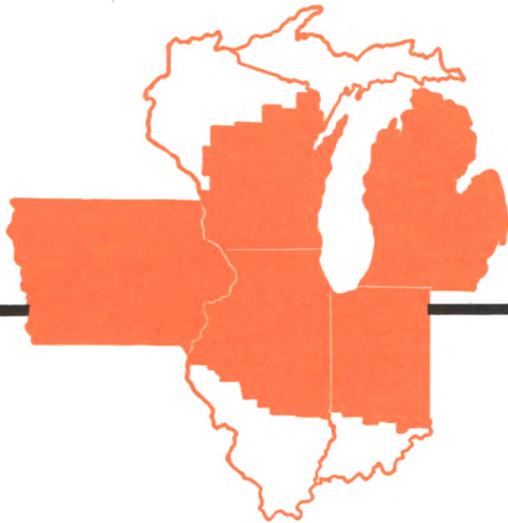


Business Conditions

1968 March



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THE Trend OF BUSINESS

Some businessmen with declining backlogs of orders question the vigor of the uptrend in total spending and output. Moreover, some economic analysts, viewing aggregate demand as less than strong, have warned of a possible "overkill" of inflationary pressures if federal expenditures are restrained and income taxes raised. But growing stresses on the nation's resources are evident.

Employment and new orders have risen sharply since October. Retail sales, slow in the closing months of 1967, spurted in January and the stronger trend appears to have continued in February. Business inventories are rising again on a large scale, backlogs of construction contracts are growing, order lead times for manufacturers are stretching out, the unemployment rate is the lowest since the Korean War, and the uptrend in prices of services and finished goods continues unabated. All these signs suggest that inflation dangers remain very real.

One of the most promising developments of recent months has been the slower growth of defense spending and, based on the new federal budget, the expectation that fiscal

1969 will see only a small increase from fiscal 1968. But the increasing North Korean belligerence and Viet Cong offensive suggest that defense outlays may rise more than planned. Meanwhile, personal income has continued to rise rapidly, and liquidity positions of individuals, businesses, and financial institutions have improved. The potential of the private sector to increase outlays further remains large.

Demand for labor

One of the fundamental economic facts of early 1968 is the short supply of workers in most industries and in most regions of the country. An estimated 3.5 percent of the labor force was unemployed in January—the lowest in 15 years. The yearly averages in 1966 and 1967 were 3.8 percent. In 1961, it was 6.7 percent.

For married men the January unemployment rate was only 1.6 percent, less than the averages for 1966 and 1967, which were the lowest in a series dating back to 1954. Married women have accounted for much of the fluctuation in total unemployment in the past

BUSINESS CONDITIONS is published monthly by the Federal Reserve Bank of Chicago. George W. Cloos was primarily responsible for the article, "The trend of business," Dorothy M. Nichols for "Reserve management made easier," and Larry R. Mote for "Regulation Q ceilings—a relief but no cure."

Subscriptions to **Business Conditions** are available to the public without charge. For information concerning bulk mailings, address inquiries to the Federal Reserve Bank of Chicago, Chicago, Illinois 60690.

six months. Many of these women enter the labor force temporarily to gain extra income. This situation, in itself, reflects the tightness of the labor market.

Labor shortages are reported in such varied industries as steel, oil-well drilling, and construction. Shortages are general in the professions and in skilled workers. The civilian labor supply is, of course, reduced by the large number of men in the Armed Forces and in colleges and postgraduate programs.

In January, 66.1 million workers were employed in nonfarm jobs. That is 1.6 million more than a year before—a rise of 2.4 percent. This rise, while substantial, was only half the increase from a year earlier in each of the two previous Januarys and reflects full-employment conditions. Manufacturing employment was equal to the record year-earlier level in January, but large gains have been made in trade, service, and state and local government.

In the Midwest, the increase in employment over the last year was only about half as great as in the nation. The difference was in manufacturing, where employment in the Midwest was about 3 percent less than a year ago, mainly because of reductions at machinery and equipment plants. Nevertheless, unemployment rates in Illinois, Indiana, and Iowa continued to be appreciably less than in the nation. These rates were slightly higher in Wisconsin and Michigan than in the nation, but still low compared with the early 1960s.

Tight labor markets and rising living costs encourage organized labor to seek pay increases managements are often not prepared to grant. The result has been a wave of strikes. In 1967 more work stoppages (4,500) occurred and more workers were involved in strikes (2.9 million) than in any year since 1953. Man-days idle because of strikes (exclusive of indirect effects caused by shortages

of materials or services) exceeded 40 million—the most since 1959, which included a long steel strike.

The most important strikes in the Midwest in 1967 came in the final four months of the year and affected the automotive and farm and construction equipment industries. Most of these disputes were settled by year-end, but work stoppages reduced auto production again in January and February.

Regardless of the merits of the issues, work stoppages resulting from labor disputes reduce efficiency and output to an extent measured only partially by direct man-days lost. The impact on customers and suppliers and the secondary effects related to shutdown and startup operations also tend to slow deliveries and raise costs. In short, these stoppages are inflationary quite apart from the terms of the eventual settlements.

The budget deficit

Seldom has the President's budget message been read with such widespread interest as in early 1968. First, the budget was presented in a new form—the unified budget recommended by the President's Commission on Budget Concepts. Second, it was viewed for evidence of long-awaited plans to slow the rise in federal outlays.

Total federal outlays, including expenditures and net increases in lending, are projected at \$186 billion in fiscal 1969—the 12-month period ending in June 1969. Assuming enactment of the 10-percent surcharge on income taxes—effective for corporations January 1, 1968, and for individuals April 1—and other less important revenue measures, receipts are expected to amount to \$178 billion. The resulting deficit would be \$8 billion, compared with \$20 billion in fiscal 1968 and \$9 billion in fiscal 1967. Without the proposed revenue meas-

ures—which are expected to yield more than \$3 billion in fiscal 1968 and \$13 billion in fiscal 1969—the prospective deficits for these years presumably would be larger by similar amounts. Until 1968, by far the largest federal deficit since World War II was \$13 billion for fiscal 1959.

Federal outlays are expected to rise \$10 billion in fiscal 1969, compared with a \$17 billion probable increase for 1968. Of the increase, \$3 billion is for defense, almost all related to Vietnam.

In recent months, a number of congressional leaders have opposed any general tax increase, and surveys show that most of the public holds a similar view. As a result, the proposed measures remain in doubt.

Total federal outlays have been rising faster in recent years than total spending on goods and services (measured by the gross national product). It now amounts to about 22 percent of this total. If they are accurate, the current budget estimates would indicate

a rise in federal outlays about proportional to the increase in total spending in fiscal 1969. But budget estimates have tended to underestimate actual outlays—some years by substantial amounts.

Even assuming the outlays are not underestimated and assuming prompt enactment of the proposed tax increase, the overall impact of the federal budget would be expansionary—that is, the federal government would be disbursing more than it raised in tax revenues. Without the increase in revenues resulting from the proposed tax measures, the much larger federal deficit would add substantially to inflationary pressures on an already taut economy.

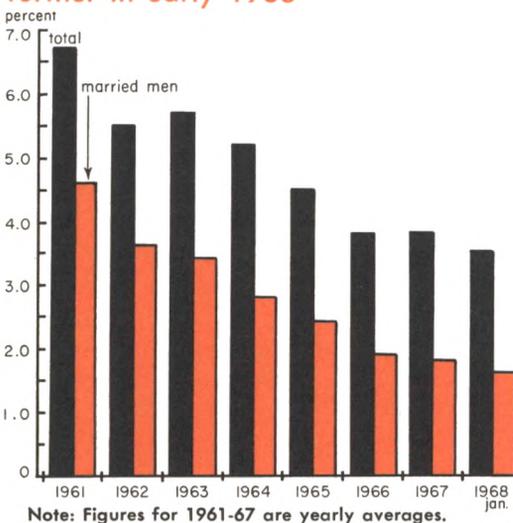
Inventories and orders

Business inventories increased \$2.3 billion in the last two months of 1967, and accumulation probably continued at a high rate early this year. Inventories rose faster late in 1966, but the rise then was largely involuntary, a result of sales failing to match expectations. Attempts to reduce inventories, or at least hold down their rate of growth, were major factors in the marked slowing of the increase in total economic activity in the first half of 1967. Currently, most inventory building is intentional, partly because of expected price increases or possible shortages and partly to replace strike depleted stocks. But, in the main, rising inventories reflect recent and expected increases in sales.

Business sales rose even faster than inventories in late 1967, with the result that the ratio of inventories to monthly sales declined to 1.52 at year-end, compared with 1.58 in October and 1.54 a year earlier.

Inventories and sales have been rising in both durable and nondurable goods. Nevertheless, many companies complain of unbalanced inventories. Such unbalances are a

Unemployment declines further in early 1968



legacy of long lead times required in much of 1966. Multiple ordering in that year to avoid shortages compounded stringencies of supplies, and some of the excess goods acquired as a result of such buying practices have still not been liquidated.

More than half the purchasing agents of Chicago were ordering materials and supplies 60 days or more in advance of delivery in late 1966—the highest proportion since 1955. By December 1967, this proportion had declined to 21 percent, reflecting the easier supply situation. Lead times increased again in January, however, and further stretchouts are expected, especially for steel.

Also suggesting that goods are more available now than in late 1966 is the ratio of manufacturers' order backlogs to monthly shipments. For producers of durable goods, this ratio was 2.98 in January—the lowest since early 1966. Even so, backlogs are much larger relative to shipments than in the years before 1966.

Steel in strong uptrend

Output of steel has been rising since the seasonal low last July. By mid-February, output of raw steel reached a record annual rate of almost 150 million tons. Operations of mills in the Chicago area, like the industry as a whole, also reached a new high in February. Mills in the Detroit area were approaching the record rate reached in the spring of 1965.

By August 1, termination date for current labor contracts in the industry, many steel users expect to have accumulated a month to a month and a half extra supply of steel—as much as twice their normal inventory.

The most recent year in which a steel strike impended was 1965. An agreement was eventually reached without a walkout. Nevertheless, manufacturers increased their steel

holdings from 9.5 million tons in August 1964 to 17.2 million in August 1965. The ratio of manufacturers' inventories of steel to monthly consumption rose from 1.98 to 3.38 in the same period. By spring 1966, these inventories had been reduced to less than 11 million tons and production of steel had declined sharply.

Through December 1967, manufacturers had not yet increased steel inventories from the midsummer level, although consumption had risen. At year-end the ratio of steel inventories of manufacturers to consumption had dropped to 1.59, by far the lowest ratio on record. Steel buying has continued in an orderly manner, and lead times have not lengthened as much as in previous inventory buildups. This is partly because steel mills have been increasing their own inventories of steel-in-process and finished steel in anticipation of customers' orders. Larger imports and increased capacities of steel producers have also helped maintain delivery schedules.

Some steel producers have already stated they are operating at capacity, while others are reopening obsolete facilities. It is not likely that total steel production will rise in the months ahead more than 5 percent from the February level. The demand for current use and additions to inventory could rise much more than 5 percent by midsummer. Any real bottleneck, however, will not be the inability to produce raw steel but the limited capacity to produce particular types and grades of steel that are often in short supply in periods of strong demand—especially such flat-rolled products as sheet and plate.

Probably 7 or 8 million tons of steel will be added to inventories by August 1 and most of this will be liquidated by the year-end. Production in the second half of 1968, therefore, may be down about 20 percent from production in the first half. In addition to

unbalancing domestic output, the strike threat gives added impetus to imports, which accounted for a record 12 percent of the steel used in 1967 and which industry analysts expect to increase substantially this year.

Auto output rises

Most estimates of 1968 auto sales have ranged from 9.0 to 9.3 million units—including about 800,000 imports. This would represent a substantial increase over the 8.3 million units sold in 1967. If the upper end of this range were reached, sales would ap-

proach the 1965 record. Because of higher average prices, the dollar volume would be larger than ever before.

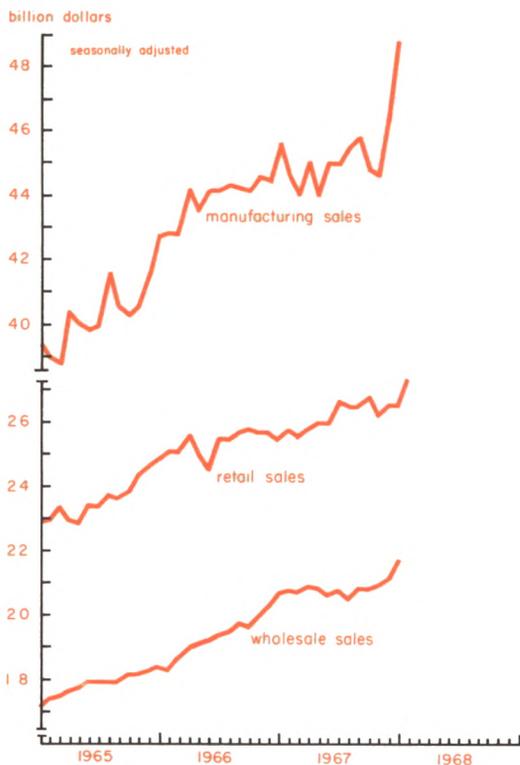
Last year, sales of domestically produced autos were reduced about 300,000 units as a result of strikes. Presumably, most of these potential sales were merely deferred and so will help boost 1968 sales.

Production schedules for the first quarter called for more than 2.5 million passenger cars. This would be up more than 35 percent from a year before and approximate the record high of the first quarter of 1965. Strikes have continued to hamper output, however. In the first half of February alone, output was reduced about 100,000 cars because of new strikes.

About 1,350,000 new cars were in dealers' stocks at the end of January, equal to about 56-days sales. Although the inventory appears large compared with most similar periods before 1967, the automobile industry plans to increase stocks further, to be in a favorable position for the peak selling period in the spring.

January saw record sales of imported cars totaling almost 70,000 units—10 percent of all new car sales. This exceeds the 9-percent proportion of imports last year and equals the record proportion in 1959. After 1959, the proportion of imports to total U. S. sales dropped, reaching less than 5 percent in 1962. Since then, foreign penetration has increased every year. The success of small cars from Germany is being emulated by producers in other countries, especially Japan. As U. S. produced cars have increased in size, power, complexity, and cost, a widening market has developed for imported compacts.

Business sales in sharp uptrend following settlement of major strikes



The need for restraint

A year ago, even before the extent of the inventory adjustment became apparent, there

was hope that inflationary pressures would ease in the second half. Instead, prices rose more rapidly as the year progressed—reaching an annual rate of 4 percent in the fourth quarter. The early months of 1968 have seen little, if any, diminution in this trend.

Declines in prices of food and other farm products helped moderate the general trend of prices last year. These prices are apt to rise in 1968. Announcements of increases for a wide variety of services and finished goods

have continued in recent months.

Recent events in the Far East indicate that the financial burden of defense is not likely to become lighter. Consumers, meanwhile, appear to be stepping up their buying. Construction activity is likely to continue pressing available resources. Inventory is being accumulated rapidly, and orders for producers' equipment are gradually increasing. In meeting these demands, the economy has little to draw on in the way of unused labor.

Reserve management made easier

Technical changes in accounting proposed

The Board of Governors of the Federal Reserve System announced in January that it is considering changes in the procedures by which member banks compute and meet their reserve requirements under Regulation D. Except as they are modified in response to comments from interested parties, these proposed changes are expected to become effective soon.

One-week reserve period. Under the proposal, all member banks would determine their reserve requirements weekly, basing them on average daily deposit balances for seven-day periods ending with the close of business on Wednesdays. Holdings of assets that could be used to satisfy the reserve requirements would also be computed on the basis of end-of-day figures and averaged for the same seven-day periods. The proposal differs from the board's current regulation in two ways:

1. The computation period for "country"

banks would be shortened from two weeks to one. "Reserve city" banks already compute their requirements weekly.

2. Required reserves would be computed on the basis of daily deposits at the *close of business*, instead of the opening of business. Holdings of reserve-eligible currency and coin, now taken as of the opening of business, would also be shifted to the close-of-business basis. A member bank's deposit at the Federal Reserve Bank would be taken as of the close of business, a continuation of current practice.

Lagged reserves. Required reserves for the week would be based on average daily deposits for the reserve period two weeks before. Currency and coin counted in meeting reserve requirements would also be the average daily amounts held in the computation period two weeks before.

The current regulation provides a one-day lag. Reserves required for the computation period ended at the *close* of business Wednes-

day are now based on average daily deposits at the *opening* of business during the same computation period.

Carryover of surpluses or deficiencies. An excess or deficiency of reserves above or below the amount required—but not more than 2 percent of required reserves—could be carried into the following reserve period. Thus, an excess in one period could be used to offset a deficiency in the next. Likewise, no penalty would be imposed on a deficiency of not more than 2 percent in one period if it was offset by excess reserves in the next period.

Under the current regulation and operating procedures, a bank cannot use excess reserves in one period to satisfy a part of its reserve requirement in the next. On the other hand, penalties can be waived on occasional reserve deficiencies up to 2 percent of required reserves if the deficiencies are made up in the following reserve period. Such deficiencies are regarded as exceptions to the general practice, however, and penalties are waived at the discretion of the Federal Reserve banks, as specified in their operating circulars.

Purpose and expected effects

The proposed amendments are designed to make it easier for member banks to manage their reserve positions with greater precision, to reduce fluctuations in excess reserves, and to improve the accuracy of the Federal Reserve System's knowledge of reserve developments. The changes would not involve any shift in policy or any alteration in the structure of reserve requirements.

It is expected, however, that the proposed changes would have a favorable influence on the money market by eliminating one source of temporary pressure that sometimes causes sharp fluctuations in the day-to-day avail-

ability of funds. Under current reserve accounting, there is a tendency toward uneven flows of day-to-day funds within biweekly periods, as country banks build up excess reserves during the first week and make them available in the next. This pattern, coupled with variations in accuracy of judgments about the resulting availability of funds, often results in either severe tightness or extreme ease in the money market toward the close of reserve periods. This is especially true in alternate weeks, when country banks and reserve city banks have the same closing date for their reserve periods.

The limited carryover provided for reserve excesses or deficiencies also would help moderate the market effects of end-of-period accumulations in either direction. The carry-over feature is designed mainly, however, to add flexibility to reserve management for member banks and to permit more efficient use of reserves by allowing small "misses" to be adjusted for in the next period.

The two-week lag feature is expected to be of most benefit to small banks where reserve management is not a specialized function. Although these banks will have to meet requirements more often, they will know their requirements well in advance. The arrangement will also make it easier for large branch systems to determine their positions.

In addition to the advantages expected from advance knowledge of reserve requirements and the amount of vault cash that can be applied, the two-week lag will tend to smooth out intra-monthly fluctuations in total reserves with less assistance from the Federal Reserve System's open market operations. Federal Reserve float, which adds temporarily to reserves, peaks around the middle of most months—about two weeks after the monthly low in bank holdings of currency and coin. The proposed lag in counting vault

cash would, therefore, permit fluctuations in these two factors to offset each other.

Operating rules

The Federal Reserve Act makes no specific provision for averaging deposits and reserves over a period in determining reserve excesses or deficiencies. Early in the operation of the system, however, averaging over a period became standard procedure in most districts. In 1923, the most general practice—a one-week averaging period for reserve city banks

and a semimonthly period for country banks—was incorporated into a regulation covering all member banks.

No other significant changes in the technical aspects of the regulation were made until 1959-60, when the reserve period for country banks became biweekly and holdings of currency and coin, which were gradually made fully reserve-eligible in accordance with permissive legislation enacted in 1959, were placed on the same computation basis as required reserves.

Regulation Q ceilings— a relief but no cure

A new chapter in the American experience with financial regulation opened in 1966, when Congress enlarged the powers of federal regulatory agencies to establish maximum rates depository institutions are permitted to pay on different classes of time money.

The immediate occasion for the new legislation was the credit stringency of late 1966. A boom in economic activity had generated excessive demands for credit—excessive in relation to the nation's capacity to produce goods and services. Allowing these demands to be completely satisfied would have strengthened inflationary pressures that were already evident. Without any substantial move being made toward fiscal restraint, the burden of responsibility for moderating further rises in prices was left largely to the Federal Reserve System.

As policies were undertaken to restrain the expansion of money and credit, interest rates rose sharply—and with greater impact on some sectors than others. The flow of funds to savings and loan associations and mutual savings banks, and therefore into mortgages, almost dried up. Continuation of this state of affairs, combined with the strong rise of interest rates on securities issued by state and local governments, led to dissatisfaction with the existing regulation of deposit rates and prompted congressional consideration of remedial legislation.

Provisions of the new law

After extended hearings, during which the competitive position of savings and loan associations and mutual savings banks continued to deteriorate, the new interest rate legislation (Public Law 89-597) passed the

House on September 8, the Senate on September 15, and was signed by the President on September 21. The act contains, in addition to provisions for flexible regulation of interest rates, amendments to the Federal Reserve Act dealing with the reserve requirements of member banks and with Federal Reserve purchases of U. S. agency obligations.

Authority was delegated to three bodies—the Board of Governors of the Federal Reserve System, the Board of Directors of the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board—to “limit by regulation the rates of interest (and dividends) that may be paid” on time and savings deposits of commercial banks and mutual savings banks and share accounts of savings and loan associations. Though required to consult with each other before establishing rate ceilings, these policymaking bodies retain final responsibility for the pattern of maximum rates applicable to the institutions under their respective jurisdictions.

The wide range of discretion delegated to these agencies is illustrated in the sections detailing powers assigned to the Board of Governors of the Federal Reserve System:

The Board is authorized for the purposes of this section to define the terms used in this section, to determine what shall be deemed a payment of interest, and to prescribe such regulations as it may deem necessary to effectuate the purposes of this section and to prevent evasions thereof . . . the board may prescribe different rate limitations for different classes of deposits, for deposits of different amounts or with different maturities or subject to different conditions regarding withdrawal or repayment, according to the nature or location of member banks or their depositors, or according to such other reasonable bases as the Board may deem desirable in the public interest.

10 Although the language of the act is permis-

sive, rather than mandatory, the legislative history of the act makes it clear that Congress intended for ceilings to be imposed and for them to be effective.

Congress also indicated that it wanted the new authority to be used to moderate rate increases and influence flows of funds to different institutions and different end-uses. The S&Ls attributed the decline in their inflow of savings to the high rates paid by commercial banks on consumer-type certificates of deposit. By allowing deposits to be classified by size for the purpose of establishing differential ceilings, the act enables the Federal Reserve to restrain banks from paying high interest rates on small-denomination certificates of deposit while allowing higher rates on certificates sold to large investors. Such regulation, of course, has both a direct bearing on the ability of banks and other financial institutions to compete for funds and important long-run implications for an economy that may often be “overheated.”

Successes and shortcomings

Shortly after passage of the act, the supervisory agencies established a structure of rates on bank time deposits and S&L shares designed to promote the flow of funds to the specialized mortgage lending institutions.

The most important change was the establishment of a lower maximum rate commercial banks could pay on time deposits of less than \$100,000. This new maximum restricted the ability of banks to bid for personal savings. It eased some of the pressure on S&Ls and mutual savings banks and helped bring relief to the residential construction industry. It also reinforced actions taken earlier to restrain the growth of bank credit. By refusing to raise the 5.5-percent ceiling on certificates of deposit and by lowering the ceiling on time deposits with more than one date of

maturity to 5 percent, the Federal Reserve had already impaired the ability of banks to compete for funds.

The result, as market interest rates rose, was a gradual lessening in the rate of expansion of bank loans to businesses. Thus, interest rate control was used as a tool of general monetary policy to achieve one of the Federal Reserve's major goals at the time—to cool off the inflationary boom in new plant and equipment.

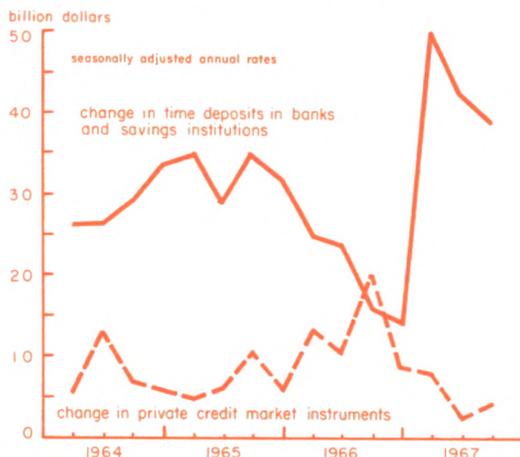
It is clear, however, that interest rate regulation was not adequate to all the tasks its proponents set for it. Its failure to arrest the excessive rate of investment, the rise in prices, and the decline in residential construction was partly the result of its tardy introduction and the insufficient vigor of its application. But a more fundamental problem was that many sources of economic distortions were beyond the reach of the new regulations.

Government borrowing in the second half of 1966 to meet the needs of both the Viet-

nam war and new domestic programs strained an already tight credit situation. Equally important, corporations unable to obtain favorable terms on bank loans turned increasingly to commercial paper. The regulation of interest rates and dividends offered by banks and S&Ls could not halt disintermediation (the flow of funds out of depository institutions in response to the higher yields available on open-market instruments). Nor could it, as some advocates hoped, prevent a rise in market interest rates to the highest levels since the early 1920s. In October 1966, a heavy runoff of large certificates of deposit resulted in the first monthly decline in time deposits at commercial banks since the beginning of the decade.

The liquidity positions of most financial institutions improved over the next year, the fear of “destructive” competition for savings passed, and the housing market showed signs of recovery. But these improvements were probably the result more of the easier monetary policy brought to bear near the end of 1966 than of interest rate regulation.

Savings flows to financial institutions slowed in 1966



SOURCE: Flow of Funds, Board of Governors of the Federal Reserve System.

Lessons of the past

Experience with the new controls has been too brief for generalizations on their effectiveness, but the past offers some insight into the general usefulness of ceilings on interest rates. The results of several experiments with such regulation are of interest here.

One of the early House versions of the interest rate control bill would have fixed a 4.5-percent ceiling on certificates of deposit issued to individuals. Because of their inflexibility, statutory ceilings have generally been less effective than those administratively determined. Experience with the interest rate ceilings on mortgages insured by the Federal Housing Authority or guaranteed by the Veterans Administration indicates some of

the problems associated with statutory ceilings. Designed to ensure that public assumption of credit risks would benefit homebuyers, rather than mortgage lenders, these ceilings have reduced the availability of mortgage loans underwritten by the government in times of strong overall demand for credit. They have done so by making such loans less attractive to lenders than other uses of their funds. The result has been an amplification of swings in residential construction.

That inflexible ceilings are at fault, and not merely factors inherent in the housing market, was indicated by the greater volatility, until recent years, of the government underwritten sector relative to housing financed by conventional mortgages with more flexible rates. The Federal National Mortgage Association has tried since the early 1950s, to even out fluctuations in FHA and VA lending by buying and selling mortgages as market conditions require. But in 1966, massive purchases amounting to more than \$2.7 billion failed to prevent a precipitous decline in the

volume of new FHA loans.

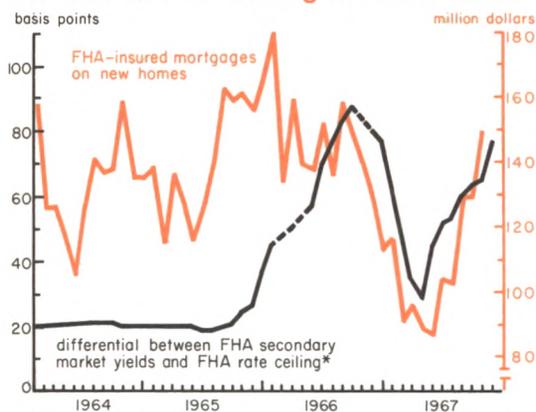
Another rigid ceiling has been the 6-percent maximum interest rate on mortgage loans federal land banks extend to farmers. This ceiling was of no consequence for many years after the federal land banks were established in 1917. Competition kept the lending rates of land banks in line with market rates and generally well below 6 percent until 1960. They then ranged between 5.5 and 6 percent until late 1966. Thereafter, the lending rates of all federal land banks were at the legal maximum until the ceiling rate was removed in December 1967.

Though limited in what they could charge on loans, the land banks had to pay the going market rate for the funds they borrowed. Federal land bank bonds yielded an unprecedented 6.05 percent in September 1966. After that, yields declined for a while, but in December 1967 an issue sold to yield a new record high of 6.2 percent. Between 1965 and the time the ceiling was removed, the sum of land bank borrowing costs and operating expenses consistently exceeded the 6-percent maximum return on new mortgage loans.

Because the banks must cover all their expenses in the long run, they became more cautious in their lending policies, favoring borrowers with low credit risk. The effect of the ceiling, therefore, was to dilute the banks' intended function—to serve farm customers unable to obtain financing on acceptable terms from private lenders.

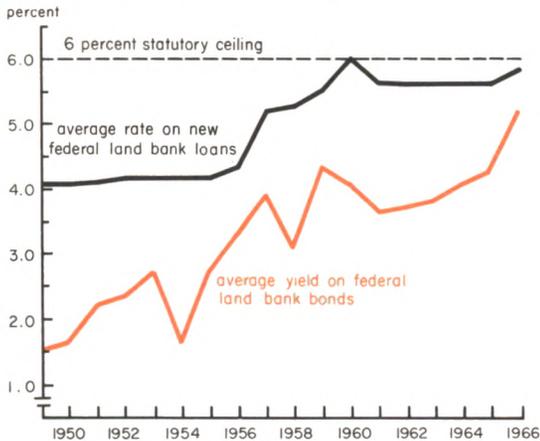
Similar problems have appeared in states limiting the maximum rate charged on mortgages. In New York, which has a usury ceiling of 6 percent, mutual savings banks have sharply curtailed their mortgage lending, preferring to invest most of their new funds in bonds at yields near 7 percent. Lenders operating across state boundaries, such as life insurance companies, have reduced their ac-

FHA lending fell sharply in 1966 after market yields moved far above FHA ceiling on new loans



*Dashed line indicates period of adjustment to change in legal ceiling.

Federal land banks squeezed as borrowing costs neared ceiling on lending rates



SOURCE: U. S. Department of Agriculture and Farm Credit Administration.

quisitions of mortgages on both farm and residential properties in states with strict usury ceilings.

Experience with deposit ceilings

Although the legislation passed in 1966 greatly broadened its scope, federal regulation of interest rates on deposits dates back to the Banking Act of 1933. Section II of that act prohibited payment of interest on demand deposits and empowered the Federal Reserve Board to establish maximum interest rates on different classes of time deposits. Designed primarily to mitigate the alleged undesirable effects of high deposit-interest rates on the lending practices of commercial banks—particularly the practice of “reaching for yield”—and to prevent destructive rate competition between banks, this section remained largely unchanged until September 1966.

The prohibition of interest on demand deposits took effect immediately and greatly

reduced interest payments by commercial banks within a year of its enactment.

There is evidence, however, that this provision—which amounts to a rate ceiling at the zero level—has had some important and unforeseen long-run effects. An increasing number of bank customers, both businesses and individuals, have reduced their demand deposits to a minimum to take advantage of rising yields on either commercial bank time deposits or deposit-like claims at other financial institutions. The result has been a constantly rising ratio of time deposits to total deposits at commercial banks—from 28 percent in 1947 to 53 percent in 1966, well above the 44-percent level reached in 1931-32 after several decades of time deposit growth. However, this most recent decline in the relative importance of demand deposits is not because of any great surge in time deposits, since time deposits also declined as a share of liquid assets issued by financial institutions until around 1960.

The ceilings on interest rates that could be paid on commercial bank time deposits were not important until recent years, because they were far higher than the rates banks actually paid. Nevertheless, there was little evidence of destructive rate competition. Between 1933 and 1945, a period of falling interest rates and low loan demand, the spread actually increased between average effective rates paid on time and savings deposits and the 2.5-percent ceiling fixed by Regulation Q. In the mid-1950s, when effective rates moved above 2 percent, the ceiling on the longest maturities was raised to 3 percent. Market rates continued to rise, and the ceilings on at least some maturities of time or savings deposits were adjusted every year from 1962 to 1965.

Until it lowered the maximum rate on multiple-maturity time deposits in 1966, the Federal Reserve Board had raised ceilings

when they appeared to restrain competition for deposits. The rate was lowered in response to urgent calls for an effective ceiling that would prevent destructive competition for personal savings between banks and S&LS.

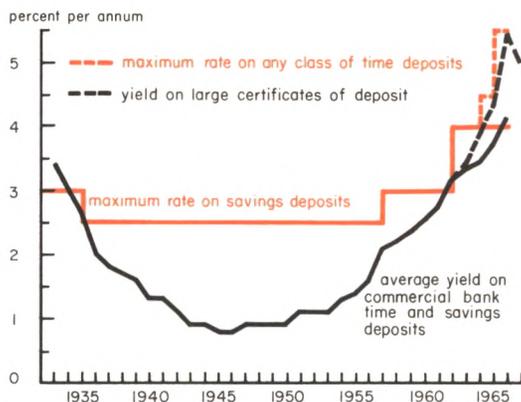
But as already mentioned, the continued rise in market rates of interest made it increasingly profitable for depositors to bypass financial intermediaries altogether and invest their funds directly in open market instruments. Their willingness to take advantage of even modest rate differentials showed that the capacity of deposit rate regulation to protect financial institutions against the effects of rate competition is limited when alternative investment media are available.

An assessment

None of the examples cited here suggests that continuous regulation of interest rates has been very helpful in achieving its intended goals. Without exception, the ceilings have had undesirable and unintended side effects or have been circumvented or rendered ineffective by the availability of unregulated alternative uses of funds. More to the point, though temporary regulation of interest rates on deposits may help ensure the survival of particular types of financial institutions in a time of stress, it is apt to prove less effective in the long run, when new sources of competition have had time to develop.

A decline in the relative importance of banks as depositories is clearly not what Congress intended in enacting the deposit-interest restrictions of the Banking Act of 1933. Yet it was inevitable that, when confidence and prosperity returned and interest rates rose above their depression levels, depositors would have a powerful incentive to replace nonearning demand deposits with earning assets—time and savings deposits, savings and loan shares, and short-term se-

Regulation Q ceilings were far above market rates until late 1950s



curities. The relative decline of demand deposits that ensued was at least partly a consequence of trying to deal with competitive conditions in banking in isolation from other industries—in effect, ignoring the interchangeability of the financial services provided by commercial banks with those that could be obtained elsewhere.

The act adopted in 1966, while extending deposit rate regulation to financial institutions other than banks, still provides incomplete coverage. To be fully effective in maintaining the flow of funds to S&LS and mutual savings banks and in bringing down interest rates generally, interest-rate regulation would have to be extended to issues of securities in the open market. But that is a step few would consider attractive or feasible.

The other side of the question

It is not necessary, however, to allow the institutional losses and disruption of economic activity that might have come with failure to impose the more detailed ceilings on

time deposit-interest rates in 1966. That was the view taken by the Federal Reserve, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board during the trying months of credit stringency.

The argument that efforts to prevent the consequences of a credit squeeze—forced liquidations and depression of some industries—entail a loss of efficiency has questionable relevance to purely cyclical swings in business activity. It is doubtful, for example, that the borrowing and spending of late 1966, and the accompanying shifts of funds and resources, reflected any basic change in either the underlying tastes of consumers or conditions of production.

In the long run, the demand for new housing depends largely on such factors as income, the rate of family formation, changes in the geographic distribution of population, and the stock of existing housing—all of which tend to be fairly stable over short periods. But interest costs and the availability of long-term mortgage financing, combined with the fact that most housing purchases can be postponed, make current demand for new housing extremely sensitive to credit conditions. Homebuilders are squeezed out of the credit market when interest rates are bid up by companies borrowing for investment purposes in expectation of increased profits. The result, in 1966, was a decline in the seasonally adjusted annual rate of private nonfarm housing starts of 39 percent between April and October. Such a decline might be viewed with equanimity if it reflected shifts in consumer demands or the relative “social costs” of investing in business inventories as opposed to building houses—especially if it had, as is often asserted, a salutary stabilizing effect on the economy as a whole.

Unfortunately, heavy corporate borrowing in the face of skyrocketing interest costs ap-

pears to have been the consequence, not of any change in consumer demands, but simply of expectations regarding those demands. As it turned out, these expectations were wrong, as the following indicate:

- The rate of inventory accumulation in late 1966 was not sustainable. Had business borrowing to expand production been fully justified by consumer demand, inventories would not have increased so rapidly, or later required so drastic an adjustment.
- The rates of use of manufacturing facilities after the 1964-66 boom in business outlays on new plant and equipment have been relatively low, indicating the rate of such investment was excessive.
- Residential construction recovered rapidly with easing of credit conditions in the first half of 1967. This suggests that the earlier decline was not the result of a major decrease in the quantity of new housing units demanded at given prices.

The dislocations in production in 1966 may have indicated a maladjustment rooted in excessively optimistic expectations rather than a smooth adaptation of the economy to changed consumer tastes. That is true of most business cycles. But the ill-effects of the investment boom were amplified by excessive reliance on monetary policy, which bears unevenly on different sectors of the economy, to restrain aggregate demand.

That an inventory adjustment took place in 1967 might suggest that such temporary misdirection of resources has no permanent harmful effects. That would probably be true if all factors of production were perfectly mobile. But rapid shifts in production bring unemployment and underutilization to some specialized or imperfectly mobile resources.

That happened in 1966. Unemployment in construction rose—despite sizable shifts of workers from residential to commercial pro-

jects—and the output and sales of many building materials declined. Falling production was most noticeable in lumber, particularly hardwood flooring, in brick and other clay products, window glass, and gypsum used in plaster, lath, and wallboard. Other results of resource immobility were less serious but more difficult to measure: the additional costs of recruiting, training, and startups in sectors expanding at rates that could not be sustained.

Finally, to the extent that resources fail to flow freely between housing and other sectors, housing's stabilizing influence—if not its contracyclical behavior—is neutralized, or even reversed. Shifts of lendable funds not accompanied by flows of real resources only intensify excess demand in overheated sectors—as in corporate investment in 1966. At the same time, the sector receiving a reduced flow of funds is depressed without benefit to the economy as a whole.

These problems differ from those arguing for contracyclical policies in general only in that they can arise despite—sometimes because of—the vigorous application of aggregative stabilization measures. To the extent that they result from excessive reliance on monetary policy—which is less neutral in its impact than its designation as a “general” control measure would indicate—these problems suggest the need for a more balanced mix of fiscal and monetary policies. When such a mix is not politically possible or is not adequate to prevent intersectoral distortions, a case can be made for the use of such selective controls as interest rate ceilings to dampen cycles within sectors.

Achievement of this goal by fixing ceilings on interest rates depends on whether the funds reallocated among financial institutions

exceed the decline in the flow of funds to financial institutions as a group or whether they fall short. Although the experience of 1966 provides no answer, the reduction in rate competition brought on by ceilings appears to have favorably affected the earnings and liquidity of savings and loan associations.

The moral of the story

When economic activity rapidly shifts between sectors without relation to changes in consumer demands—as seems to have been the case in 1966—the use of selective interest rate regulation to help allocate funds between sectors takes on a rationale totally unrelated to the expressed intentions of avoiding widespread failures of financial institutions or “starvation” of an economic sector, such as homebuilding, that has long been favored and subsidized by Congress. If regulation succeeds in stemming flows of funds resulting from mistaken expectations, it might even contribute to improved economic efficiency. Greater readiness to apply fiscal restraint would lessen the need for such regulation, however, even as a temporary measure.

But past experience with interest rate regulation indicates neither the feasibility nor the effectiveness of regulating the deposit rates paid by competing financial institutions on a comprehensive and continuing basis. A fixed or administered differential between the rates paid by different institutions drawing funds from the same general sources seems to be particularly undesirable. Under such an arrangement, the regulatory agencies would determine the relative growth rates of the different classes of institutions and, to a lesser extent, the end-uses of credit—determinations better left to the impersonal forces of the marketplace.