

For release at Noon
Monday, July 18, 1966

Monetary Policy, Savings Competition
and Commercial Bank Lending Behavior

Remarks by

Andrew F. Brimmer
Member,
Board of Governors of the
Federal Reserve System

Before a

Luncheon of the Boston Business and
Financial Community

at the
Federal Reserve Bank of Boston
Monday, July 18, 1966

1: p.m.

Monetary Policy, Savings Competition and
Commercial Bank Lending Behavior

The Nation's commercial banks -- while working diligently to meet the legitimate loan demands of their individual customers -- are collectively posing a difficult problem for the Nation as a whole during this year when the fight against inflation is such a vital struggle. In the face of intense competition for savings and much slower growth in their loanable funds, they have expanded their business and industrial loans at an unusually rapid pace. Moreover, although it is impossible to trace such loans with precision, it appears that a substantial share of the funds is being used to finance plant and equipment expenditures, thus further stimulating demand in those sectors where inflationary pressures are already serious.

To obtain funds for new loans -- and frequently simply to reduce the run-off of funds already on hand -- banks have offered progressively higher interest rates on time deposits. They have also fashioned a variety of instruments (many of which are truly ingenious) to attract depositors. But they have also liquidated a sizable amount of other assets, especially U.S. Government securities.

With the passing of each week, more and more banks are finding it difficult to orchestrate the expanding demand for loans and their own limited resources. One result has been a rising volume of borrowing from the Federal Reserve Banks.

Since this pattern of commercial bank behavior has developed in the context of a progressively tightening monetary policy, an interesting and critical question is raised:

- "Where is the evidence of monetary restraint?"

The answer, in my opinion, is that moderating the rate of expansion of bank credit -- in the light of such strong demand -- is the operational meaning of monetary restraint. The effectiveness of this restraint can be seen in a number of mirrors:

- The efforts of the banks to attract more deposits, through posting higher interest rates and the adoption of other measures.
- Through sales of securities, even at a considerable capital loss.
- Through cutting back on various kinds of credit extensions (such as for mortgages, securities' dealers and brokers and finance companies.)
- Through the encouragement of some customers to utilize the capital markets rather than term loans.

But, in my opinion, despite these adjustments, the overall pace of bank credit expansion is clearly too fast. The need is for further restraint on both the demand and supply sides of the credit market. While I obviously cannot speak for my associates on the Federal Reserve Board -- in my personal judgement -- bank reserves are likely to / ^{become} less rather than more readily available. After all, moderation in the provision of such reserves is the essence of a monetary policy aimed at countering inflation. The recent action by the Federal Reserve Board to ease the intensity of rate competition for savings was also designed to ease the availability of funds for bank lending.

However, further restraint is also needed on the demand side. Here again, I obviously can only speak for myself. But I do believe that a general increase in income tax rates, taken earlier in the year, would have been the most effective step to deter further escalation of capital expenditures and the demand for credit to finance such outlays. Although a considerable amount of fiscal restraint did result from other moves (including higher Social Security taxes, the acceleration of income tax collections and the restoration of some excise taxes), an even

larger measure of fiscal assistance still seems in order.

To help reach the most strategic twin targets of unsustainable capital outlays and the excessive rate of expansion of commercial banks' business loans, I suggest that:

- Serious consideration be given to removing temporarily the stimulus provided by the investment tax credit.
- Despite the serious time lags and technical difficulties associated with such a move, I think the situation clearly calls for a strong and reinforcing effort -- on the part of the monetary and fiscal authorities and the banks and business firms -- to check the unsustainable level of demand for our limited resources.

The evidence to support this case is plentiful. It is found in:

- The overall liquidity position of commercial banks.
- The rate and pattern of business loan expansion.
- The sources of funds for loan expansion.
- And the level and pattern of member banks' borrowing from the Federal Reserve System.

Decline of Bank Liquidity

Taking all commercial banks together, the ratio of total loans to total deposits rose to a new high of 66.5 per cent at the end of June -- an increase of nearly 3 percentage points since December and the highest ratio since the early 1930's. At weekly reporting member banks -- a series consisting mostly of the larger commercial banks in the country -- the end-of-June ratio was 73.5 per cent. In New York City, the ratio reached a new postwar peak of 81.3 per cent.

It must be recognized, of course, that the loan/deposit ratio, by itself, is not an adequate indicator of the degree to which a bank might be regarded as "loaned-up". In addition, consideration must be given to many other factors, such as the composition of the loans (particularly their liquidity characteristics), the volume of other liquid assets the bank might hold, the volume and types of

assets needed for pledging, and the structure and volatility of the bank's deposits. Nevertheless, while there certainly are exceptions, the balance sheets of the larger city banks at this time suggest that there is little further elbow-room for loan expansion in excess of deposit growth. And, with monetary restraint continuing and yields on market investments at high and rising levels, maintenance of past rates of deposit growth certainly does not seem to be assured.

Thus, the crying need today is for more effective bank restraint on loan expansion. This is so not only in view of present and prospective inflationary pressures at work in the economy; it is also required to help assure the preservation of a sound and adequately liquid banking system itself.

Expansion of Business Loans

As already mentioned, business loans have continued to expand at an unusually rapid pace during the first half of 1966. At weekly reporting member banks, outstanding commercial and industrial loans rose 10 per cent during this period compared with 11 per cent in the comparable period last year. (In the Boston Federal Reserve District, the rate of growth in both periods was about 1 percentage point above that for the Nation as a whole.)

The rapidity of this year's rise is highlighted by the fact that it was so close to the year-ago increase -- notwithstanding the unusual circumstances that had contributed to the large expansion in business loans in early 1965. It will be recalled that during early 1965, business borrowing at banks was exceptionally heavy -- the most rapid in nearly a decade -- owing to a number of unusual circumstances. Particularly important in leading to heavy demands on banks then were the dock strike, steel inventory stockpiling in anticipation of a shutdown, the rebound of automobile production to high levels following a work stoppage in that industry, and a surge in bank lending abroad stimulated by

expectations that the Interest Equalization Tax would be extended to bank term loans. Moreover, these growth rates in commercial and industrial loans in both periods are net of the substantial seasonal loan repayments that are regularly made in the first half of the calendar year by ^{some industries, particularly} commodity dealers and food processors.

Loan expansion at city banks in the first quarter of this year, as might have been expected, was substantially less than in the first quarter last year, since the special circumstances described above had their main impact in the early months of 1965. But the second quarter rise this year, totaling nearly \$3 billion, exceeded by close to 70 per cent that of the second quarter last year, when borrowing was still substantial even though these special influences had abated considerably.

Pattern of Lending by Industry

An analysis of the industry composition of recent loan expansion suggests that the economic impact of that lending extends well beyond the question of magnitude. A substantial part of the recent loan growth at the 200 large city banks that regularly report ^{to the Federal Reserve} an industry breakdown of their loans has been to industries that are engaging in substantial investment programs to expand plant and equipment. The increase in loans to the metals producing and fabricating group of industries was particularly large. In the second quarter of this year, growth in loans to this one group alone totaled over \$900 million and accounted for nearly one-third of the entire rise in business loans at city banks. This was nearly three times as much as the increase in loans to this group in the second quarter of 1965, when anticipatory inventory accumulation was still in progress.

Other industries with large fixed investment programs that have borrowed

manufacturers
heavily at banks this year include textiles/and petroleum and chemical companies. On the other hand, loans to the construction industry -- which in the case of large banks probably would involve / ^{in large part} loans to finance development of shopping centers, apartment houses, and other large projects -- have risen considerably less so far this year than last, particularly in the second quarter. Loans to transportation, communication, and other public utilities also have been smaller, mainly reflecting the offsetting effect of some large loan repayments out of the proceeds of capital market financing.

Finance companies have also been heavier borrowers in the second quarter this year compared with a year ago. But loans actually declined this year in the case of other nonbank financial institutions, which include borrowing by insurance companies, savings and loan associations, and mutual savings banks -- all categories in which some financial stringency has been experienced this year.

Financing of Fixed Investment

Information on the extent to which bank lending this year has been for the specific purpose of direct financing of fixed investment is not available. Some indication of purpose, however, is implicit in the maturity structure of the loans made, since term loans (maturities over 1 year) normally are made for longer-term needs while short-term loans usually are for inventory and other working capital purposes.

Term loan data are not available for all weekly reporting banks, but figures are reported by banks in New York City. Data for these banks show that term loans rose 14 per cent during the first half of this year compared with 8 per cent for short-term loans. The ratio of term to total business loans -- 61 per cent at the end of June -- was 2 1/2 percentage points above the June, 1965, ratio. In the

metals industry group, term loans at New York City banks rose 23.5 per cent in the first half of 1966 -- more rapidly than any other major industry category.

Sources of Funds

The liquidation of U.S. Government securities and the expansion of time deposits (other than negotiable certificates of deposits - CD's) have been the principal sources of funds for financing the growth of commercial bank loans in the first half of 1966. These other time deposits (consisting primarily of savings certificates, savings bonds and other non-negotiable certificates) provided about two-fifths of the \$12.4 billion ^{of} funds available to all weekly reporting banks in the January-June months of this year. This was more than three times the proportion registered during the same period of 1965, when these banks' total funds available amounted to \$14.4 billion. The increased share of time deposits was broadly based -- with the ratio climbing from 1.4 per cent to 24 per cent in the Boston Federal Reserve District. As mentioned above, the increase in other time deposits resulted mainly from the offer of higher interest rates, from attractive features of the instruments and from aggressive promotion by banks.

The importance of the rise in other time deposits as a source of funds is also illustrated by comparison with the growth of commercial and industrial loans. In the first half of 1965, these deposits accounted for about 37 per cent of such loan expansion; in the same period this year, the proportion jumped to 100 per cent.

Sales of U.S. Government securities by weekly reporting banks rose by more than \$600 million in the first half of 1966 compared with a year ago. Such liquidation provided roughly one-third of their total sources of funds this year -- against less than one-quarter in the first six months of 1965. In the Boston Federal Reserve District, however, the banks lessened slightly their dependence of security sales

as a source of funds. The weekly reporting banks (particularly in New York City and Boston) also reduced their holdings of cash assets in contrast to a build-up in 1965.

It is particularly interesting to note that the weekly reporting banks have depended on sales of negotiable CD's as a source of funds to a smaller extent than a year ago. In the first half of 1966, these large-denominated CD's represented about 13 per cent of the banks' total sources, compared with 19 per cent in the same period of 1965. However, there was great dispersion among groups of banks. In the City of Chicago, the ratio rose from approximately 6 per cent to 18 per cent; in the San Francisco Federal Reserve District the climb was from 7 per cent to 14 per cent. In New York City, the ratio declined from 29 per cent to 12 per cent; in the Boston District, the decline was from 26 per cent to 17 per cent.

Sales of negotiable CD's also dropped sharply this year compared with the expansion of commercial and industrial loans. For all weekly reporting banks the ratio shrank from about three-fifths in the first half of 1965 to only one-third in the same period this year. Again the drop was particularly sharp in New York City.

As banks found loan demands continuing strong and the availability of funds for lending being strained, they successively raised offering rates on large denomination negotiable CD's. The ceiling rate of 5 1/2 per cent was reached in May for 6-month maturities, and this higher rate was extended to shorter-term CD's in June. On June 27, in order to apply moderate additional monetary restraint and to exercise a tempering influence on bank issuance of CD's and other time deposits, the Federal Reserve Board raised the reserve requirement on time deposits ^{holdings by and individual Bank} in excess of \$5 million from 4 per cent to 5 per cent.

Savings deposits at weekly reporting banks decreased by \$2.3 billion during the first half of 1966, in contrast to a rise of \$2.4 billion a year earlier. As

we know, this drastic turn-about reflects the response of savers to rising market yields and the attractive rates offered by commercial banks on consumer-type time deposits. In the first half of 1965, the growth of savings deposits accounted for about one-sixth of the total sources of funds available to the banks. This year, the banks had to use roughly the same proportion of their funds to cover withdrawals of savings deposits.

Total demand deposits declined in the January-June months of this year at all weekly reporting banks -- primarily a seasonal factor. However, New York City banks experienced a net rise in demand deposits representing 10 per cent of their total funds and almost one-quarter of the expansion in commercial and industrial loans. The Boston District also saw a rise in demand deposits.

Thus, we have seen that, at all weekly reporting banks, business loans expanded more rapidly than total assets. In all districts, growth in such loans was either greater than (or accounted for the largest share of) total asset changes. Clearly we must ask just how long can banks expand their loans to business beyond the expansion of deposits.

Borrowing at Federal Reserve Banks

The ability of member banks to borrow temporarily from their Federal Reserve Bank is an integral part of the process by which the banking system adjusts to the changing pressures of public credit demands against available supplies of loanable funds, as conditioned primarily by the Federal Reserve's day-to-day open market operations. Operating with this kind of philosophy, we have seen a steady growth in borrowings as monetary policy has moved further and further toward a posture of vigorous restraint. Currently, in an average reserve period, member banks may typically borrow roughly \$700 - \$800 million from their Reserve Banks. This is more than 2 1/2 times as much as two years ago (although still only about 3 per cent of their total required reserves).

There has also been a substantial recent rise in the number of banks turning to their Federal Reserve Bank for assistance in accomplishing the adjustments made necessary by the rapid ebb and flow of financial payments. On the average today, about 74 per cent of the Nation's 193 reserve city member banks are seeking and receiving credit assistance at the Reserve Banks in at least one week in a three-month period.

Even more dramatic has been the rise in the number of country member banks having recourse to Federal Reserve assistance. Typically, only a minor portion of country banks are ever subjected to such sudden shifts in the pressures upon their ability to accommodate that they require external assistance. But during the last three months, about one country member bank in 7 has found it helpful to borrow from its Federal Reserve Bank at some time. This proportion may not seem large relative to reserve city banks, but it still is almost twice as high as the ratio existing in the spring of 1965 or earlier in this expansion.

Neither the rise in the amount of borrowing nor in the number of borrowing banks that has occurred in this expansion is a surprise to the Federal Reserve. Nor is it an indication that the credit supplied through the discount window is in any way out of control. In fact, our open market operations have been conducted with a view to achieving this greater level of overall member bank indebtedness, among other things. Furthermore, the growing number, particularly of country bank, borrowers is a sign of both the increasing pervasiveness of monetary restraint and the expanded usefulness of Federal Reserve membership to smaller banks -- both of which we welcome.

But it is an essential part of our current discount philosophy that all such borrowings, in the absence of emergency circumstances, be temporary. Such borrowing should cushion the portfolio adjustments that banks are called upon to make in these

circumstances, and they should not substitute for these necessary adjustments. In this spirit, our regulation covering discounting and the Federal Reserve Bank officers implementing it, focus strongly on the instances of repeated or continuous borrowings by a member bank.

The number of member banks "frequently" indebted has increased substantially in recent months. This rise has been concentrated in country banks where the number frequently indebted nearly doubled from the first to the second quarter of this year. When it becomes apparent that such an increase is in progress, then we, and you, may be sure that this is followed by a stepped-up degree of consultation of Federal Reserve Bank discount officers with the member banks in question. They are working to insure that each such borrowing circumstance is appropriate under the terms of our regulation, or, if not, that an orderly portfolio adjustment is underway in order to retire such borrowings.

The specific reasons why country banks are turning more frequently to the discount window are too numerous to cite. However, recent comments by the Presidents of the Federal Reserve Banks give some indication of the factors underlying the recent substantial increase in the requests of country banks for accommodation. The most frequent reasons mentioned were:

- Unusual and growing demand for loans by large national and regional corporations which normally depend on big city banks. As funds become less available at the latter, these firms are turning increasingly to country banks for assistance. Since many of these smaller banks have sought such customers for years, they are anxious to meet the demand. If their own resources are insufficient, they borrow more heavily from the Federal Reserve.
- Reduced availability of funds at city correspondents to assist country banks. Many of the latter normally borrow from big city banks -- despite membership in the Federal Reserve System. As the fringe of unsatisfied borrowers widens at correspondent banks, more and more country banks get less and less accommodation. Again, the alternative source is the Federal Reserve Banks.

- The fact that general monetary tightness is beginning to reach smaller banks. The regular customers of the country banks are also sharing in the high level of economic activity, and they, too, are generating a strong demand for funds. But, since country banks are also experiencing a slower expansion of deposits, the overall tightness is being registered with increased effectiveness.

As I said above, this pattern of borrowing by member banks is certainly consistent with the overall objectives of current monetary policy. In fact, in my personal opinion, the level of borrowing could well rise even further without causing exceptional concern. In other words, what we seek is a revolving total of member bank borrowing that helps to achieve an orderly and gradual -- but nevertheless inescapable -- application to the whole banking system of the degree of monetary restraint being sought by the Federal Reserve.

Need to Intensify Restraint on Bank Lending

From the foregoing, it should be evident that I -- personally -- believe it is desirable to moderate even further the rate of growth in commercial bank lending. For this reason, I was pleased to support the series of steps recently taken by the Federal Reserve Board which:

- Raised member bank reserve requirements on time deposits in excess of \$5 million from 4 per cent to 5 per cent.
- Restricted the use of promisory notes to raise loanable funds without setting aside required reserves.
- Lowered to 5 per cent the maximum rate which member banks can pay on consumer-type, time certificates of deposit with multiple maturities.

I was particularly pleased that we asked Congress for broader discretionary authority (for the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board) than is now available to regulate the maximum rates which banks and savings and loan associations can offer to attract funds.

Naturally, one cannot predict whether Congress will enact the recommended

legislation nor how the new authority would be used by the Federal Reserve Board. Yet, perhaps the only promising way to help moderate the excessive competition among banks and other institutions for savings is to establish different maximum rates on the basis of amount of deposit. While the Board has serious reservations about such an approach, it may be the only effective one under current circumstances. Moreover, it would clearly be inequitable and ineffective to attempt to moderate an interest rate war by setting ceilings only for banks. But, if such authority is granted -- and used -- the banks may well have to temper the rate of expansion of commercial and industrial loans to keep more in tune with the growth of deposits.

Beyond these monetary measures, I believe the present circumstances call for additional fiscal restraint. As already mentioned, this need is particularly pressing because of the high level of spending for capital formation. Outlays for plant and equipment (currently expanding at an annual rate of 17 per cent) are approaching unsustainable levels and thus pose an ultimate threat to continued economic expansion. In addition, since this spending is being financed to an unusual extent with borrowed funds, including funds obtained from banks, it is contributing significantly to the extreme pressures in credit markets. Further increases in plant and equipment spending, and in demands for credit to finance it, appear to be in prospect at least well into next year.

In my opinion, something should be done -- and soon -- to moderate these developments. Reliance on monetary policy alone to achieve this goal is not enough. Business capital spending appears to be less sensitive to the resulting increases in borrowing costs than some other forms of investment expenditures. Moreover, perhaps the most sensitive area -- housing -- is already under severe pressure. Hence, fiscal action is also needed.

An increase in income tax rates earlier this year would have been the most

effective deterrent to further escalation in capital expenditures. But in the absence of a tax increase, serious consideration should be given to removing temporarily the stimulus provided by the investment tax credit. This involves more than just suspending the present tax credit provision. Simple suspension would affect spending only with considerable lag, since the present provision applies only after a project is completed and placed in operation.

The need for restraint on business capital outlays is immediate, and what is needed is a suspension measure that would affect decisions to begin spending. Such a measure, if enacted soon, could well moderate spending at least by early next year. While it would not be easy to develop a measure effective with a minimum lag, I think it is worth searching for a workable approach. One approach might be to make expenditures on new capital goods ordered after a given date permanently ineligible for the tax credit.

Concluding Remarks

In the meantime, the task for commercial banks is real and immediate. As demonstrated above, they are expanding their business and commercial loans at unusually large rates for a period in which monetary policy has become much more restrictive. Many large commercial banks keep assuring us that -- owing to strong loan demands, reduced liquidity, and curtailed availability of reserves -- they have adopted much tighter lending policies.

Perhaps they have (and the recent increases in prime lending rates certainly point in that direction) and the effect simply became submerged by the large surge in demand in June. It will be recalled that June was the first month to feel the full impact of the acceleration both in corporate income tax payments and in payments of withheld personal income and Social Security taxes. Corporations undertook

only moderate direct borrowing at banks in April, when acceleration of their own income tax payments first became effective, and they probably entered the June tax period with sharply reduced liquidity.

Under the circumstances, perhaps a substantial part of the June increase in business lending was under established lines of credit against which corporations had a clear right to draw. Such borrowing, of course, would tend to be largely short term, as was the case at New York City banks, where the ratio of term to total loans declined much more than usual.

But even short-term financing under these circumstances does not necessarily mean that banks are not helping indirectly to finance the unsustainable rate of expansion in business investment now in progress. There is no substantive difference in the end result whether a bank makes a term loan to finance an expansion program or whether the corporation reduces its liquidity in financing an expansion program and subsequently borrows from the bank to meet tax payments or other short-term needs.

Thus, it is possible that -- despite much firmer lending policies -- banks may have found it difficult to resist the June surge in business borrowing. Even so, it is essential that banks gain better control over the pace of lending. Hopefully, this will slow up over a not too distant time horizon, as periodic reviews of informal lines of credit result in selective reductions and, of course, as applications for new commitments for term loans and revolving credits are reduced or turned down.

In the present environment, however, I must stress again that the time horizon available to the banks appears relatively short. With bank liquidity sinking to new lows and the availability of funds (including bank reserves and deposit inflows) becoming increasingly restricted, it would appear that commercial banks, particularly the large city banks, need to act promptly to bring their loan growth under better

control. This is particularly true of their business loans, which have continued to balloon thus far this year. For most other major categories of bank loans, growth has slackened somewhat in recent months, though more restraint in these areas also may prove necessary.