

For release at 11 a.m. Pacific DST
(2 p.m. Eastern DST)
Friday, September 23, 1966

The Strategy of Monetary Policy in a
High Employment Economy

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Before the
76th Annual Convention
of the
California Savings and Loan League

Hotel del Coronado
San Diego, California

Friday, September 23, 1966

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High Employment Economy

Two days ago, another milestone was passed in the management of monetary policy. The President signed a new law giving broader and more flexible authority to set maximum rates payable on time deposits and savings accounts at commercial banks, savings and loan associations and mutual savings banks. On the same day:

- The Board of Governors of the Federal Reserve System reduced to 5 per cent from 5½ per cent the highest rate which member banks in the System can pay on any time deposit under \$100,000.
- The Federal Deposit Insurance corporation also placed a 5 per cent ceiling on interest rates payable by insured nonmember banks on accounts of less than \$100,000. The same ceiling was set on any size account in mutual savings banks.
- The Federal Home Loan Bank Board limited to 4 3/4 per cent the rate member savings and loan associations generally can pay on passbook accounts - except that associations currently paying in excess of 4 3/4 per cent cannot raise this beyond 5 per cent and units in California, Nevada and Alaska can pay up to 5½ per cent.

For us in the Federal Reserve System, this action was a continuation of our efforts to enhance further the growth and stability of the national economy. The reduction was designed primarily to dampen the upward climb of interest rates paid in the campaign to attract consumer savings. But it will also help to keep the further, orderly expansion of commercial bank credit in step with the growth of the Nation's productive capacity.

Thus, the reduction in the rate ceiling payable on time deposits at member banks does not represent a watershed in the general thrust of monetary policy. Rather, it is an integral part of the over-all strategy underlying the principal monetary actions since the current effort to moderate inflationary pressures got underway. The major elements in this strategy are known

and have been discussed widely. However, a systematic review of the current objectives and instruments of monetary policy may place these elements in better perspective.

Simply put, the present task of monetary policy has its roots in the need to counter the challenge to economic stability arising from:

- The military build-up in Vietnam;
- The enormous expansion of plant and equipment expenditures, and
- The strong demand for credit, both in the market and at financial institutions.

As this growing demand far outstripped the availability of funds, the consequences were soon evident:

- The escalation of market yields and interest rates;
- Substantial shifts of funds from financial intermediaries to the open market and among different types of institutions.
- A striking change in the disposition of credit flows, e.g., a sharp expansion in business loans and an even sharper decline in the availability of funds for housing and other construction.

In carrying out our monetary responsibilities, we have been ever mindful of the above developments. This sensitivity has led us to be concerned with the choice of policy instruments and the techniques of using them as well as with the achievement of our objective of moderating credit expansion.

Nevertheless, we have employed all of the general instruments of monetary policy - i.e., open market operations, discount rates, and changes in reserve requirements. But the use of one policy instrument has undoubtedly attracted the most attention among members of this group. This instrument is the Federal Reserve Board's Regulation Q. Under this regulation, the Board sets the maximum interest rates which member banks can pay on time and savings deposits. As the year unfolded and the competition for savings

became more intensive, Regulation Q developed into one of the Board's most effective monetary policy instruments.

At the same time, while convinced of the need to help keep the growth of bank credit in line with the expansion of our real resources, we have also felt that a better balance between monetary and fiscal policy was required. Thus, we welcomed the program announced by the President on September 8, assigning to fiscal policy somewhat more of the responsibility in our common efforts to counter inflationary pressures.

With this introduction, we can now review the main contours of monetary policy during 1966 - a year in which the problems of a high employment economy also posed special problems in the area of monetary management.

The Move to Credit Restraint

For the present discussion, we can chart the current policy of monetary restraint from the beginning of last December. You will recall that the quickening of military activity in Vietnam just over a year ago occurred at a time when spending in other sectors of the economy had already moved the Nation close to full employment. Thus, while the demands attributable directly to Vietnam are small relative to the total economy and substantially smaller than those registered during the Korean conflict - their appearance virtually on the eve of full employment rapidly accentuated inflationary pressures. In the absence of the expanded military requirements, expenditures originating in other sectors - perhaps even those supporting the boom in business capital formation - probably could have been accommodated without pressing on the limits of available resources. However, along

with the further broadening of the Vietnam commitment, spending in non-Federal sectors has also been generally maintained and augmented. The one striking exception is the housing industry on which I shall comment below.

In the face of the mounting evidence of inflation, the Federal Reserve Board last December adopted a posture of restraint, aimed at moderating - but not halting - the expansion of bank credit. This change in policy was signaled by an increase in the discount rate from 4 to $4\frac{1}{2}$ per cent, coupled with a simultaneous advance in the Regulation Q ceiling on longer maturity time deposits from $4\frac{1}{2}$ to $5\frac{1}{2}$ per cent.

Discount Rate Action

The increase in the discount rate has been popularly interpreted as an example of the use of the discount instrument to signal Federal Reserve intentions. While its immediate purpose was to help dampen demands on banks for still further credit extensions (and not to cut back the existing credit flows), it did demonstrate clearly Federal Reserve concern about the implications for future price stability of the already accelerating military and business investment demands for real resources. Without reviewing the debate about the appropriateness of this action which occurred at that time, in retrospect, it is clear that these twin concerns about developments in Vietnam and the risk of an over-stimulated business investment boom were not uncalled for. It is also clear that the discount rate action did anticipate correctly a necessary and subsequent shift in open market policy toward a position of greater monetary restraint.

The change in the Regulation Q ceiling last December was motivated essentially by the sharp rise in market interest rates during the late Summer

and Fall of 1965. With the rapid rise in the structure of interest rates, the $4\frac{1}{2}$ per cent limit on rates payable on negotiable time CD's at commercial banks became uncompetitive compared with rates available on other short-term money market instruments. With market rates on Treasury bills continuing to rise - and with the expected increase in market rates accompanying the new stance of monetary policy - banks were faced with the prospect of heavy attrition in their time deposits, especially large-denominated CD's. If such an attrition had occurred, a sizable - and unwanted - reduction in the availability of bank credit would have resulted - to avoid which it may have been necessary to ease the policy of moderate monetary restraint. Thus, some increase in the Regulation Q ceiling was required. But the advance in the maximum rate by one percentage point reflected a Federal Reserve judgement at the time that banks should be provided needed flexibility to attract deposits chiefly, it was thought, from businesses - in the face of anticipated further increases in short-term interest rates.

Very recently, interest rates on short-term securities/advanced sharply further, again putting large denomination negotiable time CD's at city banks at a distinct competitive disadvantage and forcing a significant decline in the deposit inflow at these institutions. Yet in these more recent circumstances, the Federal Reserve has raised neither the discount rate nor the Regulation Q ceiling. Because of this, many observers see a paradox between last December's approach to the Regulation Q ceiling and the Board's present position. In fact, there is no inconsistency. The circumstances have changed and so have the policy considerations governing the discount rate and Regulation Q. The explanation of these considerations lies at the heart of recent monetary strategy. To provide this explanation, it is first necessary to review the uses and effects of other monetary instruments since last December.

Open Market Operations

During the first half of 1966, the Federal Reserve relied almost exclusively on open-market operations to implement its more restrictive monetary policy. It will be readily recognized that this is the traditional strategy of monetary policy. Open market operations provide more flexibility for gradual policy modification and sensitive adjustment to changing economic conditions than any other monetary instrument.

But as the year progressed, it became increasingly clear that reliance on the open market instrument alone for intensification of general monetary restraint was not fully realizing its desired objectives. In particular, the combination of generally reduced deposit inflows to all depositary-type intermediaries and the propensity for banks to give higher priority to established business customers in the allocation of their credit extensions was tending to some extent to distort the distribution of total credit supplies. Increasingly, commercial banks were using the competitive advantage provided by their more diversified credit operations to bid aggressively for an enlarged share of the reduced total flow of savings to all depositary-type financial intermediaries. Given the inherent (and understandable) tendency for banks to favor their business customers, credit demands of major non-financial corporations supporting the business investment boom continued to be generally satisfied. In contrast, credit supplies to would-be borrowers in some other major sectors - particularly **the** housing industry - were being cut back abruptly.

Changes in Reserve Requirements

As mentioned above, the Federal Reserve Board on two occasions this year has resorted to increases in reserve requirements to implement its general approach to monetary restraint. Both actions (the first effective in July and the second in September) raised reserve requirements on time deposits at member banks with total time accounts in excess of \$5 million. In both cases, the change amounted to one percentage point - raising the requirement from 4 per cent at the end of June to 6 per cent at the end of September.

The principal purpose of these actions was to exercise a tempering influence on bank issuance of time certificates of deposit. An additional aim was to apply further restraint on the extension of bank credit to business and other borrowers. Thus, the increases in reserve requirements were expected to help reinforce the operation of other instruments of monetary policy in containing inflationary pressures.

Business Loans and the Allocation of Bank Credit

Despite the use of the general credit instruments discussed above, the Federal Reserve Board this summer has had to face a particularly difficult policy dilemma: how to encourage more effective credit rationing of business customers by member banks without precipitating a large-scale liquidation of securities that would give a significant boost to market yields? For some time, officials of the Federal Reserve System had been talking privately with bankers, encouraging them to limit the rate of

expansion of their business loans. Moreover, the two increases in reserve requirements on time deposits were designed partly to convey to bankers (perhaps more directly than moral suasion) the message that the Board was seriously concerned with the increasing emphasis on loans to business.

Demands for bank credit from established business customers were rising strongly in June and July. This demand reflected financing requirements stemming from both the continuing capital goods boom and the special speed-up of withheld personal income tax payments coming on top of already heavy current and advance corporate income tax liabilities. Confronted with these pressures, banks found it desirable to accommodate business demands first, even though it meant reducing their liquidity positions through asset liquidation.

The resulting reallocation of credit flows had the effect - among others - of cutting back the availability of funds for housing more abruptly than had been anticipated. At the same time, the banks continued to finance the business capital investment boom - the key source of inflationary pressures in the private sector of the economy. In short, sharply rising costs of business credit at banks and in the capital markets were not acting as a sufficient deterrent to business capital outlays. And in bargaining with their prime business borrowers, banks were finding it difficult to exert any strong allocative restraint on the availability of funds.

In the face of this situation, Board members began to question whether the 5½ per cent ceiling rate on time CD's should be raised in the

period ahead - even if rates on competitive short-term money market instruments should rise seasonally to levels in excess of the 5½ per cent maximum. When the ceiling rate was not raised in the face of advancing market yields, this policy approached necessarily implied a more rapid attrition of time CD's at large city banks. As the policy became effective, and as banks sought to prepare for an expected sizable run-off of time CD maturities in September, a substantial liquidation of bank-held securities occurred - particularly in the municipal bond market.

These asset sales (in the face of a record volume of corporate bond offerings in the public market, and expectations of further heavy corporate, Treasury, and Federal agency borrowing in the fall) led to a very rapid further rise of interest rates in August to the highest levels reached in 40 years. At the same time, stock prices sharply extended the steady decline already in evidence since early spring.

To a considerable extent, this sharp securities market reaction reflected market uncertainties about the outlook for monetary policy. One clear cause of uncertainty was concern over the extent to which monetary policy might be left to shoulder essentially alone the main burden of curbing the developing inflationary pressures. Increasingly, market observers began to ask whether the pace of CD attrition might become too rapid, forcing some individual banks into such a liquidity bind that they might have to cancel some loan commitments - particularly in the provision of credit to facilitate the regular underwriting and carrying of securities. Since these questions emerged at a time when loan funds available to the capital markets from life insurance companies were also severely curtailed - due to heavy

commitments made earlier in the year and to the unexpectedly large increase in demands for loans from policy holders - questions began to be raised whether all of the expected heavy fall demands for credit could be financed at any price.

The strength of this market reaction to the prospect of no change in the Regulation Q ceiling suggests the answer to the question I posed at the beginning of my remarks, - namely, why did the Federal Reserve raise both the discount rate and the Regulation Q ceiling last December (when rates on market securities pressed against them) but kept both rates unchanged this summer when the same set of circumstances developed again?

The simple answer is that last December a discount rate increase was needed to help combat the prospective pressures of demands on real resources then developing. But the over-all state of the economy at that time did not seem to justify an abrupt accentuation of pressures in financial markets of the type that might have resulted if the Regulation Q ceiling had not been raised.

This fall, on the other hand, with the inflationary pressures anticipated last December now a fact, and with banks needing further encouragement to ration credit to their established business customers, it did seem appropriate to permit some additional attrition in banks' CD's which would result from keeping the present Regulation Q ceiling. Nevertheless, since this latter approach clearly represented an innovation in the strategy of monetary policy, it seemed wise not to augment the pace of the fall rise in short-term market rates with a discount rate increase as well. Moreover, at the existing discount rate, the Federal Reserve

Banks were not experiencing any difficulty in policing discount window accommodation to insure that Federal Reserve credit was not used by some banks to profit on interest rate arbitrage in the Federal fund market.

In these circumstances, more reliance on administrative techniques (rather than a further increase in the discount rate) seemed to be the proper course to follow. With this in mind, the Federal Reserve System on September 1 sent a special letter to all member banks outlining a new approach to the administration of the discount window. The letter explained that Federal Reserve credit would be available to help banks adjust to reserve losses resulting from the attrition of their time deposits. This letter underlined what should have been obvious: there is no need to fear a liquidity crisis. But as banks become more indebted to the Federal Reserve banks (above and beyond their normal seasonal requirements or for emergencies), the extent and duration of accommodation at the discount window will be conditioned in part on each bank's efforts to moderate the extension of business credit and to maintain a reasonable balance in its over-all allocation of loan funds.

In this way, and by providing the requisite reserves to meet normal seasonal and growth needs for loan expansion, the Board of Governors hopes to support member banks in their efforts to ration business credit - even to their best customers - but at the same time to obviate the need for drastic liquidation of existing bank investments.

Market Yields, Savings Competition, and the Availability of Housing Finance

Against the background of monetary policy actions sketched above, we can now examine more closely the competition for savings which has occupied so much of the time of all of us this year. Since the nature of this competitive process has already been indelibly imprinted on your memories, it can be summarized rather briefly here. Two quite different aspects of the process should be kept in mind, however, for these differences help to account for the recent innovations in Federal Reserve policy instruments described above.

First is the tendency for historically high market yields to pull savings from the non-financial public directly into market securities and away from financial intermediaries - a process which may be referred to as dis-intermediation.

The second is the tendency for banks to compete more aggressively for a larger share of the shrinking volume of total savings still flowing through depositary-type financial intermediaries.

Within your industry, blame for this year's sharp further cut-back in the growth of share capital has tended to be concentrated more on the increased competition from banks than on the process of dis-intermediation created by competition from market rates. In fact, however, a not insignificant stimulus for banks to compete more aggressively with you arises from their efforts to maintain deposit inflows threatened by market rate competition with their highly interest-sensitive time CD's.

During the first half of 1966, the sharp further general upturn of market interest rates created the most attractive investment opportunities in securities markets since the 1959-60 period of previous monetary restraint. As in that earlier period, high and rising interest rates rapidly accelerated the process of dis-intermediation, with an increasing share of savings of the non-financial public going directly into credit and equity market instruments. For example, in 1962-63, direct purchases of such instruments by the non-financial public amounted to only 9 per cent of total flotations. In 1965, the public share was still only 14 per cent of total credit flows. In contrast, in the first half of 1966 the flow of funds directly to securities markets ballooned to nearly 30 per cent of total flows. This proportion was not much below the 40 per cent rate that developed in the record final quarter of 1959 when the Treasury offered an instrument carrying an extremely attractive (at that time) coupon of 5 per cent.

So far this year, much of this enlarged dis-intermediation of savings flows represents direct public acquisition of longer-term bonds and stocks. But shorter term Treasury and Federal agency securities, as well as commercial and finance company paper, have strongly attracted business savings, as well as some personal savings. It is these shorter term types of instruments that have put special competitive pressures on the time CD's of banks.

Early in 1966, commercial banks showed considerable reluctance to raise their time CD rates as market rates continued to rise. At that time, banks were highly sensitive to the added cost of the high rates necessary to attract CD's. Indeed, not until the banks increased the prime rate in late winter did they again begin to bid aggressively for new funds from

the money market. In the meantime, with all rates moving up, the consumer savings market became a promising alternative source of loanable funds.

However, some of the stimulus to banks seeking funds in this market was clearly defensive - designed to offset the attrition resulting from the (low) 4 per cent ceiling rate to which their traditional savings accounts were subject. In retrospect, it is also clear that a great deal of the sharpened focus on consumer-type CD's yielded little net gain. Much of the enlarged flow of funds attracted through such instruments actually occurred at the expense of bank savings deposits - often within the same institution.

Indeed, in the first eight months of this year, while the large commercial banks did increase their inflow of time deposits other than CD's by \$7.3 billion (\$5.1 billion more than in 1965), their passbook savings deposits declined by \$3.3 billion over the same period - compared with a gain of \$3.1 billion a year ago. Since the growth of negotiable time CD's at these banks was \$1.7 billion less than in the like period of 1965, total time and savings deposit inflows of the large banks fell about \$3.0 billion short of the 1965 volume.

This reduced pace of deposit inflows began early in the year at the same time that loan demand was becoming more intense and bank liquidation of securities (or cut-backs in acquisitions) was becoming more prevalent. With loan demand higher, the need for funds larger, and the added leeway of several prime rate increases - banks intensified their efforts to gain time deposits in the Spring.

By late March, their efforts apparently spread to consumer-type CD's in a number of local market areas - just in time to accentuate the competitive

pressures on savings and loan associations and mutual savings banks that developed during the April dividend re-investment period. As a result, the brunt of the Spring dis-intermediation process tended to fall on your institutions and mutual savings banks - rather than on commercial banks.

Since the Spring, despite increases in offering rates on CD's to the $5\frac{1}{2}$ per cent maximum and the shrinkage in maturities almost to the 30-day minimum, bank inflows of negotiable time CD's have slowed to a trickle - only \$200 million from the end of May to the end of August. In the face of this situation, banks apparently pressed even harder into the consumer savings market. This behavior, I am sure I need not stress with this audience, accentuated the problems faced by savings and loan associations and mutual savings banks during the July 1 dividend date.

This year's pattern of dis-intermediation contrasts sharply with that of the 1950's. In that period, commercial banks (because of the narrower limits then imposed by the Regulation Q ceiling) had much less flexibility to counter the cyclical process of dis-intermediation that developed in periods of monetary restraint. In fact, the bulk of the adjustment to cyclical swings in financial intermediation occurred at the banks, and the growth pattern of savings and loan associations was much less affected than it has been recently.

In the first seven months of 1966, commercial banks have experienced a year-to-year shrinkage of only 10 per cent in flows to their time and savings deposits other than CD's. In contrast, the year-to-year shrinkage of savings flows to mutual savings banks over the same period amounted to 50 per cent and that for savings and loan associations to 80 per cent.

Adverse Impact on Housing and the Search for Special Relief

As everyone in this audience knows, these sharp changes in the relative shares of savings flowing both to the market and through different types of institutions brought unexpectedly abrupt adjustments in the housing industry. The question naturally arose: was the housing industry becoming so socially disruptive that it dictated a need for easing the policy of general credit restraint? Or were there more specialized actions that might be taken to increase the availability of housing credit?

Since both current and prospective developments in economic sectors other than housing indicated a need to combat continuing inflationary pressures, the general economic situation did not warrant any easing of general monetary policy. This is not to say, however, that some relief to housing was not in order. The circumstances merely argued for selective action that would help housing directly, without lifting credit restraints on other forms of spending. The most logical measures of this kind were expansion of the FNMA secondary market purchase authorization (which has now been accomplished) and steps to bolster the lending resources of the Federal Home Loan Bank System, so that temporary liquidity could be made more readily available to savings and loan associations. While financing of each of these approaches poses some technical problems, if the Administration covers the net cash requirements of these programs outside of the already congested capital market, the special measures taken should provide an additional stimulus to housing starts.

Moreover, as I see it, the objective of housing relief measures at this time should not be to generate a sustained near-term rise in housing starts to levels that were prevailing earlier in the 1960's. Rather it should be to moderate the severity of the recent cut-back. Given the over-built state of many local housing and commercial construction markets that developed earlier in the 1960's, some moderation of the pace of activity in these sectors has made economic sense in a period of general inflationary pressures.

Moderating the Competition for Savings

Your industry has consistently recommended that relief also be given to the housing industry indirectly through a moderation of the competition for savings among financial intermediaries. The most widely recommended form of this proposal was a roll-back of the Regulation Q ceiling on consumer-type time deposits at commercial banks, defined generally as deposits of \$100,000 or less. Unfortunately, however, the Federal Reserve Act did not permit rate ceiling differentiation among time deposits by size. Under the Act, any general roll-back of the 5-1/2 per cent ceiling, therefore, had to cover all time deposits, including large negotiable time CD's at banks as well as consumer-type CD's. A roll-back of the time CD rate ceiling to 4½ per cent or even 5 per cent risked the encouragement of an overly drastic dis-intermediation of time deposits at the Nation's major banks. This was particularly so because market interest rates since mid-year have put time CD's at a competitive rate disadvantage even at the 5½ per cent ceiling.

Lacking the statutory authority to differentiate rate ceilings by size of deposits, the Federal Reserve Board took action where it did have the legal powers. As mentioned above, the Board twice raised reserve requirements for banks with time deposits in excess of \$15 million - thus increasing the costs of time deposits for banks that were competing most aggressively for CD's.

In addition, since the statute permits differentiation among time deposits on the basis of maturity, the rate ceiling on multiple-maturity time accounts was reduced to 4 per cent on accounts of less than 90 days, and to 5 per cent on longer maturities. At the same time, the Board asked Congress for the statutory authority to differentiate rate ceilings applicable to time deposits on other bases besides maturity.

It was on the basis of this broadened authority that the Board reduced the interest rate ceiling on consumer-type time deposits earlier this week. In setting the new ceiling, the Federal Reserve Board was highly sensitive to the fact that too large a roll-back in the structure of rates paid by all financial intermediaries would simply risk an acceleration in the diversion of savings flows from intermediaries to market securities. While prevailing yields in bond markets have edged down on balance from the late August highs, some of this decline has very recently been reversed; short-term rates have continued to rise further, carrying the yield on 6-month Treasury bills to 6 per cent and that on new Federal agency issues to $6\frac{1}{4}$ per cent. While market securities of these types are not usually very competitive with the claims of financial intermediaries, the fact that available rates are at or near 6 per cent could easily be an important competitive factor in view of the fact that savers generally have become increasingly interest sensitive.

Given these possibilities for further dis-intermediation and given the pressure the banking system is already under due to the fact that the ceiling rate on time CD's has not been raised, a reduction to 5 per cent on consumer-type bank CD's seemed to be the most logical move. But the new rate levels at all depositary-type institutions will have to be watched carefully from this point forward to make sure that a viable competitive balance has been established among different groups of institutions and that diversions of funds to the market is not too large.

Looking beyond the immediate situation on interest rate ceilings, I can understand the reluctance originally expressed by your industry toward the extension of rate controls to shares offered by savings and loan associations. No one likes price controls - including the price controllers. If your industry prefers a world without rate controls, however, it seems to me that logic calls for extension of this same freedom to other types of institutions as well. On the other hand, recent experience suggests that under our present institutional arrangements your industry lacks the flexibility needed to compete equally with the banks. Thus, for the moment, some form of rate control - while admittedly onerous - seems to be necessary for your own - as well as the economy's - well-being. For the longer run, however, it seems to me as an outsider that your industry ought to press for the institutional changes needed to make you more competitive. This opens up a host of problems with which you are much more familiar than I am. Yet, I am convinced that the ideal of a competitive economy to which we all give lip-service, has considerable merit and an efficient allocation of savings will be inhibited if we allow our rate control system to become too rigid.

Concluding Remarks

In the meantime, the new rate ceilings should bring a measure of stability in the conditions governing competition for savings. In the last few weeks some of the extreme fears prevalent at the end of August among participants in financial markets concerning the possibilities of a credit availability crisis appear to have moderated, and longer-term interest rates have declined on balance. In part, this change reflects the early September announcement of the President's package of fiscal and debt management proposals, designed to help curb inflationary pressure and to relieve interest rate pressures in financial markets.

As we said at the time, these actions were welcome news to the Federal Reserve. As their effects unfold, we in the Federal Reserve System will continue to be alert to any easing in inflationary forces in order that monetary policy can be adjusted accordingly.