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Current Business and Monetary Developments

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Keeping informationally abreast of financial markets over the past two and a half years has been a challenge to almost everyone--and that includes professional observers and interpreters. In consequence, contemporary comment on evolving financial conditions recently has often been obscure or inconsistent. Ordinarily we expect a certain amount of deliberately infused confusion in financial expectations and a certain amount of incompetent misjudgment, but the period we have been going through is particularly distinguished for honest confusion. Nowhere is this more evident than in the evaluation of the adequacy of monetary policies to the needs of the economy, given the vulnerability to disintermediation of the nation's financial institutions and established patterns of financial behavior.

It takes a long trip back in memory for me--and perhaps for you--even to recall the placid period of the early Sixties, with its stable prices and interest rates and what--in retrospect--almost everyone would regard as a well-balanced growth in monetary and economic aggregates. I do not need to review here the factors leading up to the very tight markets of 1966. Financial markets did begin to relax late in that year, and monetary policy did, too. And for a while it began to look as if 1967 might be a year in which we at the Federal Reserve could devote less time to fighting fires and more energy to pushing ahead on our fundamental studies of the discount mechanism and the U.S. Government securities market. We have, indeed, accomplished much in those respects, but financial markets, too, have remained highly active and demanding of attention.

Long-term interest rates last year reached levels higher than we've seen at any time in this century; Federal government borrowing during the last half of the year was the largest since the Second World War; and the money supply--currency and demand deposits in the hands of the public--grew more rapidly over the year than at any time since 1946.

These diverse developments have posed problems for many concerned with financial markets. Some have thought money has been too easy recently but are puzzled by its high cost. Others who think money is too costly also wonder if it is not too readily available. How to reconcile the developments underlying these two views is a question that reaches perhaps to the heart of an explanation of current monetary developments.

Financial Flows and Liquidity

The critical element to understanding the financial environment--and one that has implications for the future--is the interpretation given to the pervasive and strong demand for liquidity on the part of the consumers, business firms, and financial institutions in 1967. The behavior of these groups last year was in large part conditioned by the financial events of 1966. But it was also predicated on expectations concerning the future.

Generally speaking, banks and other lenders last year made sizable acquisitions of liquid assets while corporations and some other borrowers made strenuous efforts to obtain large sums in long-term markets. Such behavior--on the part of lenders and borrowers alike--was generally prompted not only by the need to restore financial positions that had eroded with the tight money pressures which culminated in 1966 but also by the desire, hopefully in their interest, to provide a safeguard against the recurrence of such pressures. Since then, expectations about the recurrence of financial pressures have been fluctuating with the state of our involvement in Vietnam and with Congressional attitudes toward the tax increase proposals.

To look at developments in specific sectors, consumer demand for liquidity in 1967 was evident in an unusually high rate of saving, in a shift of saving into depository claims, and in a reluctance to borrow. During 1967, on average, consumers saved about 7 per cent of personal disposable income, a full percentage point more than in any year in almost a decade. And a full percentage point translates into sizable dollar amounts--about $5-1/2 billion at current levels of income.

At the same time, individuals were liquidating market securities. In good part this shift reflected the more convenient accessibility and attractiveness of deposit-type instruments offered by financial institutions, as short-term market interest rates became much less competitive and moved well below peak 1966 levels. Consumers also added sizable amounts to their demand deposits, which, of course, earn no interest. And despite the relative ease of credit availability, instalment credit extensions last year rose only 1-1/2 per cent, as consumers spent relatively little on durable goods and appeared reluctant to borrow in order to finance what they did spend.

The psychology and reasoning behind the behavior of consumers are often a mystery, and last year was no exception. But one might hypothesize that consumers became extra cautious because of the Vietnam War and social disorders or perhaps in resistance to the accelerating rise in the price of goods or in desire to provide a cushion against any reductions in disposable income generated by anticipated and actual hikes in Federal, State and local taxes. Their mood is still obscure.

The financial behavior of businesses last year is, by now, an epic episode in corporate psychology. Corporate borrowing in long-term markets reached levels that not only surprised all observers, in view of the very small rise in spending on plant and equipment, but pushed rates and terms beyond any experienced in the century. Corporate new bond issues (public and private placements) accumulated to almost $22 billion, over one-third higher than in 1966. Long-term borrowing, on such a scale, appears to have been related mainly to efforts to restructure financial positions, given the 1966 experience and expectations of higher interest rates and credit tightness to come.

With business needs reduced and financing concentrated in security markets, business borrowing at banks was less than in 1966. By now, moreover, businesses have been able to restore credit lines or commitments to a significant degree. Businesses also have been able to build up their liquid assets to some extent, including not only time deposits at banks and short-term paper but also demand deposits. While it does appear that most of the rise in money supply ended up as demand deposits in the hands of consumers, businesses also added somewhat to cash balances, partly perhaps in the form of compensating balances or at least balances that might be potentially compensating. If I sound allusive about the distribution of cash holdings in the economy and its causes and uses, let me add that it is because, unfortunately, we do not yet have direct measures that break out private demand deposits by ownership and enable us to guage the rate at which these deposits are used, or held idle, by the various groups.

These demands for liquidity by consumers and businesses, and also by banks and other financial institutions, could be accommodated last year because monetary policy actions added significantly to the reserve base of banks and encouraged a level of short-term market interest rates that was low relative to the year before. As a result, net inflows of funds to banks and nonbank financial institutions were very sizable for most of last year, in sharp contrast to the often large deposit outflows of 1966. Savings and loan shares and mutual savings bank deposits increased around $16 billion--a record amount. The increases were rapid enough to enable these institutions both to rebuild liquidity and to increase the availability of funds to mortgage markets by $11 billion.

Savings and loan associations rebuilt liquidity by increasing their holdings of U.S. Government securities and by repaying a very substantial amount of short-term borrowings, mostly from the Federal Home Loan Banks. Reflecting the repayment of these borrowings, the Home Loan Bank's ability to meet future needs of savings and loan associations has been sharply improved, following a retirement of almost $3 billion of its short-term debt and a buildup in its portfolio of Governments.

Mutual savings banks invested very heavily in corporate securities, as well as in mortgages, with the growing attractiveness of corporate yields relative to those on mortgages. Insurance companies, as well, apparently found corporate securities quite attractive relative to mortgages. They added corporates to their portfolios in sizable amounts. Life insurance companies had more funds available for such investments relative to 1966, in part due to a lesser use of cash flows for loans to policyholders.

The commercial banking system was perhaps the chief beneficiary from the public's demand for liquidity last year, through rapid growth in both its time and demand deposits. In turn, banks placed a considerable portion of the rise in their deposits in U.S. and State and local government securities rather than loans.

As a matter of fact, demands for bank loans were not strong over the year, and over one-half of the rise in bank assets last year was in the form of securities. Banks made the largest acquisitions of Treasury debt since 1958 and made record purchases of other securities, primarily municipals. Banks also managed to improve their liquidity positions compared to 1966 levels, as measured by loan to deposit or liquid asset to deposit ratios, but bank liquidity remained less than it had been before 1966.

Whether, or to what degree, banks and other financial institutions are in a position, or are motivated, to continue improving liquidity is a matter of conjecture. Financial institutions experienced the largest inflows of funds in the first half of last year, and after six months of record inflow some were experiencing the pangs of excess liquidity. But by the second half of the year, and particularly in the last few months of the year and into early 1968, market interest rates--both short- and long-term--had risen to levels that were reducing the extent to which the public was willing to acquire and hold time and savings deposits and accounts, given the legal ceiling rates that could be offered on such deposits. There has been, consequently, a significant reduction in the net inflow of funds to banks and others. But the reduction was not as great as many had feared and it was received with relative and perhaps surprising calm in financial markets. In part this can be attributed to the already improved liquidity position of the institutions and the stratification for selective treatment of interest-sensitive funds, but it might also be attributed to their relative prudence in extending forward commitments. In addition, market interest rates in recent weeks backed off some from earlier peaks, and the feared market pressures did not tend to cumulate.

Interest Rates

The liquidity demand forces that were so prevalent last year had a twisting--or maybe reverse twisting--influence on the structure of interest rates. While interest rates generally rose after spring, long-term rates were under relatively more pressure than short-term rates, as precautionary motives persuaded individual and institutional investors to prefer, relatively speaking, short-term assets, while borrowers moved into long-term markets.

Short-term yields had declined rather sharply from the fall of 1966 through mid-1967, as you may remember. They then began to rise after midyear. And long-term rates began to show an accelerated rise, mainly as a result of the burgeoning of corporate bond market flotations.

The upward movement of the whole interest rate structure was in good part a result of the large Federal budgetary deficit that developed in the absence of a tax increase. The Federal Government was a direct factor in the credit markets as a whole in two respects. By its July-December record deficit (some $20 billion on a cash budget basis) and borrowing in the market it placed interest rates under direct upward pressure. Most borrowing was relatively short-term in nature, but a few sales of participation certificates were also effected and new intermediate-term direct debt was issued. Secondly, uncertainties relating to the Government's fiscal and other policies led to frequent reassessment of expectations by market participants, and resulted in wide oscillations in market interest rates superimposed on a generally rising trend. The more important of these uncertainties were the status of the Administration's proposed tax increase, the course of the war in Vietnam, including the likelihood for peace, and, late in the year, the nature of the governmental program that would be developed to improve the U.S. balance of payments position.

During the last half of 1967, the urgency of a program of fiscal restraint seemed more and more apparent as the economic outlook became more bullish and as our balance of payments situation deteriorated. Moreover, the devaluation of the pound last November served, among other things, to focus attention on the international value of the dollar. In this environment, the Federal Reserve, as you will recall, raised the discount rate by 1/2 percentage point to 4-1/2 per cent. Also, reserve requirements on demand deposits in excess of $5 million were raised by a 1/2 percentage point--an increase that took effect in mid-January.

Most long-term interest rates had risen to levels well above their 1966 peaks in the fall of last year. They showed relatively little reaction in the wake of the British devaluation and the Federal Reserve actions. Short-term rates rose somewhat further, but remained below their 1966 peaks. And, as I have already noted, pressures in short-term markets appear to have abated somewhat most recently.

Interaction of Financial and Nonfinancial Developments

The rapid growth in bank reserves, bank credit, and liquid assets last year not only contributed to moderation of interest rate pressures, while accommodating liquidity demands, but it also encouraged spending in key economic sectors during a period, the first several months of 1967, when industrial output was declining. Thus, what might have been a contraction in over-all economic activity during the first half of last year--when businesses were rapidly cutting back on their rate of inventory accumulation and cutting production in the process--was kept to a pause. And the groundwork was laid for the quick resumption in the second half of last year of a much more vigorous rate of growth in economic activity--although one that at existing levels of employment carries inflationary dangers, as was attested by the accompanying accelerated rise in wholesale and retail prices and by the deterioration in our trade surplus with foreign countries.

The increased availability of financing last year had its most notable effect on construction outlays, which had been reduced markedly in the 1966 period of stringency. The greater net inflows to savings institutions enabled them to expand commitments to mortgage borrowers. Life insurance companies were fairly active in the mortgage market, but the competition as the year progressed of high and rising long-term market rates of interest served to moderate the growth in funds that insurance companies made available to finance construction. And the potential slowdown in saving inflows as short rates rose also caused savings institutions to reduce the extent to which they undertook forward commitments during the latter part of the year. Nevertheless, enough of a start had been made early in the year so that construction activity advanced throughout the year--and quite sharply after the first quarter, as housing starts moved rather continuously upwards from the postwar low of October 1966.

The easing of financial conditions also enabled State and local government expenditures to continue their fairly steady annual rate of growth, even in face of a relatively slower growth in their tax revenues. Net borrowing by State and local governments was considerably more last year than the year before, despite substantial postponements of new issues in the final months of the year in response to the high levels of yields that emerged. So large a volume of borrowing was made possible by the return of commercial banks as large, not to say predominant, investors in such securities. Banks last year purchased municipals at a much more rapid pace than their previous record rate in 1963.

While outlays for housing, and services provided by State and local governments, on the face of it, appear to have been the chief beneficiaries of the enlarged availability of funds last year, the ability of businesses to borrow was also improved. Demands on banks were reduced for the liquidity and expectational reasons already mentioned. But the reduced need for inventory financing in the period was also a factor that kept business demands on short-term markets at relatively moderate levels. At the same time, the fact that the inventory adjustment did not turn into an outright inventory liquidation might be attributed, in part, to the easier position of banks, who were no longer under strong pressure to restrain their lending to businesses.

Implications

Perhaps this review of the forces at work in credit markets last year has left you as puzzled as the financial markets themselves, not to mention financial analysts, appear to have been for some months now. If so, I hardly blame you. The markets are puzzling indeed. The key facts seem to me to be that the overwhelming demand to replenish liquidity reserves, which had been depleted in 1966, was accommodated through a rise in the stock of liquid assets outstanding, including money. The rapid rise in the money supply occurred in the context of only a moderately growing GNP (particularly in real terms) for the year as a whole and rising interest rates. In effect, the easier monetary policy permitted the public's demand for liquidity to be met without serious dislocations in the economy--to be specific, without still sharper rises in interest rates or a more prolonged pause in economic activity than actually occurred early last year. One might well ponder just how high interest rates might have gone, and how depressed the real growth of the economy might have been, without such a rapid growth in bank reserves and in the stock of money.

With respect to where financial markets go from here, no one can look forward with any great certainty, in view of such imponderables as taxes, war or "peace," and how consumers will or will not spend their income. As I have tried to point out, banks, other financial institutions, and the public all appear to be in somewhat more comfortable positions now than they were at this time last year. On the other hand, net inflows of funds to these institutions have slowed down recently, and long-term interest rates are much higher than they were a year ago. Thus, one might say that financial markets do not appear to have any real slack in them. Maybe this is just another way of saying monetary policy was not overly easy last year; nor was it overly restrictive.

While I cannot foretell how pressures on credit markets are going to develop from here on, I can point to some of the specific areas which appear critical. Will offerings of corporate bond issues continue to abate? Will consumers find that they are liquid enough and begin to spend more, borrow more in the process of doing so, and reduce their demands for liquid assets? Will Congress bring the budget into closer balance? What will be the impact of the new balance of payments program abroad--and at home?

And you will have another question--what about monetary policy? If I knew the answers to the above questions, I could almost tell you what monetary policy would do. But I don't--like you, we at the Board will be waiting most watchfully.