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Monetary Policy and the Allocation
of Commercial Bank Credit

Remarks by

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

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Commercial banks are front-line troops in the current campaign to moderate inflationary pressures and to enhance the over-all health and stability of the Nation's economy. In general, as we would expect, they have acted conscientiously to restrain the extension of credit and thus further the objectives of monetary policy. All of us applaud their efforts.

At the same time, however, many of our banks -- especially the largest ones catering to the financial needs of leading national and international corporations -- have found themselves in an extremely difficult position: as the availability of loanable funds has grown more slowly in the face of a rapidly expanding demand for credit, these banks have been pressed to increase their business loans at a rate roughly equal to that registered a year ago.

To do this, they have embarked on a virtual scramble for funds:

- They have competed vigorously for time deposits, although they have become less-and-less successful in their efforts to attract large denominated negotiable CD's.
- They have liquidated marketable securities, frequently at sizable capital losses.
- They have borrowed from the Federal Reserve Banks, although the principal reliance has been on the federal funds market for short-term accommodation.
- Over the summer, they have greatly increased their borrowings from their Foreign branches, who have in turn actively sought Euro-dollars.

And perhaps of special importance, the banks have changed significantly the allocation of credit among different types of users.

For example, for far this year, they have:

- Reduced their purchases, and most recently have been liquidating their holdings of -- municipal securities -- after having been a major supplier of funds to local governments in the 1960's,
- Induced finance companies and securities underwriters and dealers to seek other sources of funds -- particularly in the capital market.
- Been less-and-less willing to finance consumer purchases of durable goods.
- Been less-and-less willing to provide real estate loans to potential home-buyers.
- Virtually ceased their short-term financing of building projects.

If asked, every bank undoubtedly would conclude that its pattern of credit extension and types of portfolio adjustments undertaken so far this year are appropriate -- given its individual circumstances. Yet, I believe we should also ask whether, from the point of view of both the national interest and of our financial system as a whole, the noticeable shift in favor of business loans should continue unabated. In my personal opinion, the orderly and efficient functioning of our money and credit markets -- as critical links in the total economy -- would be enhanced by a less skewed allocation of loanable funds at commercial banks.

To a considerable extent, many of the recent policy actions taken by the Federal Reserve System -- especially the revision of discount administration -- have been aimed at moderating the allocation of funds

and other market adjustments during the present period of monetary restraint. These measures (which also included changes in reserve requirements and other modifications applicable to certain types of member banks' time deposits) have unquestionably been helpful. But the current against which we have had to swim is particularly strong. The pressure on banks to lend to business has been stimulated and re-inforced by:

- The high rate of business investment in fixed facilities and inventories and the corresponding demand for external funds.
- The strong bonds of customer relationships and the vigorous competition among banks for customers.

These are among the factors which have made it difficult for the effects of monetary restraint to be fully registered where it is most needed. For this reason, many of us have called attention to the need for greater assistance from fiscal policy to ease the burden of countering inflation being carried by the monetary instruments. Thus, we welcomed the anti-inflation program announced by the President last week.

Business Spending and the External Demand for Funds

Business outlays have been a major source of inflationary pressures in the U.S. economy during 1966. These pressures have been associated primarily with stepped-up spending for plant and equipment, but the quickened pace of inventory building has also contributed to the strain.

The latest survey of plant and equipment outlays announced last week by the Commerce Department and the Securities and Exchange Commission indicates that the Nation's businesses are still planning to raise such expenditures by 17 per cent this year. This is the same rate of growth recorded a year ago when excess manpower and other resources enabled our capital goods industries to respond to such expanding demand without exerting severe pressure on prices. The latest survey (for the first time since 1964) did not indicate an acceleration in the pace of capital spending through the rest of the year; yet, it also did not indicate any lessening in a rate of spending that may have already reached an unsustainable level.

While a 17 per cent increase in fixed outlays is not a record (the rise was 29 per cent in 1950 and 23 per cent in 1955), the years 1965 - 1966 would be the first time gains of this magnitude have occurred back-to-back. Moreover, the share of GNP accounted for by business fixed investment climbed to 10.7 per cent in the second quarter of this year. This proportion was last reached during the capital goods boom of 1956-57.

Significantly, a somewhat larger proportion of business capital outlays this year has gone for equipment -- rather than structure -- than was the case in the mid-1950's. It will be recalled that the 7 per cent investment tax credit applies to equipment but not to buildings. Of course, factors other than the investment tax credit have influenced the amount spent on equipment, and our appraisal of the effects of the tax allowance in the present inflationary environment should not rest too heavily on the higher ratio of equipment outlays to total capital goods outlays.

Yet, if the mix of plant and equipment had not changed in favor of equipment since the mid-1950's, total spending by business for fixed investment this year would be about \$2.5 billion below the current annual rate of \$78 billion.

Business inventories, another critical component of business spending, have also expanded quite sharply. Such stocks rose by 8.4 per cent in 1965 compared with 5.1 per cent in 1964. So far in 1966, inventories have continued to expand rapidly. For example, in June and July, the average increase in manufacturer's inventories was almost half again as much as the average gain in the previous twelve months. While inventory holdings relative to sales are now no higher than in 1964 (and they are lower than in the early years of the present decade), the inventory demand of the business sector still remains large in the aggregate.

Indeed, if one combines fixed capital spending with inventory expenditures, the sum of these types of business outlays currently account for almost 12.5 per cent of GNP -- the largest share of GNP in 15 years. Moreover, even a slight retardation in sales could produce an unusually large dollar amount of excess inventory.

The above evidence not only quantifies the very large growth in business expenditures -- despite Presidential appeals for voluntary moderation of capital outlays and the reduced availability of credit. The evidence also helps to explain why business demand for credit has grown so rapidly. In 1964, corporations had an excess net cash flow (or internally generated funds) over capital outlays (including inventories) of about \$1.5 billion. Even in 1965 such outlays exceeded cash flow by only about \$4.5 billion. Yet in the first quarter of 1966, corporate expenditures on plant, equipment, and inventories exceeded internal cash flow by a seasonally adjusted annual rate of \$10.5 billion. Last quarter the deficit jumped to \$13 billion, despite the continued growth in corporate savings to about \$58.5 billion. Indications are that this short-fall of funds will continue in the remainder of the year at about a \$12 to \$13 billion rate. This prospect clearly suggests that capital outlays during 1960 will exceed cash flow in the corporate sector by roughly twice the previous 1956 record of \$6.1 billion.

These large business demands for external funds were reflected in both capital market financing and loan expansion at commercial banks.

In the first eight months of 1966, nonfinancial business firms raised \$11.5 billion in capital markets, compared to \$7 billion in the similar period of 1965.

At banks, firms raised another \$9 billion (seasonally adjusted), expanding their loans at near a 20 per cent rate, about the same as last year. But over the combined June-July period, such loans rose at a 30 per cent annual rate -- the largest expansion in business loans at banks for a two-month period in 10 years, despite increased bank tightness. To some extent, of course, accelerated tax payments influenced the recent pace of loan demand. Moreover, business loans at banks declined somewhat in August. Nevertheless, the heavy trend in external business financing -- including financing at banks -- continues to be evident. Indeed, our expectations late last month were that business demands for credit, in both the capital market and at banks, would continue to expand at rates similar to the ones I have just quoted.

In general, business borrowers have been extremely strong competitors for commercial bank credit during the present period of monetary restraint. For example, so far in 1966 monetary policy has provided bank reserves through open market operations at a rate roughly 40 per cent as fast as during the same period of 1965. Reflecting this policy, total bank credit (loans plus investments) expanded at an annual rate of 3.4 per cent during the first eight months of 1966, compared with

So far
10.2 per cent in all of 1965./ this year, total bank loans rose at a
all of
12.5 per cent rate, against 14.7 per cent in/1965. In sharp contrast,
the banks' business loans expanded by almost 20 per cent during the
first eight months of 1966 -- or slightly faster than the rate of
increase registered in all of 1965.

Sources of Bank Funds: Competition for Savings and Portfolio
Adjustments

Banks have relied on a variety of sources of funds to meet the expanding demand for business and other loans. The method which has received the most publicity was their active solicitation of time deposits. Over the first 8 months of this year, total time and savings deposits expanded at a seasonally adjusted annual rate of 6.5 per cent. This was less than two-thirds of the pace over the same period in 1965. While this suggests that banks as a whole were less successful than last year in attracting deposit, a much more vital development they reveal is visible behind the aggregate experience. Banks had very large declines in passbook savings deposits as the public shifted funds to higher yielding financial assets. Savings deposits at large banks for example, declined \$4.4 billion in the first eight months of 1966 after expanding by \$3.1 billion in the same period of last year. On the other hand, time deposits other than negotiable CD's -- offered at steadily rising interest rates -- more than made up for this decline. The latter type of time deposits expanded by \$7.3 billion so far this year at large banks, more than

three times the 1965 pace. The competition from banks for these deposits, along with rising market yields, has in turn made it more difficult and expensive for nonbank financial institutions to attract deposits and shares. With their inflow reduced, these institutions have sharply reduced the availability and cost of the credit they extend. This reduction has been especially noticeable in the case of residential mortgage lending. Over the summer months, banks have continued to attract consumer type time deposits, thus contributing -- along with the securities markets -- to the difficulties of non-bank institutions. Smaller banks in particular over the last three months seem to have been doing quite well in competing for time deposits.

However, large denomination negotiable CD's, even at yields which rose 100 basis points to 5-1/2 per cent since last December, have not provided funds as rapidly as in 1965. Since the ceiling on time deposit rates has remained at 5-1/2 per cent, banks are finding it increasingly difficult to retain their holdings of CD's or to attract new funds. As substitute financial assets, such as finance company paper, provide yields above that rate, the banks' ability to compete for negotiable CD's will be lessened further. Indeed, from June through August, New York City banks lost almost \$450 million of CD's; in the previous five months, these banks were able to obtain only one-third as much money from this source as in the same period last year. During the month of September, large commercial banks in the Nation as a whole face \$5-1/4 billion of maturing CD's. Thus, large denomination negotiable CD's will

probably decline relatively as a source of bank funds -- and as a means of financing a greatly expanded volume of business loans.

As the banks search for loanable funds during 1966 has run ahead of the growth of time deposits, they have turned increasingly to their own securities portfolios. By thus adding to the market supply of securities, banks have contributed significantly to the increase in market yields. ^{special tax bill financing late last month,} If one ignores the/banks have liquidated their holdings of Treasury issues at an annual rate of approximately 11 per cent. This pace of liquidation is about twice that recorded in the same period last year. Consequently, many banks are now thought to have very few Govern-ments in excess of the amounts required for pledging purposes.

The banks' holdings of other securities -- mainly municipals -- have grown at a seasonally adjusted annual rate of less than 6 per cent so far this year, or about one-third of the pace of the same period in 1965.

While individual banks have expanded their municipal holdings in 1966, it is becoming increasingly clear that large banks in the aggregate have been net sellers since mid-year. Moreover, in the last few months, large commercial banks have also been net sellers of the very attractively priced participation certificates and other Agency issues. To me this also is strong evidence of the degree of portfolio adjustments being made to finance business loans.

Other kinds of loans have also been reduced in order to make business loans -- mainly securities and finance company loans. For example, in the last three months, business loans at weekly reporting banks rose \$2.7 billion, or \$1.0 billion more than last year at the same time. In the same period, other loans declined by almost \$0.5 billion, compared to a \$1.1 billion increase last year. In New York,

the comparison is more striking: in this money market center which handles such a large fraction of the Nation's total financial requirements, business loans rose \$1.3 billion over the last three months, compared to \$500 million in 1965; other loans declined by more than \$1.0 billion, compared to a modest expansion a year ago.

But even the considerable portfolio adjustments undertaken in 1966 have not been sufficient, and banks have turned more and more to other sources of funds. Member bank borrowings at Federal Reserve Banks have generally stayed in the \$750-\$800 million range over this summer -- about \$200 million more than last summer. The higher and more frequent level of borrowing at the discount window, I might add, reflects not only the general bank scramble for funds but also the shifting of pressure to more banks as alternative sources of funds become less available. Earlier in the year, country bank borrowing had risen sharply as demand pressures and reduced time deposit inflows placed them in a tighter position. In the spring and early summer, however, country banks gained more time deposits and reduced their borrowing while heavy loan demands forced reserve city banks to the window. Last month, larger banks reduced some of their borrowing with proceeds from loan repayments, but country bank borrowing increased again. Parallel with the increased level of member bank borrowing, the rates paid for Federal funds have risen to new peaks, with the volume of transactions remaining at high levels. In addition, over the summer pressure on large banks became so intense that some banks borrowed very large sums from their foreign branches, which in turn were actively seeking deposits in the Euro-dollar market

All of these efforts of commercial banks to obtain funds to meet the huge demands for credit have been reflected in, and have contributed to, very taut financial markets. Four times since December banks have raised their prime rate as the cost of time deposits, market borrowing, and liquidation of investments has increased their own costs, and as their own liquidity has become increasingly reduced. These indications of growing market tightness have also been paralleled by changes in bank lending standards.

Recent Changes in Commercial Bank Lending Practices

As some of you may know, the Board of Governors periodically surveys a sample of member banks in order to detect any significant changes in their lending practices. In the Spring and again about mid-year, our surveys indicated that banks, in fact, were feeling the bite of monetary restraint. While the degree of response was obviously varied in this large and diverse Nation, banks generally across the country apparently stiffened their standards considerably in 1966. They indicated less willingness to lend to new customers, customers outside of their local market area, and finance companies. They suggested that they were looking more closely at customers' long-run value to the bank and were enforcing compensating balance requirements more strictly. Loan requests were being scaled down whenever possible, and the intended purpose of the loan was being given more weight. Yet, despite this evidence of increasingly tougher lending standards, business loans continued to grow.

Consequently, last month, we again asked Federal Reserve Bank Presidents to review the situation with a group of banks in their Districts. Their conclusions were:

- The tightness of banks has generally continued or accelerated, with some exceptions. For example, smaller, less aggressive

banks were still in a comfortable position. Agriculturally centered banks in the South and mid-West, in fact, were past their seasonal peaks and expected to be quite comfortable this Fall. However, many of these banks expected demand to be related to special situations -- e.g. cotton purchases in Memphis and grain marketing in the mid-West. In the far West, the variation among banks was most striking. In general, only the banks with Eastern customers were very "tight".

Banks in a comfortable position were the exception, however. The large aggressive, CD seeking banks were in an especially tight position. They were concerned about future fund sources, and they expected heavy loan demands this Fall. Their Treasury securities were at minimum levels; they were liquidating municipals and reducing mortgage and sales finance company commitments. In their business loan markets, increased selectivity was the rule. Compensating balances and past customer relationships were more important. Emphasis on local customers was the rule of the day. Fewer term loans and shorter maturities were also emphasized.

Large banks in the New England District were cases in point. They mentioned all of these factors plus refusal of new business, no solicitation of new clients, special reviews of large loans, refusal to enter into large participations with correspondents, and greater attempts to shift customers to the market.

You would think from this review that the Board would be content. However, despite the obvious attempts of many banks to reduce loans, the amount of business credit, as I have indicated, continued to expand rapidly. Moreover, a prevalent report received in the August survey was that banks were under intense competitive pressures to make business loans -- especially to old, established customers. Indeed, one had the feeling that banks felt they must accommodate their business customers, even, it seems, at the expense of virtually all other clients and the absorption of heavy capital losses through liquidation of marketable securities.

Customer Relations and Bank Response to Monetary Restraint

This reaction of the banking and financial system to the diverse pressure placed upon it has suggested to some of us that, so far, general monetary policy has not exerted sufficient restraint on business expenditures or on credit flows to the very sector that has been the dynamic center of excess demand for resources. In fact, business outlays and the ability of corporations to finance these outlays seem to remain relatively exempt from a good share of the general attempts to moderate the level of aggregate demand. At the same time, other sectors -- both real and financial -- have borne a disproportionately large share of the burden of credit restraint.

There are understandable -- and perhaps obvious -- reasons for this conjecture of circumstances. One, of course, is the myriad of institutional constraints embodied in law, regulation and customary practices that tend to reduce flows of credit to, say, the municipal and mortgage markets. But, for the major problem at hand -- inflationary pressures originating in the business sector, financed in large part with bank credit -- it is clear that the principal factor is the preferred position of the business loan customer at a commercial bank. Banks expend considerable effort in a highly competitive milieu to cultivate relations with business customers. The credit requests of large, old, and important clients are, therefore, exceedingly difficult for a banker to deny. If denied, such customers are quite likely to be attracted by future offers of competitor banks. Thus, not only does the bank attempting to curb business loans run the risk of losing profitable business, it also risks losing deposits -- its basic raw material. Consequently, in

banking it appears to be common practice to place business customer demands on a very high priority. To meet these demands, banks seem willing to bite ever deeper into other parts of their portfolios.

Such developments are not inconsistent with higher lending rates or tougher loan standards, or even the scaling down of customer loan requests or demands that we have learned from our surveys are in fact going on. But, in the environment of today, the net result remains a very high rate of increase in loans to just those firms whose expenditures are presenting the most difficulty. In addition, the efforts of banks to finance the loan demand of businesses by liquidation of securities and reduction in other loans can produce some of the side effect -- e.g., disorganization in financial markets -- that the Federal Reserve always seeks to neutralize.

In addition to the obviously adverse effects of these kinds of reactions by the commercial banking system on the health of the economy, we must also not lose sight of their implications for an individual bank. The strong efforts of banks to meet business credit demands are increasingly exposing banks to additional risks by continuously eroding their buffer stock of liquid assets at the very time when their ability to attract time deposits has been greatly reduced. Therefore, it is gratifying to note that many banks -- in consideration of both their self-interest and the public-interest -- have already limited the growth of their business loans. I am convinced that even more banks would prefer to curtail their business loan expansion, but the kinds of customer relationship that I have described have made it extremely difficult for them to do so.

Revision of Federal Reserve Discount Administration

Despite the strength of bank-customer relationship (and perhaps precisely because of this bond), the continued health of the total economy requires that every encouragement be given to banks to moderate their loans to business. With this in mind, just ten days ago, the Federal Reserve System addressed a special letter to all member banks asking for their support in achieving this objective. We fully expect these banks to give us this support.

In sending this letter, we made it clear that we are convinced that an orderly expansion of bank credit should occur in our growing economy. No one should have any doubts whatsoever about the genuineness of this position, because no one in the Federal Reserve System takes exception to it. On the other hand, we also feel that the growth of credit-financed spending should not exceed that which can be accommodated by the expansion of our physical resources.

Moreover, the letter also advised the member banks that they will be expected to consider the reduction of their business loans as one of the methods to be used in adjusting their position when obtaining accommodation from the discount window. This, we feel, is very much in keeping, in the present circumstances, with the Federal Reserve Act's concern with "sound credit conditions." Indeed, the foreword to the System's Regulation on member bank borrowing specifies that "each Federal Reserve Bank give due regard to the purpose of the credit and to its probable effects upon the maintenance of sound credit conditions, both as to the individual institution and the economy generally." To the Federal Reserve System "sound credit conditions" in banking today means

a slower growth in business loans and a reduction in the liquidation of other parts of bank portfolios.

Reserve Banks will keep these circumstances in mind in reviewing each member bank's request for accommodation at the discount window. The discount officers at Reserve Banks, in turn, will keep in mind "that banks adjusting their portfolios through loan curtailment may at times need a longer period of discount accommodation than would be required for the disposition of securities." Of course, seasonal and emergency assistance will remain available -- as always. Moreover, although a member bank may not find it necessary to borrow from its Federal Reserve Bank, it should also keep in mind that a slower growth of business loans is clearly in the national interest -- including the interest of its banking system.

In asking banks to pursue this course of action, we are not unmindful of the difficult position in which many institutions will find themselves in dealing with their long-established customers. At the same time, if business loans are to be curtailed, bank managements may well have to take a new look at its loan commitments. Obviously no one is asking a bank to default on a formal and legally binding commitment to provide funds to a borrower. On the other hand, many lines of credit outstanding at banks are not firm and binding commitments. In these cases, it seems entirely proper for banks to re-examine with their customers the latter's credit needs in the light of the necessity to restrict loans to business. Undoubtedly, opportunities can be uncovered to revise these credit lines in a downward direction.

I believe the recent revision in the administration of the Federal Reserve discount window will be quite helpful to banks in dealing with their business customers. The market for bank loans is now quite imperfect, as I attempted to indicate earlier. In many banks, present lending policies almost amount to an informal agreement to satisfy virtually all requests for funds made by business customers. Indeed, many banks come very close to saying as much in seeking deposits from their business clients. The prime rate and compensating balance conventions have not served very well to limit this commitment. Expressed differently, price and non-price terms used by banks have not, as in many other markets, served to erode the excess demand for business loans. A mortgage loan or a loan to a finance company can be denied; securities can be sold. But if an increase in the prime rate does not discourage potential borrowers, banks seem to have developed no ready way to reduce excessive demands of their large business customers.

In these circumstances, the Federal Reserve actions provide needed external assistance to supplement the banks' own allocative machinery in the business loan area. At the same time, I think that all concerned look forward to the time when the banking system itself develops a balancing mechanism which will make out new discount administration program of much less significance.

In the meantime, however, we are urging, and directing our policies toward, a reduction in the rate of growth of business loans. Each member bank will be expected to make the market oriented decision as to which particular customer loans are curtailed. The end result, however, should be a gradual and orderly reduction in the growth of loans to businesses. This result, as I have attempted to show, will be not only in the national interest, but also in the interest of banks.

Orchestration of Monetary and Fiscal Policy

As I mentioned at the outset, we have felt for sometime that a greater share of the effort to counter inflationary pressures should be borne by fiscal policy. My personal view was based not on any reluctance to use monetary policy but on a clear recognition of its limitations -- including its differential impact on particular sectors of the economy.

When the President announced last week his determination to expand further the contribution which fiscal policy can make in the fight against inflation, the Federal Reserve Board responded immediately and favorably. We took note of the fact that the proposals in the program are aimed at moderating the exceptionally strong demands for goods, services and credit which have generated both higher prices and higher interest rates. Our own efforts have been directed at the same objectives.

There is no need to list the details of the President's program, because these have been described fully in the press. However, I would like to make several observations without attempting to judge the implications of the proposed measures for monetary policy. Clearly all of us must wait until the Congress has responded to the President's recommendations with respect to:

- Holding down non-essential appropriations.
- Suspension of the 7 per cent investment tax credit until January 1, 1963.
- Suspension of accelerated depreciation on buildings and structures until January 1, 1963.

But, in the meantime, I personally think these steps are clearly in the right direction. In fact, just two months ago, in a speech here in New England, I suggested that -- as a minimum -- the investment tax credit should be suspended to help ease the inflationary pressures originating in the unsustainable rate of business spending for fixed investment. At the time, I also recognized that such a move would entail a number of technical problems and time lags before its effects could be registered. Yet, I felt (and still feel) that suspension is desirable to avoid providing an extra stimulus in exactly the area in which more restraint is called for.

In his message, the President called upon the financial community to give close attention to the allocation of credit among competing users. As indicated above, the Federal Reserve has been concerned with the differential rates of growth of business loans at member banks, and our recent letter was designed to help curb the rapid increase. We also registered our concern for the stability of securities markets if banks chose to adjust their positions primarily through sales of securities -- particularly municipal issues. Thus, this earlier move by the Federal Reserve was entirely in line with this part of the President's request.

In addition, the President urged that we remain alert to any easing of inflationary pressures so that the restraint of monetary policy can be lessened as quickly as possible. His expression of concern with the present level and trend of interest rates was particularly strong.

We clearly cannot forecast the future course of interest rates. But the stimulus to aggregate demand in the economy would be moderated

as the program outlined by the President moves into execution. This in turn should ease the pressures in the credit and financial markets. Moreover, the slackening in sales of securities by Federal Agencies, also announced by the President, should enhance this prospect. If these circumstances do materialize, the upward pressure on interest rates should also be moderated.

In the meantime, the Federal Reserve System will continue to be alert to any easing in inflationary forces in order that monetary policy can be adjusted accordingly.