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MONETARY POLICY, MARKET DECISIONS, AND THE BEHAVIOR OF INTEREST RATES

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Monetary Policy, Market Decisions and the Behavior of Interest Rates

The response of the financial system to the easing in monetary policy which began last November has been dramatic.

Federal Reserve open market operations, changes in reserve requirements, and a reduction in the discount rate have produced a striking turnaround in deposit and credit growth at commercial banks and in financial markets generally. But we are also hearing a rising chorus of doubts about the ability of management in certain types of financial institutions to make interest rate decisions without explicit direction by Federal supervisory agencies.

Personally, I find the growth of deposits and credit quite gratifying. Moreover, I am still optimistic about the potentialities for interest rate adjustments in a market environment.

Easing of Monetary Policy

The dimensions of an easier monetary policy are clearly recognizable:

- Total reserves of Federal Reserve member banks rose by more than $1.0 billion during the four months ending in March. In the same period, they reduced their borrowing at Reserve Banks by over $400 million. By early April, these banks had net free reserves of $340 million, compared to an average of $430 million of net borrowed reserves in October.

- Interest rates since their 1966 highs have declined 50 to 70 basis points in long-term markets -- despite a record volume of financing. In short-term markets, rate declines have ranged from 100 to over 150 basis points.

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- With market yields declining, inflows of bank time and savings deposits (which were little changed from July to November) have accelerated as their relative attractiveness increased. In the four months ended in March, such deposits expanded at a 16 per cent annual rate -- almost three times as fast as in the second half of 1966, and about the same as the rapid pace of 1965.

- Outstanding negotiable certificates of deposits by the end of March had risen to a new record of $19.3 billion -- some $750 million above the previous peak in August and almost $4 billion above the December low.

- Consumer time deposits at banks and even savings accounts have also increased sharply -- each accounting for one-third of the March growth in time and savings deposits.

- The money stock, after generally declining from April through November, rose at almost a 6.5 per cent annual rate since the easing of policy in late November to a new high of $172.8 billion during March.

Bank Response to Monetary Easing

With deposit inflows enlarged, bank loans and investments have risen at almost a 13 per cent annual rate in the four months ended in March. In contrast, there was virtually no change in these assets from mid-summer through November. Of the $13.1 billion growth in loans and investment over this period, almost two-thirds have been in securities -- mainly Treasury and municipal issues with less than five-year maturities.

Since late last year, loan demands in general, and business loans in particular, have moderated. In the first half of last year, business loans rose at a 20 per cent rate. But under both policy pressures and some easing of demands, such loans expanded at a more moderate 7½ per cent rate in the second half. In the past four months, business loans have risen at almost a 9 per cent rate.

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In the first quarter alone, bank lending to businesses was particularly large and was concentrated in January and March -- months of heaviest tax payments. Sizable borrowings probably will also be registered in April as corporate tax payments run substantially above those in April last year. The April rise in business loans outstanding will probably occur despite the fact that a considerable amount of bank credit is expected to be repaid from the proceeds of bond flotations.

Yet, in the face of the continuing heavy demand for business loans, banks have made considerable strides in rebuilding their liquidity by expanding their holdings of short-term securities and money market assets. On the other hand, banks have not become aggressive searchers after lending opportunities. To some extent, this apparently reflects the fact that many banks are still not fully satisfied with their overall liquidity position. For example, the loan-deposit ratio of the weekly reporting banks is still around 69 per cent -- compared with the peak of 72 per cent reached last fall.

Nevertheless, with loan demands moderating, with market interest rates declining, with reserves expanding rapidly, and with their liquidity somewhat improved, the banks have begun to adjust their own deposit and lending rates. After some hesitation, the prime rate charged by banks on their best quality loans was reduced (in two stages) from 6 to 5½ per cent. With less reluctance, they have reduced their offering rates on negotiable CD's by more than 100 basis points to below 4½ per cent.

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Capital Market Response to Monetary Easing

The capital markets have also had to handle an exceptionally heavy volume of flotations. During the first quarter, gross new corporate security offerings were close to $6 billion, and state and local governments floated another $3.8 billion. As the January volume passed through the market and the volume of prospective issues grew steadily, yields on long-term issues turned up in early February. However, the reduction in reserve requirements generated renewed investor interest, and yields began to move down again.

The record March calendar of new publicly-offered securities of all types, for the most part, was successfully distributed at declining interest rates. However, just prior to the discount rate reduction effective April 7, investors had shown some resistance to further yield markdowns on both corporate and municipal bonds. But investor interest in both corporate and municipal bonds was stimulated by the discount rate action, thereby reducing somewhat the buildup in unsold bonds.

At current levels, yields on new corporate bonds are still about 1/5 of a percentage point -- and municipals about 1/8 of a percentage point -- above their early February levels. The net decline since the 1966 highs of late summer has thus amounted to approximately three-fourths of a percentage point on new corporates and three-fifths of a percentage point on municipals.

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New issues of publicly-offered debt aggregated more than $3.9 billion in March, and this huge volume was a major factor inhibiting yield declines since late February. Included in the total was nearly $1.7 billion of corporate bonds, an all-time high for any month. Also included were $1.2 billion of municipals, $750 million of participation certificates and $300 million of foreign and World Bank bonds.

The April calendar of public debt offerings may total roughly $1.5 billion less than March. If it does, it should relieve some of the pressure on yields from the weight of new offerings.But corporate bond offerings estimated at $1.0 billion or more in April will exceed a year ago by about $375 million, indicating that immediate corporate demands for long-term funds are still high. Moreover, the May and June forward calendars have been building up rapidly, so that even though no repeat of the March experience is likely, corporate debt financing will remain relatively high in the second quarter. Municipal debt issues are also expected to drop off in April from the record first quarter pace of offerings which averaged over $1.2 billion a month.

Response of the Mortgage Market to Monetary Easing

The tone of the mortgage market has also improved with the easing in monetary policy. However, the response in this sector has been less dramatic than in the case of bank lending and capital market flotations.

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This difference in behavior, of course, is partly due to the situation of savings and loan associations (S&L's) and mutual savings banks which play such a dominant role in the mortgage market.

Nevertheless, the decline in yields on market securities has enhanced the attractiveness of S&L shares and savings and time deposits in banks. The inflow of funds at S&L's expanded at a 6.2 per cent seasonally adjusted annual rate in December and January, and the February rise was about 9.5 per cent. Net inflows at mutual savings banks rose at a seasonally adjusted annual rate of 7.8 per cent in December and January and at 10 per cent in February. This was clearly a dramatic turnaround for the S&L's compared with their experience in 1966. In fact, the February growth in share capital at S&L's was only 7 per cent below the previous peak for the month, recorded in 1963. Moreover, the rise experienced by mutual savings banks was greater than that registered last summer and fall, which had already shown an increase in response to the higher deposit rates posted at mid-year.

While the principal mortgage lenders were still gaining sizable amounts of new funds in March, new loan demand expanded only moderately and the supply of existing mortgage loans expanded slowly. The result was a further easing in the mortgage market, including further declines in home mortgage yields.

Through February alone, home mortgage rates have shown the most rapid decline immediately after a turning point on record. As measured by the FHA secondary market series, mortgage rates decreased by about 35 basis points from November through February. Over the same period,

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yields on conventional loans declined by roughly 20 basis points. In fact, the decline in conventional mortgage yields in the three-month period December through February was four times as great as the decline registered in the first three months following the cyclical peaks in mortgage rates in October, 1957, and January, 1960. For FHA loans, the most recent 3-month decline was even greater relative to those which occurred in the earlier periods.

Nevertheless, neither S&L's nor mutual savings banks greatly expanded the acquisition of mortgages during February. In fact, in January, the latter institutions acquired about as many securities as they did mortgages, and the pattern was apparently repeated in February -- hardly a picture of aggressive mortgage activity.

Moreover, S&L's on the surface have been equally inclined to employ the sizable inflow of funds other than to make new loans. From the beginning of January through the third week in March, S&L's repaid approximately $1.7 billion of their outstanding indebtedness to the Federal Home Loan Bank System. Since late last July, when such indebetedness reached a peak following the large withdrawals of share capital last summer, S&L's have repaid a total of over $2 billion to FHLB's. In consequence, the FHLB System has been able to retire more than $1 billion of its own debt since the beginning of February, and it still holds unusually large reserves.

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Market Decisions and Interest Rate Reductions

As I mentioned above, a number of observers have serious doubts about the ability of many financial institutions (particularly S&L's and mutual savings banks) to reduce further either the rates paid to savers or the rates charged on mortgages. What is even more distressing, many participants in these industries seem to be similarly convinced. Because of these convictions, an increasing number of persons is urging the Federal bank supervisory agencies to use the authority granted by Congress last September to order a reduction in the maximum rates payable on time deposits and share accounts.

As I have stated publicly, I believe it would be a serious mistake for Federal agencies to get into the habit of substituting their judgements as to a desirable rate structure -- on a quarter-to-quarter basis -- for those of the managements responsible for the conduct of the affairs of particular institutions.

My own position, which I have expressed before, is this: under normal circumstances, there should be no invariable ceilings set by Congress on rates payable by member banks. But given the possibility that competition among financial institutions for savings can at times become excessive and thus destabilizing to the entire economy, standby authority for regulatory agencies to set variable ceilings should be available to be used as needed.

In reaching this position, I am not unmindful of the fact that many depository institutions compete in imperfect markets and thus

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run the risk of losing deposits (or gaining them at a slower pace) if they were to attempt a reduction in rates while their competitors continued to advertise higher rates.

On the other hand, if an institution discovers (as many are now doing) that it cannot profitably employ the large volume of funds it is receiving because of its high posted rate, it might well ask itself just how far it is willing to go in the face of shrinking profit margins. My hunch is that many institutions will conclude that it is worthwhile trying to experiment with offering lower rates to savers on at least some kinds of instruments. Moreover, given the posted rate on deposits or share accounts, they may also be induced by the need to employ their funds to offer lower lending rates to attract potential borrowers.

Of course, my own view of the way depository institutions might behave may be simply wrong. On the other hand, fragments of evidence are beginning to appear which suggest that some institutions are prepared to respond to the forces of competition in the market place in the adjustment of interest rates. For example:

- First National City Bank, New York City, has reduced its rate on consumer savings certificates from 5 per cent to 4 3/4 per cent.

- Bankers Trust, New York City, has restricted eligibility of holders of consumer-type savings certificates to individuals and non-profit organizations and lowered the maximum amount of certificates to $50,000.

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- Watertown Savings Bank, Watertown, New York, has reduced its rate on savings deposits from 5 per cent to 4½ per cent, effective May 1.

Among S&L's also there apparently have been relatively few announcements of reductions in dividend rates. But some have occurred:

- In Sacramento, California, from 5¼ per cent to 5 per cent -- while other S&L's remained at 5¼ per cent.

- One each in Tucson and Phoenix, Arizona, from 5 per cent to 4¾ per cent (while simultaneously announcing higher-yielding certificate plans). Among other S&L's in Tucson, the prevailing rate remains at 5 per cent.

- One each in smaller cities in Texas and New Mexico, from 4 3/4 per cent to 4½ per cent.

Moreover, a fairly large number of S&L's have cut the maximum rate on certificates from 5¼ to 5 per cent. Still others apparently are set to do the same. Furthermore, many S&L's are no longer advertising high rate certificates. In a number of areas, the reduction in certificate rates appears to have been widespread, including Miami, Fort Lauderdale, Palm Beach and Tampa, Florida; Fort Worth, Odessa and Midland, Texas, and Southeast Minnesota. A few cases have also been announced in Cleveland, Washington, D.C., and in Missouri and Nebraska. In many of these areas, certificate accounts represented one-quarter or more of the total savings held by the S&L's which reduced the rates offered.

Let me emphasize again that the above cases are cited as illustrative of the decision of some institutions to cope with the task of interest rate adjustment without relying on direction from the Federal Government. So far, the institutions which have followed this course account for only a small part of the total savings flow to depository institutions, and

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their impact on the general structure of rates is hardly noticeable. Nevertheless, they have demonstrated their commitment to the vital role of private market decisions in the allocation of funds. I wonder how many other institutions -- especially among those with the capacity to affect in a significant way the structure of interest rates on savings and mortgages -- are also prepared to act with similar conviction and determination? Or -- will they -- despite a basic ideological attachment to free market processes -- quietly await the word from Washington?

As far as Washington is concerned, I believe that we can afford to wait somewhat longer for competitive market forces to bring about a lower structure of interest rates -- rather than attempting to establish such by setting a lower rate ceiling. In the first place, rates generally (including some deposit and mortgage yields) have been moving downward under the sizable expansion of bank reserves brought about by an easier monetary policy. Moreover, the recent reduction in the Federal Reserve discount rate from 4½ per cent to 4 per cent should give greater impetus to the downtrend -- even in the mortgage sector. Still a further downward nudge in mortgage interest rates should follow from the reduction earlier this week in the FHLB's rate on outstanding advances from 5 3/4 per cent to 5½ per cent.

Thus, against the background of general market developments to date, I think it would be well for all of us to give the market a real chance to bring about the lower structure of deposit and mortgage rates which is sorely needed.

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