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BANKS' PERFORMANCE IN THE RECENT PERIOD OF MONETARY RESTRAINT

Address by William W. Sherrill, member, Board of Governors, Federal Reserve System, Washington, D.C. before the Banking and Financial Research Committee Workshop "How To Manage 'Tight Money'" at the 95th Annual Convention of The American Bankers Association, Hilton Hawaiian Village Hotel, Convention Center, Coral Ballroom IV, Tuesday afternoon, September 30, 1969

Let me first review briefly the more important ways in which banks have responded to the pressures of monetary restraint thus far this year--at some risk I admit of boring you with familiar facts or, worse yet, reminding you of unpleasant interludes. One of the earliest sources of pressure was the run-off of certificates of deposit. This occurred as the rising level of market rates of interest passed Regulation Q ceilings and holders of maturing CD's shifted their funds into higher yielding market instruments. Initially, this CD run-off took place primarily at the large money center banks, where depositors are typically more interest sensitive than at smaller banks. The most frequent responses to this loss of funds were to sell Treasury bills and to borrow increased amounts of Eurodollars. Faced with continued strong loan demand and aggressive competition, individual banks made every effort to maintain their lending volume. This was apparent not only in current credit extensions but also in future loan commitments.

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Market rates continued to rise through the early spring and deposit weakness began to spread to other types of time and savings deposits, especially so-called "consumer CD's." Again the large money center banks were probably most strongly affected, but at this stage significant pressures also began to reach other areas of the country. Banks reacted in a variety of ways to these increased pressures. The liquidation of short-term Government securities continued and became more widespread, and large banks also reduced their holdings of municipal securities. The Federal funds market came under more intense pressure, with substantially higher rates for day-to-day money becoming common. In a further effort to avoid loan cutbacks--and to meet increasing demands under outstanding lines of credit--banks began to bid even more actively for non-deposit sources of funds. These included Eurodollar borrowings and, domestically, repurchase agreements and financing indirectly through affiliates. There were also reports of efforts to participate out loans, which helped to relieve pressures in the money centers but absorbed liquidity at other banks, thus increasing the penetration of monetary restraint.

Pressures on banks continued to intensify and spread through the late spring and summer. Losses of time and savings deposits accelerated at banks outside the major financial centers and, after the mid-year interest crediting period, began to affect even country banks. In the latter case these were the first net outflows since late 1966.

With the banking system under such restraint, adjustments of the kinds I have just cited, while helpful, soon proved inadequate. Banks were forced to undertake widespread and increasingly intense efforts to cut back on lending as early as the spring. They did this largely by stiffening lending terms to business and generally raising interest rates on all loans. We have been seeing some of the results of this in a smaller rise in business loans

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outstanding over the past few months, along with reduced consumer and mortgage lending.

While our major interest today is in the actions of commercial banks, it is important to remember that the impact of monetary restraint was being felt among other financial institutions as well. Net inflows of funds to mutual savings banks and savings and loan associations were steadily reduced during the first half of 1969, and appear to have dropped off further since mid-year. This has caused considerable tightening in the mortgage market, although the pressures have been cushioned somewhat by support provided to the market by the Home Loan Banks and FNMA.

The ability of these nonbank financial institutions to supply funds to the credit market has been sharply curtailed, but the most dramatic effects of monetary restraint have been shown by commercial banks. In the second half of 1968, banks accounted for about 55 per cent of the nation's credit flow, a share well above average. Yet by the first half of 1969 their share had plummeted to only about 10 per cent, now well below average.

This decline in lending ability, which is apparent in virtually every type of financial institution, reflects at least in part a case of disintermediation; that is, funds are flowing out of financial institutions and being placed directly in the market. But this is not the whole story. These movements of funds have taken place at increasingly high interest rates, which have in themselves discouraged some borrowers. And more importantly, not all borrowers turned down by institutions have the ability to borrow successfully in the open market. Thus it is not a simple case of credit flows bypassing the banks and other financial institutions. These financial intermediaries can generally serve the nation's borrowing demands more efficiently, expeditiously, and at lower costs than can the market alone. When they are bypassed the result is almost inevitably a cut-back on credit flows relative to demand. This suggests a continuing vital role for banks and savings institutions in the long run, although it also supports the need for restricting this role in periods of inflationary pressure.

All told there was about a 15 per cent reduction in the total of funds raised in credit markets between the second half of 1968 and the first half of this year. Much of this resulted from increased fiscal restraint and the consequent improvement in the Federal budgetary position. But we also saw some gradual moderation in the amount of credit raised by other sectors of the economy, including State and local governments. And the signs are that this is continuing in the second half of 1969, as the lagged effects of monetary policy work themselves out.

The process I have just described appears to have reached the point where we should be seeing some results in the real economy over the next several months. Credit conditions remain very tight, reflecting in part the reduced growth in monetary aggregates such as money supply, bank deposits, and savings shares. In addition, the value of the public's financial assets has fallen as both bond and stock prices have dropped. This reduction in wealth should also contribute to moderation in spending.

I am sure that virtually all bankers agree that the present inflation must be stopped and, further, that a policy of monetary restraint is necessary to that task. But there the agreement often ends and the debate begins. Have the methods used thus far by the Federal Reserve been the best of those available? And, even more basic, are the presently available methods the best that could be devised, not only for banks but for the economy as a whole?

In a sense, the present process does appear to fall most heavily on banks, initially major money market banks. This has been the unavoidable result of making Regulation Q the cutting edge of policy. But this distribution of pressures seems consistent with the fact that one of the major sources of the inflationary thrust has been business spending and borrowing, a good part of which is financed through banks. Under these circumstances, a policy which forces cutbacks of bank lending is in a sense a rather direct means of affecting the root of the problem.

In pursing this path, none of us expected to see the pressures passed on undiluted to business borrowers. Given the importance of these customers, in both the short and the long run, and the active competition for their patronage, it is only normal for banks and other financial institutions to do their best to continue accommodating them by devising other means of cushioning the impact of restrictive monetary policy. And, from one point of view, this inventiveness and flexibility is, I believe, a healthy sign for the capacity of credit markets to evolve and finance the long-run, non-inflationary growth of the economy. But at the same time, the resulting postponements of lending reductions inevitably delays the successful working out of monetary restraint.

In an environment such as today's, with banks and financial markets subject to rapid change and innovation, those of us charged with policy making must be especially alert to the possibility of our tools becoming out of date. Changes in markets and in the economy can well create conditions that require differing policy tools, or differing use of existing tools in the future. For example, it may be that Regulation Q no longer represents the most effective cutting edge of policy, in light of the development of nondeposit domestic sources of funds, the ability of the banking system to tap funds from abroad, and the increasing use of the open market as a source of funds by borrowers.

But whatever the future brings with respect to adaptation of policy instruments, an effective monetary policy will always require the cooperation of bankers. This cooperation can help to minimize both the degree and duration

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of monetary restraint that is required to control inflation. For example, a greater willingness on the part of bankers to initiate tougher lending terms earlier--and I mean actually turning down loans, not merely raising the interest rate charged on them--would almost certainly shorten the lag with which policy takes effect.

I realize that competitive forces, and the desire to retain customers by extending credit lines to them, must of necessity be the major factor in determining the loan policies of individual banks. Nevertheless, there is reason to think that banks may be obliged to have more foresight and more sense of public interest than other groups in society. The banking system does have a somewhat special position among financial institutions in that banks alone can, in effect, issue the major means of payments in the economy-interest-free demand deposits. And with this privilege comes responsibilities.

On the other hand, you may tell me that those responsibilities are thrust upon you in any event since the banking system is the major vehicle through which monetary policy is implemented. And in tight money periods the Federal Reserve cuts back on reserves and thus on banks' ability to create credit and deposits, thereby determining the timing and intensity of restraint irrespective of whether banks do or do not shoulder a special burden of the public interest.

There is obviously merit to such an argument. And the question of the public interest responsibilities of banks, or of other business and labor for that matter, in an open, free, and competitive society is clearly a difficult one--one that could probably engage philosophers in long debate. But it is also a question well worth pondering for us too. What responsibility for the public interest should commercial bankers take? Should it differ from other private groups? And secondly, what responsibility can you take in light of the current competitive situation?

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