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A New Look at Monetary Policy Instruments

Remarks of George W. Mitchell

Member, Board of Governors of the Federal Reserve System

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There has always been, I suspect, a gulf of sorts separating monetary practitioners from productive contact with monetary theorists. The reason is not, as is often implied, that central bankers are always obtuse or that all monetary theorists are obscurantists. Their differing interests and responsibilities shape quite different appraisals and understanding of the monetary environment and quite different time horizons in their thinking. Some say the difficulty lies in the lengthy gestation interval between central bankers' college training and the assumption of responsibility for their country's monetary practices. However, there is some question as to how much of the blame or credit for monetary practices in the fifties and sixties should be attributed to the theories taught in the twenties and thirties.

Particularly in view of the rapid developments both in the field of monetary theory and in the arena of financial experience, obviously what is needed is some method of keeping monetary theory and practice in much closer touch. Conferences such as this one and meetings which the Board of Governors and the Federal Reserve Banks periodically hold with academic economists, as well as those in business and commercial banking, are useful in exposing shortcomings in both theory and practice.

Today, I propose to discuss two questions of long-run interest but with current overtones in which monetary practitioners and monetary theorists are involved:

1. Is it necessary, or at least desirable, in order to enforce monetary restraint to restrict the access of commercial banks and other financial intermediaries to domestic money and credit markets?
2. Should the Federal Reserve place greater reliance on monetary and credit aggregates in guiding and gauging its activities?

The first question centers on the role of regulatory or statutory ceilings limiting the rates of interest that can be paid on time deposits. Since most major units in the banking system have become heavily dependent on time deposit intermediation to achieve their growth objectives, rate ceilings are said to be the real barricade to bank credit expansion and thus vital to the potency of monetary restraint. Moreover, restraint is said to be jeopardized if rate ceilings are rendered partially ineffective by banks turning to new money and capital market instruments or to unconventional asset and liability management techniques to capture loanable funds through nondeposit channels.

If banks and other depository institutions can significantly dilute monetary restraint by one technique or another, is it necessary to develop additional tools for achieving adequate credit restraint? This might be done, for example, by imposing reserve requirements on assets instead of deposits. Such requirements could be differentiated

by type of asset or by changes in holdings. Another possibility is an enlargement in the definition of deposits to cover additional, if not all, kinds of banking liabilities.^{1/} As in the case of assets, various type of liabilities or changes in holdings could be subjected to differential requirements.

There is also the possibility of extending the reserve requirement to bank competitors or affiliates functioning as intermediaries directly or through money and credit markets.

1/ Banking liabilities other than deposits are subject to leverage limits in laws covering National Banks and in many State Banking Codes. But statutory limitations on bank borrowings have not been a very confining influence on the flexible use of this source of funds up to now because of numerous exceptions to such limitations and because of the relative ease with which banks have been able, under normal conditions, to purchase time funds. However, if monetary constraints were long continued it is more than likely that debt ceilings would become operative and important limitations for some banking institutions.

National banks may not have liabilities outstanding to exceed 100 per cent of their paid-in unimpaired capital stock and 50 per cent of their unimpaired surplus excepting, of course, deposits or drafts drawn against them. There are several other items excepted by law or regulation but the main categories pertinent to this discussion are Federal Fund transactions, repurchase agreements and acceptances of bills payable abroad. The aggregate limitation on National Banks amounted to about \$12 billion (December 31, 1968), compared to total deposits of \$259 billion.

Several of the largest banking States do not have limitations on indebtedness, including New York, Illinois, and, with minor exceptions, Massachusetts. Thirteen States, including California, Ohio and Texas, have restrictions approximating the sum of capital and surplus. State member and non-member insured banks' total of capital and surplus as of December 31, 1968 was \$9 billion compared to total deposits of \$176 billion.

The avenues for extending credit, on the one hand, and of expanding or reinforcing the scope of monetary restraint on the other, are virtually unlimited in our highly organized economy--the question to be faced is, however, are new monetary control techniques required, and could they work more efficiently and surely in attaining policy goals.

The commercial bank can be regarded as a primary transmission link of monetary actions--particularly those actions involving changes in the rate at which reserves are supplied. But it does not necessarily follow that banks or their customers absorb or enjoy the full impact of Federal Reserve open market or reserve requirement actions. For example, banks under reserve restraint and losing deposits, or gaining them at a reduced rate, can, by selling securities, restore their liquidity by finding someone in the market willing to reduce his. Re-achieving a given liquidity position in order to accommodate loan demands is not ordinarily costless for the bank--its asset sales under restraint conditions are likely to result in transactions losses or, alternatively, some yield loss if more liquid assets are held to avoid such losses. In this sense some monetary restraint bites into bank management at the outset and is not shiftable.

Increases in reserve requirements likewise have shiftable and non-shiftable components. The meeting of higher requirements shifts assets from an earning to a non-earning category and thus adversely affects bank net income but the ability to meet customer requirements may be retained in whole or in part by security sales, borrowing, or more aggressive promotion of demand and time deposits. If bank links to money and capital markets are convenient and well established, banks can be expected to shift a larger share of monetary restraint toward those markets by outright or conditional asset sales, borrowings and the attraction of deposits.

In general over the past decade, commercial bank shares of the flow of funds have shrunk markedly in periods of tight money, but have expanded even more in the intervening periods of easier credit conditions. 1967 and 1968 were the lush years of the decade for bank intermediation; market shares were 44 and 39 per cent, respectively, compared to 26 per cent in 1960. Monetary restraint in 1966 reduced banking's share to 25 per cent--a decade low. But the record low may go to 1969 since banking's share for the first half is now estimated at only 15 per cent.

Other depository institutions (savings and loan associations, mutual savings banks and credit unions) as a group, in contrast

to commercial banks, have been experiencing a general decline in their market shares in the 1960's. They started the decade with a 30 per cent of the market and dropped to a low, excluding the monetary restraint years of 1966 and 1969, of 20 per cent in 1967 when commercial banks were hitting their peak of 44 per cent.

Essentially all depository institutions are under rate ceiling limitations similar to those for banks and are also vulnerable when monetary restraint widens the gap between deposit and market interest rates. Their market share in 1966 was 10 per cent--so far this year it is running at a seasonally adjusted rate of 14 per cent, not too different from their 1968 position.

In the sixties, the larger banks have moved aggressively to broaden and diversify their contact with the money and credit markets. They have been particularly aggressive in bolstering their deposit bases by the solicitation of time deposits. But opportunities are not confined to deposits as is evident from a comparison of outstandings of major categories of money market instruments now and seven years ago.

Among market instruments, Euro-dollar borrowings, commercial paper of holding company affiliates, and repurchase agreements have provided the most important sources of funds to banks to offset the disintermediation in their time deposits over the past eight months. Euro-dollar borrowing from mid-January (the year-end level is not used because it was influenced by a very large and very temporary reversal) has

increased about \$6 billion, commercial paper has provided nearly \$2 billion and repurchase agreements about \$1.0 billion (at one time as much as \$1.3 billion). In all, these and other miscellaneous arrangements have provided at least \$10 billion of resources to the banking system from domestic and international markets.^{1/}

1/ Non-deposit Fund-Raising Devices Used by U.S. Banks

- A. Euro-dollar and related transactions
 - 1. Bank head office borrowing from foreign branch
 - 2. U.S. bank borrowing from foreign bank, directly or through broker
 - 3. U.S. bank sale of assets to foreign branch
 - a. Under repurchase agreement
 - b. Outright
 - 4. Customer shift to borrowing from foreign branch
 - a. U.S. resident customer
 - b. Foreign customer
- B. Selected Domestic non-deposit liabilities
 - 1. Repurchase agreements on U.S. Government and agency securities
- C. Liabilities issued by bank holding company or its non-bank affiliate (with proceeds transferred to bank directly or indirectly)
 - 1. Commercial paper
 - a. Sold by bank holding company
 - b. Sold by non-bank affiliate
 - 2. Other liabilities
 - a. Issued by bank holding company
 - b. Issued by non-bank affiliate
- D. Contingent liabilities incurred by bank
 - 1. Documented discount notes
 - 2. Ineligible bankers acceptances (usually domestic transactions)

This magnitude should be related to deposit trends thus far in 1969. Through August time and savings deposits showed a seasonally adjusted decline of about \$10 billion (an annual rate of \$15 billion or -8.0 per cent). The demand deposit component of the money supply, seasonally adjusted, rose about \$2.0 billion (an annual rate of \$3.0 billion or +2.0 per cent). Government demand deposits declined \$1.5 billion. In the aggregate, seasonally adjusted, net demand, time and savings deposits have declined about \$10 billion in the first eight months of the year.

There is no way of knowing what bankers' expectations of 1969 deposit trends were when they were making loan commitments and investment decisions early in 1969. No doubt many were underestimating the intensity of monetary restraint they have had to face and many more were looking for an early turn-around in policy. But had they been significantly influenced by the experience of the past four years, their frame of reference for deposit growth would have been in the range of annual total deposit increases of \$25-\$35 billion, with the exception of a \$14 billion increase in the "crunch" year of 1966. If they had given particular attention to time and savings aggregates, annual flows, excluding 1966, were \$20 billion or more; 1966 was up \$13 billion. There is little in the past record which would have caused them to prepare for the sizable shrinkage which has taken place so far in 1969. It is small wonder, therefore, that they have turned to such an aggressive exploitation of deposit substitutes.^{1/}

^{1/} Some bankers have had greater reason for developing additional sources than others. While time and savings deposits of all member banks showed a -11.8 per cent annual rate of change through August, those of Reserve City Banks were dropping off at a -24.9 per cent pace. Even taking into account a somewhat better showing on net demand balances than country banks, the Reserve City Banks' total net deposits fell at a 11.7 per cent rate compared to 5.6 per cent for all members.

As banks extended in scope and magnitude their access to money and credit markets in 1969, apprehension that such techniques were undermining the force of monetary restraint grew despite the magnitude of the change in deposit flows.

On July 24, 1969 (effective August 25, 1969) the Board of Governors adopted amendments to Regulations D (governing member bank reserves) and Q (governing the payment of interest on deposits) restricting the use of repurchase agreements by commercial banks. This was done by making the bank liabilities on such agreements deposit liabilities provided the agreements had been entered into with nonbanks and on assets other than Treasury securities and agency issues.

The purpose of the regulation was to prevent banks from borrowing on their portfolios of loans, mortgages, and municipal securities and thus to obtain funds for other lending and investment or to meet liquidity needs. The constraint of Regulation Q ceilings applied to such transactions as it would to time deposits generally. However, if an RP could be arranged at a ceiling rate because of some customer relationship and in spite of a non-competitive rate handicap, the amount obtained would be subject to reserve requirements.

This action not only had the effect of limiting the banking system's access to money and credit markets but also to downgrading mortgages and municipal securities as liquidity assets relative to Treasury and agency issues.

Commercial loans have also been used in repurchase agreements but much less frequently. The aggregate of repurchase agreements affected by the revised Regulations appears to have been about \$1.3 billion.

Two other market sources of funds for banks were adversely affected by amendments to Regulations D (governing member bank reserves) and M (governing the foreign activities of member banks) adopted on July 24, 1969 and August 13, 1969. These related to Euro-dollar transactions.

The July 24 action required member banks to include in deposits used to compute reserve requirements all so-called "London checks" and "bills payable checks" used in settling transactions involving foreign branches. Some banks had issued such checks to repay borrowings from abroad without including them in gross demand deposits, as is required for cashiers' checks. At the same time, these banks were allowed to deduct the checks previously received to convey the proceeds of such borrowing from demand deposits used to compute reserve requirements. This amendment was strictly a technical change to thwart an accounting avoidance operation on reserve requirements. It also had the effect of reducing the attractiveness of overnight Euro-dollars. The amount involved was on the order of \$500 million.

The imposition of a marginal reserve requirement on Euro-dollar borrowings contained in the August 13 amendment and its application to the sale of outstanding loans to foreign branches had more than one objective but, among others, was intended to make this source of funds somewhat more costly and thus discourage greater use of this market than prevailed in the base period.

Without doubt regulatory policies aimed at insulating the banking system from money and credit markets via rate ceilings or regulations curbing banks' ability to substitute other liabilities for deposits, or to make contingent asset sales, have limited the banking system's ability to serve its customers. This is abundantly clear from the magnitude of the decline in market shares of funds going to banks in 1966 and 1969. The same rate ceilings have hampered the savings and loans and the mutual savings banks from serving their customers, too, although their plight in 1969 has been ameliorated by the operations of FNMA and the lending policies of the FHLB Board.

The policy of reinforcing monetary restraint by constraining banking's access to money and credit markets may be more controversial than its practical significance in the present situation warrants. But for the long run it clearly raises important issues relating to financial structure and the role of credit policy.

As seen by their proponents today, regulatory constraints have forced a sharp contraction in the rate of bank and other intermediary lending and investment. In particular, Q ceilings by limiting bank access to funds, have led to greater restraint on business loans than would otherwise have occurred and this distributional effect on credit availability was desirable in view of the role of business investment in generating excess demand and inflation. Furthermore, since intermediaries are more efficient in their credit allocative function than direct lenders and markets the reduction of intermediation is the quickest and surest way

to slow and restrict the availability of credit and thus lead to the modification of spending and investment decisions. All of those borrowers who are exclusively dependent on intermediaries encounter credit restraint even though they may be preferred customers. Those borrowers who also have direct access to money and capital markets and non-intermediary funds may shift to these sources of funds but they will rapidly bid up the price and terms for a supply which, in the short run, will become increasingly inelastic.

The main argument against sealing off the intermediaries from the markets starts with the proposition that the effectiveness of restraint is not significantly diluted as a result of its being shifted by an intermediary to the market or another intermediary, however different the incidence. As banks disperse monetary restraint, and they cannot disperse all of it, they force borrowers other than their customers to pay higher prices for credit and to face uncertain availability. Their action in selling assets, raising interest rates paid for funds, entering into repurchase agreements of assets and the like, does not result in the diminution of over-all restraint. Even if intermediaries were given unlimited access to money and credit markets they would themselves be increasingly restrained by the market environment they were creating. The argument continues that the channeling and confinement of restraint to intermediaries and their customers results in the unnecessary dislocation of credit patterns, in inequities in the distribution of credit and inefficiencies in the operation of the financial system.

The differential effect of forcing intermediaries to contract their lending operations has the most certain and serious effect on smaller customers who do not have significant access to capital and credit markets. Shutting off or restricting the flow of bank credit to large corporate borrowers only means they become more dependent on markets. Taken in conjunction with the expansion of non-depository credit instruments which occurred as CD's ran off this year, some have argued that corporate borrowers were more favorably situated so far as credit availability was concerned as a result of bank disintermediation.

While I am more persuaded to the view that intermediaries should have had more ready access to markets, the contrary position is not without merit from a pragmatic short-run standpoint. However, I believe the real problem is not one of making monetary and credit restraint effective in some given interval but the longer run effect of such tactics on the process of intermediation and the institutions providing this service.

A significant change in the financial environment has occurred in the sixties in the form of a greatly expanded role for intermediation. Liquidity services have been shifted on a large scale to intermediaries or specialized intermediary devices. There has been a resulting relative decline in demand deposits and non-intermediary holdings of non-intermediary debts. If long-run policies are adopted to cut off intermediary access to markets fulfilling their liquidity function will be greatly handicapped. In this view, they are more in need, from a public policy standpoint, of assistance in dispersing restraint rather than constraints on their doing so.

As soon as a speaker approaches the subject of the role of monetary and credit aggregates in policy formulation and action, he can expect that most of his listeners will become alert long enough to categorize his views as Friedmanesque, Friedmanite or anti-Friedmanite, and then go back to thinking about something else. For once the speaker is typed there is very limited interest on the part of the listeners, other than that which is vanity oriented, in what he has to say on this well worn subject. Nonetheless, and without attempting to conceal my views, I hope to avoid both categorization and boredom.

If one rejects monetary mysticism, as I would, whether in the form of the "Black Box" or the "tone and feel of the market" he has as alternatives a sterile agnosticism or a belief that monetary linkages are not beyond our expanding analytic capabilities. The most profitable line of approach seems to me to be found in a quantitative scrutiny of changes in the economic and financial environment and the way in which financial variables interact with real variables. These interactions may measure causal influences, responses to such influences, or be mere reflections of the changes in spending and investment decisions or in their timing. In any event, before specifying a role for a particular monetary or credit aggregate, whether that role be the target for policy-makers or the measure of policy by outside observers, it is helpful to have as much understanding of the nature and limitations of the underlying data as is necessary to avoid misuse and misinterpretation. Take the narrowly defined money supply as an example.

The popular assumption is that money has the same form and meaning for monetary guidance or interpretation--whether it be coin, currency or demand deposits. Coin is not a very important component in the money supply but it is the only one showing relative growth in this decade (about 25 per cent relative to GNP or consumer expenditure). The reasons are more or less obvious--the very large growth of meter hoards, silver smelting, foreign usage, and Kennedy halves in bureau drawers. It is hard to see much of monetary significance in any of these uses.

Currency stock and demand deposits have declined about 40 per cent relative to GNP or consumer expenditure in the past 15 years. The relative decline in currency is due to the expansion in consumer checking accounts,^{1/} charge accounts, and credit cards. Non-cash sales make up over two-thirds of the transactions of many of our largest retailers. Convenience credit is widely available via vendors' credit facilities and, more recently, through bank and the expanded role of oil company and travel and entertainment cards. It has been estimated that in 1970 there will be at least 50 million bank credit cards in use. The evidence that currency is playing a diminishing role is observable today--it will become more and more apparent as payment patterns change in the coming years.

Net demand deposits--and I should emphasize the "net"--reflect predominantly the declining transaction demand for money.^{2/}

^{1/} There are between 70 and 75 million today, and the number is growing twice as fast as the population.

^{2/} Parenthetically, the netting of demand deposits which is essential to avoid double counting of items in the process of collection was exposed this year as being vulnerable to the process of reserve requirement avoidance. While the idea of avoiding taxes is commonplace, avoiding reserve requirement by increasing items in the process of collection was so unexpected in some quarters as to be non-credible. The difference between gross and net demand is large--the latter is roughly 75 per cent of the former today--and has been growing as turnover rates have been rising.

Nonfinancial business holdings of demand deposits and currency are no higher today than they were in the early fifties--and many corporate treasurers would regard this average showing as a poor performance. Actually corporate balances today probably reflect more than anything else compensating balance requirements for check processing, loan and other banking services. Theoretically, a skilled money-managing treasurer, unhampered by compensating balance requirements, could manage his firm's checking account so that toward each day's end he would know if he had a balance large enough to cover the transaction costs for an overnight investment. And if he had, his resultant late-day investment action might, under certain circumstances, indirectly turn out in effect to be lending that residual in his account to his own bank. Electronic facilities for check processing will make possible much closer management of cash positions, particularly if scheduled credit transfers become commonplace.

The best information we have on the ownership of the demand deposit component of the money supply is none too good, but it indicates that households own about \$70-75 billion, nonfinancial businesses \$45 billion, financial business \$15 billion, and State and local governments \$13 billion. About \$4 billion is in foreign accounts. It is safe to say that all professionally-managed accounts are at or near minima established by banking rules or practices.

Households are managing their money position more closely, too--many use a fee-no-minimum balance-type account. Individuals have become

increasingly sensitive to interest costs and interest yields. Their response to the promotional efforts on the advantages of time and savings accounts has been to progressively reduce demand balances to the minimum levels consistent with the timing of income receipts.

The June 1968 Summary of Accounts and Deposits reported 79,069,000 I.P.C. demand accounts. Sixty-four million of these had balances of less than \$1,000 and an average account size of \$240. From data presently available, business and corporate accounts cannot be distinguished from personal accounts in this group but it is hardly likely there were a significant number of business accounts with balances of less than \$1,000. In any event, 80 per cent of the demand deposit accounts of individuals, partnerships and corporations with an average balance of \$240 could hardly provide any significant liquidity for their owners.

High demand deposit turnover rates are additional evidence to me that demand deposits are held overwhelmingly for transaction purposes and that liquidity needs are largely satisfied by near monies of one type or another. In New York, for example, where superactive financial and business accounts dominate transactions, turnover has been on the order of 2-1/2 to 3 times per week for the past year. It is now running 1.3 times a week in six other major cities where similar influences are important. In the nation outside of these cities turnover is about .75 times per week and has been rising steadily for some time. Even though many of the 233 cities covered by these data are relatively unaffected by hyper-active accounts, virtually none has an average turnover rate of less than .3 per week.

It would be tempting to conclude, perhaps, that the central bank's control over economic activity is heightened by these developments, and that the money supply is becoming an increasingly useful guide to the effect of central bank actions on money income. For it might appear that the kind of trends I have been describing are converting the public's demand for money into the kind of functional relationship to money income that Irving Fisher popularized. It seems to me, however, that such a conclusion is unwarranted, at least as it pertains to conventional central banking in the United States. In the first place, while the public's money holdings are increasingly for transaction purposes, I do not believe that there is a stable functional relationship between the public's demand for money and its income or transactions. Thus, even if we could successfully control the money supply narrowly defined, this would not by itself give us a handle with which to control the volume of transactions. In addition, the Federal Reserve does not directly determine the money supply; the instruments it manipulates are reserve requirements, discount rates, open market operations, and ceiling rates on time deposits. These actions serve initially to augment or diminish liquidity positions of the banks and the public. The public's reaction is most clearly observable in the change in its holdings of such non-monetary assets as time deposits, savings and loan shares and of market instruments as these are channels of fundamental importance in communicating monetary processes to the real sectors of the economy. The impact of monetary policies on the money supply are not felt until later, when the

results of policy actions in markets for goods and services begin to affect spending and money incomes and thus raise or lower the demand for money for transaction purposes.

As is apparent, my preference for monetary aggregates either as a guide or gauge is generally for those that measure liquidity changes in the economy. Moreover, I would differentiate liquidity positions of households from those of business and financial intermediaries. There are important time lags in the basic data for such series but they are not too difficult to fill in or to bridge since the problem is basically one of disaggregation in the ownership of deposits and market instruments. It does, of course, involve some technique for getting changes in access to credit.

The important consideration for those who urge the use of either monetary or credit aggregates is to provide more evidence of their linkage to spending and investment decisions--I doubt this evidence will be found in the behavior of a single aggregate or in those most closely related to transaction media.