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Federal Reserve Policy and the Liquidity Squeeze

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In the postwar years we have become conditioned to expect that the sequel to periods of excessive economic activity will be counter-acting policies of monetary restraint. Such monetary shifts may promptly induce precautionary cutbacks in commitments and spending by some sectors of the economy, but the usual sequence of events includes enforced reductions in the liquidity positions of those sectors of the economy where an attempt is made to continue "business as usual." The period 1967-1970 is illustrative; households cut back early on their spending and commitments but financial institutions and businesses responded to restraint only after their liquidity positions had been significantly curtailed. In fact, the extent of the deterioration in liquidity was much greater in these sectors than it had been in comparable previous cyclical periods, partly because monetary restraint was maintained for a longer period of time in order to successfully combat inflationary pressures as well as expectations of further inflation.

Not the least of the influences extending the period of restraint was the credibility gap so prevalent for a time in banking, business and investment circles. Many believed that inflation could not be brought under control or that the Federal Reserve would not persevere in its policies. Another retarding factor was the widespread attempt throughout the various sectors of the economy to avoid the impact of public policies of restraint.

While these avoidance techniques took a variety of forms-- some new and some old, as you know--they nevertheless quite clearly represented judgments of both borrowers and lenders as to how far and how long to run down liquidity positions in order to finance an unabated level of activities and commitments.

In the nonfinancial corporate sector, liquidity-- conventionally measured by the ratio of cash and U. S. Government security holdings to total current liabilities--has been trending down throughout the postwar period, almost without interruption. This appears to reflect a deliberate policy on the part of corporate treasurers to tap other sources of liquidity or to seek greater profits from their cash positions, even at the risk of greater exposure to liquidity risk. In any event, the erosion of conventional liquidity accelerated sharply in 1969 and continued into at least the early part of 1970.

The limited availability and sharply higher cost of credit in 1969-70, in conjunction with heavy capital spending programs and enlarged working capital needs, virtually forced corporate managements to further economize on liquid asset holdings. Doubt that a restrictive monetary posture would persevere and euphoric attitudes about inflationary trends seemed to generate a willingness to erode financial flexibility much more than would have been viewed as prudent only a few years ago. Although there is really no way of knowing what

level of liquidity is critical for the corporate sector as a whole, or for various industries and firms, the early 1970 liquidity position over-all did not, by historical standards, leave much flexibility for an adverse change in economic prospects. The 1969-70 experience, mirroring the consequences of a move toward more monetary stability, must be causing some reappraisal of corporate liquidity requirements today.

Much earlier in the period of restraint, but in a similar way, commercial banks with a much less plausible credibility attitude considering their sophistication in monetary matters had also constrained their flexibility by very rapidly running off liquid asset holdings to meet deposit drains, loan commitments, and other obligations. By mid-1969, the general level of liquidity in the banking system was below that reached in 1966, the previous year of similar circumstances, and it was still declining through the spring of this year. Standard liquidity measures, however, do not reflect the degree to which banks placed increased reliance on non-deposit sources of funds and on foreign and domestic pools of relatively "hot" money. In the process, the rules of money position management were changed, liquidity no longer depended on run-off flows or on portfolios that could be sold outright but on what could be contingently sold, transitorily borrowed or collaterally arranged.

Other financial sectors were not immune to the liquidity squeeze. Savings and loan associations and mutual savings banks reduced liquid assets to meet outstanding mortgage commitments when deposit inflows slowed, but mainly the savings and loan associations borrowed heavily from the Federal Home Loan Bank System. Life insurance companies experienced liquidity pressures from a rapid expansion in policy loans, although their relatively cautious commitment behavior earlier did not leave them as exposed as was the case in 1966.

The liquidity position of the household sector--in contrast to that of the corporate and financial sectors of the economy--did not decline significantly during 1969 and has improved appreciably this year. In part, this performance is accounted for by moderation in spending and the unusually high savings rate in the economy during a period of strong gains in personal incomes. The income side not only reflects maintenance of relatively high levels of economic activity, but also large wage increases and special income supplements including retroactive Social Security benefits. Households have acquired a large volume of liquid assets, particularly claims at commercial banks and the nonbank thrift institutions this year. Moreover, growth in consumer debt outstanding has been modest, as consumer willingness to assume additional debt has eroded with the apparent increase in uncertainty over the economic outlook. Hence, the liquidity squeeze evident in other sectors of the economy has not occurred in the household sector.

With liquidity limited throughout the financial and nonfinancial business sectors, there was a danger that the slow-down in economic activity that accompanied efforts to curb inflation would be associated with relatively widespread liquidity problems. In light of the widespread and strongly held views of many business managements as to the certainty of continued inflation, liquidity problems for their concerns became more and more critical as the economy cooled. But it was essential that a widespread loss of confidence due to general illiquidity be averted in the transition from a period of inflationary growth to one of non-inflationary growth.

The Federal Reserve in 1970 acted in a variety of ways to ensure that this could not happen. As early as January, the Federal Reserve Board, in coordination with the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board, moved to limit the pressures on depositary institutions by raising the maximum rates payable on consumer-type claims at commercial banks and on deposits at savings and loan associations and mutual savings banks. By permitting these institutions to better compete against the attractiveness of yields on market securities, it was hoped that an improvement in their fund inflows

would strengthen liquidity positions and provide a framework for an expansion in the commitment of funds to the mortgage market. To a significant degree, this goal was achieved and the nonbank savings institutions were insulated from the liquidity squeeze that emerged later.

As the outlook for corporate profits became more consistent with an effective anti-inflationary policy, securities markets came under unusual pressures in the spring. Bond yields began to rise and stock prices plunged. While the disturbing nature of domestic and international developments at the time were no doubt deeply related to the crisis of confidence, investors and lenders, nonetheless, began to reflect more carefully upon the quality of various credits.

In this atmosphere, it was made clear that the Federal Reserve's policy stance had been changed and that it was now moving toward a resumption of moderate monetary growth. The directive to the Manager of the System Open Market Account was revised to be more responsive to the change in attitudes and avert an all-out scramble for funds. Excessive pressures on financial markets were moderated by the System's more liberal provision of reserves, without generating sustained rapid growth in the monetary aggregates that would have been inconsistent with longer run objectives.

The April-May period of unsettling events was followed by the filing of bankruptcy proceedings by the Penn Central in late June. This event showed just how fragile confidence was and called for immediate, convincing action by the central bank. Interest rate ceilings on large denomination negotiable certificates of deposit with maturities of less than 90 days were suspended so as to enable banks to attract funds in volume, and thereby accommodate the expected surge in loan demands by those industrial and finance company borrowers who could not obtain funds in the commercial paper market. As it turned out, bank credit demands by such borrowers amounted to more than \$2-1/2 billion.

Not all of these funds were provided by sale of CD's. Some came, temporarily, from a liberalization of Federal Reserve discount policy that was designed to insure the availability of funds to firms imperiled by temporary circumstances. Borrowings at the discount window rose 90 per cent as banks necessitously turned to the lender of last resort or probed the extent of its resolution. System open market operations were geared to ensuring that financial conditions remained stable and recognized that more money supply and bank credit growth might have to be permitted for a time than would be desired over the longer run. In addition, the

Federal Reserve prepared stand-by procedures to make credit available to worthy borrowers facing unusual liquidity requirements that could not be met by obtaining funds from other sources. The last step proved to be superfluous. The commercial banking system, given the System assurances, dealt promptly and expertly with emergency liquidity needs that had arisen.

It appears that we have successfully weathered the liquidity squeeze and, barring any further disturbances to financial and business confidence, can look forward to more tranquil markets. Some individual problems may still remain to be worked out, but the risk of a cumulative general problem of illiquidity seems behind us. Indeed, short-term and long-term interest rates have declined substantially on balance over the past few months. Major attention may now be devoted to the goal of attaining stable economic growth without inflation.