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Liquidity and Monetary Management in 1967

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The monetary climate of 1967 is often superficially described as a return to "easy" money. Accompanying this assertion is the implicit inference that the supple string of ready credit availability has already set in motion plans and projects for spending that will give rise to unsustainable levels of economic activity in the future.

This diagnosis leans on such phenomena as the 8.0 per cent annual rate of expansion in the money supply in recent months, the contrasting levels of free and net borrowed reserves this year and last, and the 12 per cent annual rate of growth in bank credit since the first of the year. However, it ignores the necessary post-monetary-restraint adjustments that are under way, the current level of long-term interest rates, the cautious lending policies of the vast majority of financial institutions and both the character and the magnitude of the task of rebuilding liquidity of corporations and financial institutions as a result of fiscal-monetary policies and events of 1966.

There is, unfortunately, no easy way for determining the extent to which adequate liquidity levels consistent with sustainable expansion in the future have by now been achieved. And I think it quite clear that the answer will not be found in some one or two postulated statistics for the banking system which are interpreted out of context of the balance sheet and

flow-of-funds situation of banks, other financial institutions, corporations and households. The problem requires a much more sophisticated analysis.

The effects of the monetary "crunch" of 1966, for example, clearly did not come to an end in November of 1966. The ensuing change in financial psychology remains a powerful tranquilizing force on lenders, in particular, and entrepreneurs, generally. This experience brought to some of them the realization, for the first time, that an excessive rate of expansion for the economy as a whole, bringing into play monetary-fiscal measures of restraint, has the potential, if not the actual effect, of modifying their commitments to spend, lend, pay or repay. Others with longer experience and greater sophistication were surprised by the impact of a monetary coolant. Many imprudently managed institutions and ventures suffered severely, and even well-managed firms found that commitments soundly based on prior experience had become vulnerable to an exuberant tempo in the economy as a whole.

The net of these influences is found in the steps that financial institutions, corporations, and households have been taking in 1967 to restore their liquidity and to avoid the hazards of over-commitment. There are, of course, many manifestations of these decisions. Households, for example, have been saving more; the saving rate rose from 5.6 in the first three quarters of 1966

to an average of about 6.7 in the four subsequent quarters. Households' use of instalment debt shows the same tendency; in the first seven months of 1966 instalment debt outstanding rose $6.7 billions; in the first seven months of 1967 the rise was $2.9 billions. Households have also been investing less in capital and money market instruments this year than last and more in depository institutions where some sacrifice in yield at current market rates appears justified by liquidity-type advantages.

Bank liquidity is notoriously difficult to measure because there are so many dimensions to the problem. A bank's liquidity is affected by its ability to convert assets into cash, control commitments, attract and retain deposits, and borrow from others. However, from the bank's point of view, it is not just a matter of actually being able to do some or all of these things but being able to do them on favorable or, at least, not unduly unfavorable terms. For the outsider, the task of appraising liquidity is especially vexing because he doesn't even know whether banks' liquidity positions are involuntarily or deliberately determined nor does he have at hand such relevant data as loan repayment schedules, details on securities holding and pledging requirements nor indications from banking's customers regarding expected needs and balances.

Still the central bank, which is an outsider of sorts, in the United States at any rate, must make judgments about bank liquidity no matter how difficult or untractable the problem because of the implications for monetary management. Liquidity measures, even of the crudest sort, are indications of how much flexibility banks have in responding to changes in loan demand or monetary policy before interest rates and credit availability are affected.

By putting several bits and pieces together a mosaic can be formed which suggests that there has been a significant improvement in bank liquidity in 1967. In the first eight months of the year, only about 40 per cent of the increase in bank earning assets has taken the form of loans, as compared to almost 90 per cent for the same period last year. As a result, the ratio of loans to deposits declined somewhat from the high of last year--from 66.8 to 64.8. Another rough indicator of portfolio liquidity is the percentage of loans and investments in the form of Treasury issues under 5 years and one-third of all other securities--which, though crude, is our best indication of the share of the latter assets that have maturities of 5 years or less. For weekly reporting banks this percentage has risen from a low of less than 14 per cent last year to 16.7 per cent at the end of August, or about equal to the ratio in early 1965.

Both the loan-to-deposit ratio and the percentage of earning assets in liquid form have thus improved this year, but both measures still indicate a level of liquidity significantly below that of the early 1960's. The liquid asset ratio at WRMB's was about 20 per cent in 1963-64 and was 16.7 per cent last month. The loan-to-deposit ratio was about 59 in 1963-64 and was 64.8 last month. But this does not mean that banks feel illiquid. There is considerable evidence that the desired liquidity ratios of banks have declined in the 1960's as banks have increased their use and access to Euro-dollars, time deposits, and Federal funds as supplementary sources of liquidity, thus reducing the amount of liquid assets they felt necessary to hold in their portfolios.

Time deposit inflows have been large in 1967--expanding at about 17.5 per cent annual rate--Federal funds have been readily available, and Euro-dollars in recent months have also been available and relatively cheap. Perhaps the best recent indication that banks feel comfortable with their present liquidity is that despite the availability of such funds banks have not been particularly aggressive in seeking them. True, with the end of accelerated tax payments and the subsequent softening of business loan demands, the current need to tap such sources has been reduced. Moreover, banks are aware that this fall their bill holdings will probably rise sharply during the Treasury financing and with business loan demands smaller than expected and time deposit inflows continuing

strong, they will be in a position to hold some of these bills for a time. But, my point is simply that they could buy more liquidity now if they wished, and they have not. In conjunction with the increase in portfolio liquidity this year, I conclude that these factors suggest that at current interest rates banks are satisfied with their liquidity position.

I do not conclude, however, that the liquidity of banks is excessive by any standard. While banks are certainly more comfortable than in 1966, a moderate surge in loan demands or a tightening of policy could dissipate bank portfolio liquidity relatively soon and sharply increase the cost of supplementary sources of liquidity. In other words, recent monetary policy has not produced redundant bank liquidity.

Moreover, the proximity of intermediate and short-term market rates to Regulation Q ceilings reinforces the moderating effect of a modest liquidity cushion on any expansionary impulse the banking system may experience.

The dominant change in the balance sheets and flow of funds for both savings and loans and savings banks thus far this year has been the rapid recovery of savings flows to virtually record amounts for both types of institutions. The first 8-months flow of $3.4 billion to mutual savings banks far exceeds the previous eight-month high of $2.6 billion in 1964 while the $6.7 billion inflow to savings and loans is nearly equal to the $6.8 billion eight-month high established in 1963. Record flows to these institutions are reassuring after the 1966 experience

but it should be borne in mind that an economy producing a $800 billion GNP (the present rate) is generating significantly larger savings flows than one producing $610 billion in 1963-64 and intermediaries should be concerned about their share of the larger flow.

During September there does not appear to be any important shifts in these inflow patterns, and for the entire month flows should be at record volume due to the interest credited at the end of the third quarter at rates higher than in previous years. For the fourth quarter, unless conditions change significantly, savings banks should continue to experience record inflows as should savings and loan associations in the most interest-sensitive areas, although there may be some small shift of share capital from California associations to other savings and loans and savings banks resulting from the July rate reduction in California.

To date there has been no evidence of significant faltering in depository inflow despite today's attractive yields on corporate and agency securities. No doubt a good bit of the hot money that left depository institutions in 1966 did not return. No doubt the instant availability of share accounts and passbook savings combined with prevailing yields has looked better to some savers in 1967 than it did in 1966. No doubt the competitive ardors of some financial institutions have been cooled by

regulation or a broader view of their effects on the whole community and in the longer run. Up to now these factors have prevailed over the temptation to depositors of higher market instrument yields but there is no guarantee that still higher yields would not reduce intermediation significantly.

While liquidity measures of savings and loans and mutual savings banks have not improved in a manner similar to savings flows--indeed savings banks' liquidity at the end of July was lower than a year earlier--both groups of institutions have restructured their assets or liabilities significantly. The liquidity ratio (cash and Governments as a per cent of deposits) reduction for savings banks has resulted both from the large growth in deposits and an $800 million reduction in their holdings of Governments from July 1966 to the end of July 1967. But accompanying this reduction has been a $2.2 billion increase in holdings of corporate securities over the same interval.

For savings and loan associations while the realignment resulted in only a small increase in the liquidity ratio (from 9.0 to 9.8 per cent) the more significant fact was the $3.1 billion reduction in indebtedness to the Home Loan Bank System from the end of August 1966 to the end of August this year. During the first two weeks of September, this debt has decreased by another $60 million to reach the lowest level, $4,092 million, in well over three years. Some believe that the continued reduction in outstanding advances during the summer months reflects a changed

savings and loan attitude towards this source of funds and even if the environment were to change, there would not be as strong a reliance upon advances as has been the case in the past.

Corporate liquidity problems in 1966 and 1967 were aggravated by changes in financial flows which came partially as a result of the Federal Government's fiscal actions resulting in the acceleration of tax payments and increased sales of Government assets.

The acceleration in corporate tax payments amounting to about $2.5 billions in the second quarter of 1966 and to about $4.0 billions in the second quarter of 1967, in effect, reduced corporate liquidity just about the time the flow of internal funds was declining (first half of 1967) or the requirements for inventory accumulation were still rising (throughout 1966). Fixed investment rose throughout this period, though flattening out in 1967. External financing in the capital markets was very large in the first half of 1966 and even larger from January through August of this year. In the first half of 1967 it supplied 28 per cent of the flow of new funds. Flows from bank loans were very large in 1965 and in the first half of 1966 but have dropped to about one-half of that level since. At the peak in 1965 and first half of 1966 they were triple the average flows of 1962-64.

Despite the evident intent of some corporations to improve their liquidity position in this period, the conventional statistical measure of overall corporate liquidity, liquid assets to current liabilities, continued its downward trend into 1967 (it has declined from 35 to 25 per cent since 1963). While some

may infer from this that efforts to strengthen corporate liquidity will continue unabated it is also possible that this particular statistical criterion has become obsolete because of the reduction in size of corporate tax liabilities. These appear to have had something like a one-to-one relationship with liquid assets in contrast to a four-to-one relationship between liquid assets and total current liabilities. Moreover, corporations have emphasized the funding of short-term debt through long-term security issues as a technique of improving liquidity.

Corporations' attempts to solve their financial problems, compounded by monetary restraint in 1966, had reverberations on other borrowers and lenders as did the Government's nearly $3 billion sale of assets in the capital markets.

Some of the same factors are at work in 1967, but in an altered environment. The trend in corporate profits and, therefore, in internal sources of corporate funds was moderately downward in the first half of 1967 but conditions are favorable to a substantial rise in the near future. The financial impact of accelerated tax payment schedules was almost entirely absorbed in 1966 and 1967 and is unlikely to be unsettling again unless a significant retroactive tax increase is enacted. At the present time additions to corporate liquidity through the sale of market securities is showing up in the repayment of bank loans, or in a slack demand for new loans, as well as in the demand for short-term investments. The worst of the corporate financial crunch appears to be over.

Let me now return for a moment to the problems intermediaries face as a result of monetary action. It is quite apparent that intermediaries are giving a good bit of thought to outmaneuvering monetary restraint in the future while accepting the evident blessings of monetary ease. I wonder if this effort to neutralize monetary restraint is worthwhile. In the past 14 years, monetary restraint of an intensity sufficient to affect the operations of intermediaries in any significant degree has been in effect for a total of no more than 36 months and only on three occasions: early fall of 1956 through October 1957; January 1959 to January 1960; December 1965 through November of 1966. Looking ahead, it would be easier to try to spot the onset of monetary restraint, even though it might be necessary to put up with a recognition lag of two or three months, and then to adjust operations to the central bank's concern, rather than to attempt to over-ride, outmaneuver, or insulate your operations from a public policy of restraint.

True, some moderation in monetary impact on your business may be possible, practicable, and desirable. But avoidance in toto is only likely to lead to the use of different methods and tools by the monetary authorities should the need for them be apparent. I suggest, therefore, that when the economic climate gets steamy and the central bank has begun to reflect that

fact in its policies, it is better for the intermediaries as a whole, and ordinarily individually, to pass along the restraint in charges and availability rather than trying to follow a "business as usual" policy.

Diversification of investment opportunities for mutual savings banks and savings and loan associations is frequently mentioned as a structural cushion providing more flexibility in adjusting changes in savings flows. It is true that lending shorter on a broader spectrum of assets could help to improve portfolio flexibility. Earnings could respond more readily to rapid changes in general credit conditions and lenders could have a broader range of investment choice at times of savings abundance. It is true, too, that lending shorter could allow thrift institutions to operate more as one-stop service outlets for their many customers.

But the advantages of this kind of approach seem to me rather marginal. Investment flexibility could be sacrificed--not enhanced--if needs to service existing customers preclude on-again off-again operations. I question whether any significant sectors of consumer, agriculture, or business customers today are as easy to put off as are mortgage borrowers once they have become regular customers. Aside from builders, in fact, few mortgage borrowers become customers of one particular lender more than once in a lifetime. Most household heads take on a new mortgage loan relatively few times from any lender as they pass through the family cycle. In this sense, you may already have the most readily interruptible credit service being offered.

Admittedly, the grass is greener on the other side of the asset fence, and there are undoubtedly some potential sectors of unsatisfied credit demand in the United States, even at current rates and terms. But none stand out as large or as available on a stop-and-go basis as mortgage lending. And most sectors are already deeply penetrated by existing lenders with considerable expertise, ready to capitalize on the trend toward a checkless cash-credit-card society.

Another investment possibility is to include more short-term marketable securities in your portfolio. Greater liquidity is indeed necessary at times such as in the past several months and to a limited degree. But in the short run, excessive liquidity is gained only at the immediate expense of earnings which may or may not be improved over the longer run. Short-dated assets are more profitable only when long yields are trailing an upward trend in short rates--and perhaps not even then at the prices you pay for money. However, your timing has to be good to make this game pay in the short run--certain it is that the differential in yields between short and long debt today makes the former a pretty expensive loss leader. This is not to deny--let me emphasize--that a cushion of liquid assets adequate to the economic environment and an institution's commitments is not desirable as a structural matter or may not improve long-run earning potentials.

Let me turn to the liability management side of the ledger, for this aspect of the problem seems to me to offer a

greater promise of success, enabling you to use your particular expertise in attracting and retaining savings flows and pools. A longer structured set of liabilities can, of course, provide a better balance for the maturity range of assets, and can bring the turnover of liabilities closer in line with the turnover of assets. This, in turn, can help to minimize operational needs for liquidity.

It is well known that many medium-sized regular savers as well as owners of somewhat larger deposit accumulations, or even debt instruments, are not particularly sensitive to favorable yield differentials on market instruments. For some, in fact, liquidity is so important that the alternative to a time or share account is a demand deposit. For still others, there is no established or familiar pattern of direct investment and no promotion of such an alternative. Thus, there is a great deal of relative stability in regular savings accounts.

Larger and more sophisticated investors have also become customers of financial intermediaries because they have found that the investment convenience and yields offered often constitute a better package than they can put together themselves by dealing directly in market instruments. Many of these customers, however, are highly rate conscious, and some are acutely responsive to expectational influences in financial markets. To give them what is in effect costless instant liquidity is to incur exposure to sudden and large withdrawals that are disruptive to the practical

operation of most intermediaries. Such depositors can only be made a useful source of funds if their rate sensitivity can be curbed through restrictions on withdrawals, through incentives not to withdraw, or can be satisfied by maintaining a close linkage between market rates and depository yields.

The large commercial banks have used several credit instruments to compete aggressively with market yields for a small but often significant part of their total resources. Negotiable certificates of deposit, Euro-dollars, Federal Funds, repurchase agreements, subordinated notes, and (in a negative sense) dealer loans have all been more or less competitive with market instruments.

In the aggregate, these devices have seldom provided more than five per cent of total commercial bank resources. But the importance to individual institutions, and in the aggregate of day-to-day, week-to-week, or month-to-month change, has, of course, been much greater.

On a limited scale, therefore, some instrument or group of instruments that enable an intermediary to pull funds out of the market--even at a possible loss in the short run--adds a degree of flexibility in periods of monetary restraint. And it is at the margin where flexibility counts most under these conditions.

At times the environment in which an institution operates changes so rapidly there seems scant opportunity to appraise and consider longer run structural modifications that previous stresses

have indicated may be desirable. 1967 is just such a year. Savings flows, credit totals, and financial conditions generally have been dramatically altered from last year by the fact that individuals, corporations and financial institutions have been building and rebuilding liquidity. In many instances the financial developments of 1966 left them overextended and determined to restore their financial position as rapidly as time and circumstances permitted. Much of this has been accomplished, particularly in the household sector where such liquidity deterioration as occurred in 1966 was no more than is involved in a shift to market instruments from depository institutions. Nonfinancial corporations' reaction to the liquidity squeeze has been of epic proportions in the capital markets. Financial institutions as a whole have greatly improved their liquidity from the depleted and overextended position characteristic of 1966.

In sum, the improved liquidity position of all sectors of the economy is a manifestation of the vastly better 1967 psychology on the part of all major private sectors of the economy relative to their economic capacity and performance. But the problems of structural reform in the functions and role of intermediaries are still with us.