetary restraint are still powerful. This is true despite the increasing dependence of banks on intermediation and the decreasing dependence on a very modest expansion of the money supply in recent years. Neither development eroded the ability of the System to slow the expansion of credit once inflationary pressures threatened to get out of hand

since it retained firm control over ceiling rates banks may pay for interest-bearing claims.

The demand deposit numbers, for those who watch money supply developments closely suggest a potential weakening of monetary control. Thus, GNP in constant dollars grew at an annual rate of 3.5 per cent between the mid-50's and the mid-60's, and money supply at an annual rate of 2.0 per cent. In the 60's alone, growth in money has been at 3.0 per cent annual rate and GNP 4.6 per cent. Output, using the crude measure of GNP in constant dollars, continued to grow about 1-3/4 times as rapidly as money supply. These figures indicate the monetary base is steadily shrinking toward a pure transactions composition with future changes in demand for demand deposits comparable to those for coin and currency today.

Looking ahead, most of the implications of money technology and banking practice point toward an accelerated erosion, relatively and absolutely, in money supply as the operation of the money transfer system is modernized and the competition among intermediaries for inactive funds continues to drive non-working balances out of the demand deposit aggregates.

2. The larger and more aggressive commercial banks of the Nation--some 700 with 70 percent of total deposits--are not content with an institutional growth proportioned to the growth in the demand deposit component of the money supply. Since 1955 this would have been an annual growth rate of only 1.8 per cent. Thus, they have already been forced into an intermediation role; for the future, the prognosis is the same--<u>a fortiori</u>. Because commercial banks as a whole have expanded time deposits at an average annual rate of about 11 per cent since 1955, their total deposits grew almost exactly in step with GNP in current dollars--5.5 per cent.

To retain this position, banks have had to compete with other intermediaries and with money and capital markets. The effective constraint on their activities was not the usual price at the central bank (discount rate) nor discount window administration but ceilings--economic, agreed to and regulatory--on what they could pay for time money. These ceilings, of whatever nature, turned out to be a major vehicle of monetary restraint.

3. The conventional lock-in effect of monetary restraint is a familiar phenomena in which holders of debt assets are temporarily inhibited from making new investment decisions using the proceeds from the sale of such assets by the realization of significant losses (assuming no offsetting tax tolerances). Growing intermediation in the past decade has significantly added to the potency of this type of monetary restraint, by immobilizing the intermediary which encounters interest rate levels to which a timely adjustment for it is difficult, if not impossible. It is not just a matter of losses from a decrease in the market value of debt assets--but the far more chilling prospect of an unexpectedly drastic cutback in cash flow on which the intermediary has lodged its major dependence for liquidity and a regular lending policy of advance commitment. The experience is one of becoming priced out of many markets for new funds, and facing the loss of funds in hand because depositors demand instant liquidity in order to move to higher yielding assets. It includes the erosion of heretofore stable expectations as to elements of cash outflow (e.g., policy loans) or cash inflow (mortgage refinancing). The concomitance of these adverse developments has produced among some intermediaries in 1966 an immobilization of investment decisions, in spades, so to speak.

4. One final point. After financial tensions have eased and more stable relationships come to prevail it seems probable that many intermediaries will be considering policies which will insulate them, in part at least, from the financial shocks experienced in 1966. These policy alternatives will surely be aimed at a closer meshing of maturity profile of assets and liabilities. Customers of financial institutions will not have carte blanche access to liquidity or credit without regard to monetary conditions. Assurances of this type will have price tags or qualifications, or both. A greater wariness of "hot" money should be evident either in its avoidance or in the circumscription of its use. The restructuring of liabilities and assets, including as much diversification as the law allows or can be amended to allow, also seems likely.

Intermediation, as events of the postwar years have shown, has great advantages for our economy but the past year has shown it is not without disadvantages too. An agenda of needed financial improvements for the future should include proposals to make intermediation a still more usable and stable element in our financial system.