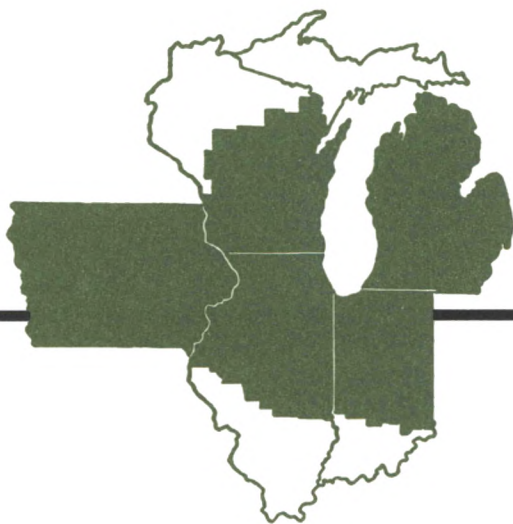


Business Conditions

1968 October



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Monetary policy— an experiment proposed

Man's desire for precision in the behavior and management of the economy is no less keen than it is in the realm of mechanical phenomena. But the possibility of achieving precision in economic affairs remains remote, largely because economic data and the units of economic performance arise out of the activities of individuals whose behavioral patterns are so widely varied as virtually to defy precise and comprehensive measurement and prediction. Indicative of the desire for greater precision in economic policy is the term "fine tuning" which has appeared repeatedly in writings and discussions in recent years. The term connotes both precise forecasts, to serve as a basis for economic policy formulation, and continuous adjustment of policy—largely in relation to taxes, government spending, and credit—in response to changes in current and prospective developments.

Monetary policy, in some ways the most flexible of economic policy tools, tends to move to center stage when fine tuning of economic policy is under discussion. But the idea of fine tuning has critics as well as proponents, as indeed its feasibility remains to be demonstrated.

Nearly everyone supports the goal of adherence to a pace of sustainable economic growth with relatively full (but not overfull) and continuous utilization of the labor force and other resources. This clearly implies a finely tuned economy, with the capability of adjusting continuously to the many changes that must occur if growth and high-level output and employment are to be achieved con-

tinuously and without undue upward pressure on prices or strain on the balance of payments. Which policy techniques hold the greatest promise of facilitating the achievement of this desirable goal?

This question is a matter of continuing interest and concern to the Joint Economic Committee of Congress, among others. Created by the Employment Act of 1946, the committee reviews the President's Annual Economic Report and studies matters relating to the health and performance of the economy. Composed of members from both the House and Senate, the committee originates no legislation of its own but investigates economic conditions and reports its findings and recommendations to the two houses. Monetary policy, quite naturally, is of continuing interest as the committee searches for ways to help obtain the benefits of a finely tuned economy, whether achieved by finely tuned economic policies or otherwise.

The committee recently has proposed that "Congress should advise the Federal Reserve System that . . . the rate of increase of the money stock . . . ought . . . for the present . . . to be within the limits of 2 to 6 percent per annum, measured on a quarter-by-quarter basis in a range that centers on the . . . long-run . . . sustainable real growth rate" of the economy.

The proposal—clearly not in the vein of "fine tuning"—is put forth as an experiment in monetary policy, to be tested operationally for several years and the results observed with care. If found wanting by this test, the guideline presumably would be revised. The

consequences of implementing such a plan as this, or other similar proposals, of course, cannot be determined in advance. Even after being tested operationally, specific economic policies are difficult to evaluate because of the great complexity of the economy and the great array of forces that always are affecting it simultaneously.

If adopted, adhered to, and gradually refined, the proposal would set the stage for a number of changes in monetary policy. Most important, it would place money supply at the top of a list of policy guides. Historically, the Federal Reserve has given substantial emphasis to moderating strong short-run fluctuations in interest rates, exchange rates, and credit availability. The rate of growth of money supply, while given consideration along with other pertinent factors, has not been the only or dominant consideration in determining the policies conducive to achievement of general economic objectives.

Although the committee's current proposal has not been cast in precise or rigid terms—doubtless reflecting the variety of views presented by monetary experts at its hearings—it is generally consistent in spirit with previous JEC findings that Congress should assume greater responsibility for the direction of domestic economic policy and that an experiment should be conducted to determine whether less variation in money supply growth would have desirable effects on economic performance.

The committee's report acknowledges that the Federal Reserve has an abundance of guidelines relating to its goals or objectives. In addition to its responsibilities under the Federal Reserve Act of 1913, the System pursues the objectives of the Employment Act of 1946, which, in the words of the committee, "involves maintenance of low rates of unemployment, reasonable stability in the

purchasing power of the dollar, a high and stable rate of economic growth, and a stable exchange rate for the dollar."

The committee also notes that the Federal Reserve must often take into consideration other important objectives of public policy such as avoiding "significant changes in money market conditions at times of new Treasury issues," avoiding "excessively high interest rates," and protecting "the flow of funds to nonbank financial intermediaries," which are important suppliers of credit for homebuilding.

Goal priorities

Economic policy invariably has a number of objectives. No single one of them can be pursued without taking into consideration the effects on others. Some weighing of the various objectives is inevitable.

The committee concluded that since monetary policy has a variety of objectives, an ordering of priorities must be made and that this ordering should be done by Congress. An important benefit the committee believes might flow from such an expression of congressional responsibility is better evaluation of "the relative roles of monetary policies and other policies, including various types of fiscal policies, in promoting and reconciling . . . economic objectives."

The committee underscored the interrelations between monetary and fiscal policies, declaring that the federal government's needs for credit cannot be denied and that under certain conditions "monetary action to accommodate management of the federal debt" would be required. It is noted that "the Federal Reserve cannot stabilize both the money stock and interest rates in this situation" and that Congress should adopt the necessary fiscal policies to forestall potential problems, such as those resulting from abrupt

Findings and Recommendations*

I

Congress should give serious consideration to providing more specific guidelines relating to the objectives of monetary policy—guidelines relating to the weights to be attached to the various objectives, among which are maintenance of continuously low rates of unemployment, reasonable stability in the purchasing power of the dollar, a high and stable rate of economic growth, and a stable exchange rate for the dollar. Such an attempt by Congress might yield two beneficial results: First, it might provide more specific guidance to the Federal Reserve in terms of goals or objectives. Second, the very process would afford Congress an opportunity to evaluate better the relative roles of monetary policies and of other policies, including various types of fiscal policies, in promoting and reconciling our economic objectives. However, as noted earlier in the report, these guidelines ought not to be interpreted as rigid directives.

II

Just as Congress has the authority to fix

government expenditures and taxes, and thus largely to determine the budget surplus or deficit, Congress has the responsibility of reckoning with the monetary consequences of its action. While the monetary authority granted to Congress by the Constitution has been delegated to the Federal Reserve System, it behooves Congress to provide some guidance to the Federal Reserve on how the system should see to the support of the government's credit and, in particular, to what extent Congress regards the expansion of Federal Reserve credit as an appropriate way to finance any part of the deficit.

III

To provide a first approximation to an economic posture that would manage to maintain price stability while encouraging maximum employment and rapid growth, Congress should advise the Federal Reserve System that variations in the rate of increase of the money stock (currency plus demand

*U.S., Congress, Joint Economic Committee, *Standards for Guiding Monetary Action*, 90th Cong., 2nd Sess., 1968 pp. 19-20.

shifts of funds from savings institutions into the securities markets, oppressive mortgage interest rates, international capital flows, and the like.

As an aid to Congress in arriving at optimum judgments on fiscal policy, the Federal Reserve authorities have been requested by the committee to submit to the committee at the beginning of each year their views on the kind of monetary policy called for in light of the expected state of the economy. The Federal Reserve Board has agreed to provide annually projections prepared by its staff of financial developments consistent with the economic prospects envisaged in the President's Economic Report. And in lieu of quarterly reports on growth of the money supply requested by the committee, the Board has proposed the preparation for the com-

mittee of a broader analysis of significant developments in financial markets following each calendar quarter.

Money supply as a guide

In proposing that the money supply be made a primary guide to monetary policy, the committee necessarily was obliged to define the term money and satisfy itself that the Federal Reserve is in a position to control the amount of money. The call for disciplined control over growth in the money supply presupposes that there is a close and dependable relationship between the amount of money and the behavior of the economy and that goals other than those relating to the state of the economy would not ordinarily become over-riding in the determination of monetary policy.

deposits adjusted) ought not to be too great or too sharp. In normal times, for the present, the desirable range of variation appears to be within the limits of 2 to 6 percent per annum, measured on a quarter-by-quarter basis—a range that centers on the rate of long-run increase in the potential gross national product in constant dollars, which is our sustainable real growth rate.

On any occasion on which the Federal Reserve System, deliberately or as a result of external monetary developments, has not maintained a money-stock growth rate within the desired range, the committee requests that the monetary authority report promptly to it, or to another appropriate body of Congress, on the reasons that the Federal Reserve System would give for this divergence. Periodic reports on the reasons for action taken within the desired range should also be made.

If, after several years' experience with a rule, refinements in the guidelines seem warranted, they could, and should, of course, be made.

IV

Finally, as a regular procedure, the Federal Reserve authorities should at the beginning of each year, set forth publicly as specifically as possible their notion of what kind of monetary policy the expected state of the economy calls for. This would supplement in the monetary field the review of the federal government's economic programs which the President is now required to set forth in the Economic Report. Such a public projection (which we understand is already available internally) would present a picture of what the financial world—money supply, flows through financial intermediaries, the appropriate course of interest rates—would look like. This would also tie in with the gross national product projection indicated in the report of the Council of Economic Advisers. It would certainly help Congress to adopt the necessary fiscal policies and to foresee and forestall potential problems such as those resulting from disintermediation, oppressive interest rates in the housing field, international capital flows, and the like.

On *what is money*, the committee took the commonly accepted measure—currency and private demand deposits (excluding deposits of the U. S. government). These are the financial assets that serve primarily as media of exchange. But other financial assets—such as savings deposits, savings and loan shares, and U. S. savings bonds—while not serving as media of exchange, are easily converted into assets that do. Some people consider these other assets to be so much like money as to merit inclusion in any list of assets the supply of which is to be controlled in the interest of promoting general economic stability. The broader the range of financial assets, of course, the more nearly the total approximates total credit—which is also believed by some to be a factor whose variability should be constrained in order to help

stabilize the economy.

The Board of Governors has expressed the belief that broader measures than money in the narrow sense of currency and demand deposits are most meaningful for economic analysis and policy purposes, and the chairman of the Joint Economic Committee has indicated his willingness to consider alternative concepts within the framework of the committee's broad objectives.

The committee concluded that the Federal Reserve could normally reach a *target level of money supply* "with reasonable accuracy." However, this may not be a simple undertaking, especially if the target were quite precise and the time period in which it was to be achieved were short. The amount of money available at any one time depends both on actions of the public and actions of

the Federal Reserve and the banking system as a whole. Since money does not include all financial assets, the public can shift back and forth between assets—between, say, demand deposits and time deposits—in response to changes in the amount of money it wishes to hold.

The amount of money the public seeks to hold tends to rise with increases in income but to decline when interest rates rise. The first effect is a reflection of the higher spending associated with greater income and the latter a matter of economizing on cash when yields on liquid, nonmonetary assets are high.

Actions of commercial banks affect the amount of deposits, and demand deposits are the major component of the money supply. Many banks hold reserves in excess of legal requirements. When the amount of these excess reserves changes, total loans and investments and, consequently, deposits also change. Because excess reserves produce no income, banks normally try to hold them to a minimum. The amount of excess reserves that banks are content to hold tends to be smaller when interest rates are high than when they are low.

A given amount of total reserves, therefore, does not always result in a given supply of money. To control the supply of money within any fairly narrow confines, the Federal Reserve would have to predict future behavior of banks and the public, which is hard to do. However, the range of growth rates proposed by the committee is relatively wide and the time period within which the average growth rate would be determined is fairly long.

Money and income

Testimony before the committee regarding the relation between money and economic activity was largely contradictory. Unless the

velocity of money held stable, total expenditures and, therefore, economic activity would not be stabilized by exercising control over growth in the supply of money. Some witnesses saw no consistent relationship between money supply and economic activity. Others saw a strong relationship. Still other witnesses testified that, while the relationship might not always be close, abrupt changes in the amount of money are closely related with succeeding abrupt changes in economic activity. The committee concluded that “a steadily growing economy with stable prices (is) likely to be best assisted by a comparable steady growth of money supply.”

While recognizing that the primary objective of monetary policy is to affect aggregate levels of economic activity, the committee also recognized that other goals must sometimes become overriding. “The monetary authority cannot be indifferent if its policy threatens to create such stringency that the mortgage and municipal bond market verge on collapse. Nor can it ignore the deterioration of monetary contracts in any important market.”

The committee noted that conditions might sometimes require that the Federal Reserve System operate outside the proposed 2 to 6 percent rate of growth in money supply. But the inference is strong that the committee is searching for a simple, precise, quantitative guide to monetary policy that could be substituted at least in part for the present judgmental process which takes into consideration a very comprehensive range of economic information. Governor George Mitchell, of the Federal Reserve Board, suggested in his testimony that such a search is almost certain to be fruitless.

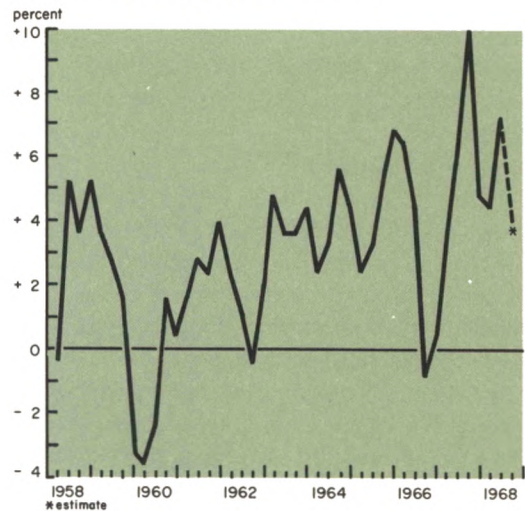
The limits of testing

Adherence to the proposed guide would

have resulted in somewhat different monetary policy in recent years. Quarter-to-quarter changes in the money supply have been outside the 2 to 6-percent range a number of times since 1958. In recent quarters, annual rates of growth in excess of 6 percent have been frequent. Slower rates of monetary growth during those times probably would have resulted in higher interest rates and intensified pressures on money, capital, and mortgage markets. Presumably, higher interest rates, after a time, would have helped restrain demand and relieve inflationary pressures with rates then receding. But unfortunately current economic knowledge permits no unequivocal statement of the precise effects of alternative policies.

The Joint Economic Committee would have the Federal Reserve System test the economic effects of a fairly stable growth in money supply. Because of the complexity of the economy, there can be no guarantee that the results of such a test can be measured accurately. Nevertheless, the search for better

Annual rates of change in money supply, quarterly



understanding and better economic policies will continue—for our stake in stability, growth, and maximum output and income is great.

Bargaining power for farmers

American farmers have long held the belief that their bargaining position is weak, relative both to their suppliers and to the processors that buy their products. Recently, proposals have again been made for strengthening the position of farmers in the sale of their products.

The President, in his State of the Union Message, called for programs to “help the farmer bargain more effectively for fair prices.” The Secretary of Agriculture has

also suggested that more bargaining power may be needed for farmers to secure a more equitable income. And farm organizations and the agricultural press, while divided on the means of gaining and using bargaining power, tend to agree that it is what farmers need.

Bargaining power for what?

Bargaining power—the ability to influence the terms of exchange, whether in price or

such matters as grade and amount of the product, delivery dates, and terms of payment—can take several forms. Under some conditions, a party to the exchange can force concessions by threatening to inflict loss on the other unless he accepts the terms offered. Under other conditions, there may be a community of interests that allows each party to benefit from concessions to the other. And there are conditions under which the two parties can gain at the expense of a third—usually consumers, other businesses, or “the public.” A combination of these conditions is present in most bargaining.

Farmers’ renewed drive for greater bargaining power comes at a time when government programs insulate them, to a great extent, from the influence of market forces. It is pointed out that these programs cover only a few “basic” commodities—that 60 percent of farm income comes from products not covered by government programs. But it is also pointed out that while many commodities are not supported directly, government programs provide considerable indirect support—for example, that the feed-grain program limits the available supply of feed and raises the prices of all grain, which in turn reduces the number of livestock raised and increases livestock prices.

Agriculture is assisted by a number of federal programs, including price supports, restrictions on production, export subsidies, and restrictions on imports. The government distributed \$3.1 billion to farmers in direct payments last year. This accounted for more than 20 percent of the net farm income. Sizeable expenditures were also made on other programs to boost farm income.

The Department of Agriculture and several land-grant colleges have tried to estimate what the level of farm income would have been in recent years if government programs

had not been in effect. Their estimates vary but generally suggest incomes about a third lower. Many farmers, nevertheless, feel they would receive higher incomes if they had more bargaining power and could directly influence the prices at which they sell their products.

Prices of agricultural products have traditionally been established by competition between processors or shippers for the available supply. But the marketing channels for many products have changed through the years, with reliance on terminal markets as points of active competition and price determination becoming less important as more and more products are moved through other channels.

Rapid strides have been made in vertical integration, contract growing, and direct buying. Along with other changes in marketing, these developments tend to emphasize differences in the bargaining power of farmers and the purchasers of their products.

With the shift in marketing channels, many farm leaders have concluded that increased bargaining power would provide a means for gaining higher prices, broader markets, more favorable terms of sales, and greater managerial independence. Some of these aims, however, are mutually exclusive. Higher prices, for example, tend to restrict markets, not broaden them. And contract commitments are more likely to reduce farmers’ independence and managerial flexibility than increase them. To achieve one goal, farmers may have to give ground on another.

Potential for bargaining power

One requirement for successful bargaining is formation of a cohesive bargaining organization. Recognition that an organization can speak for the group provides considerable power in itself. But members must recognize

that effective group action requires that they give up the freedom to make some production and marketing decisions. For a bargaining organization to be viable, members must be willing to make individual sacrifices.

Experience seems to indicate that the possibilities of achieving effective group action are greater in cases where a commodity is produced primarily in a small geographical area and by relatively few producers. It is also helpful if producers are highly specialized in the commodity and, therefore, keenly interested in its marketing. The producers of cling-stone peaches, grown largely in California, can work together much easier than producers of beef cattle, which are grown nationwide by a large number of producers operating under a variety of conditions.

Market management

Higher prices, a goal of most farmers, are not achieved by demanding them. Prices respond to supply and demand.

A seller can influence the market, and therefore prices, by changing supply conditions or demand conditions, or, of course, by changing both. Most nonagricultural businesses use advertising and other forms of promotion in efforts to improve demand conditions for their products, either by enlarging the market or by increasing their share of it. They can also schedule output to the sales expected at the price asked.

Such efforts to manage the market are easier to plan, however, than to carry out. Typically, such efforts must be continuously adjusted—but with less adjustment in price than is usual in agriculture, the adjustment being more in production, promotion, and product design.

Agriculture closely approximates a theoretically pure competitive situation, albeit with government intervention. With millions

of producers selling essentially homogenous products, individual producers usually cannot benefit noticeably from advertising. Similarly, because the demand for food in the U. S. is tied mainly to population growth, gains from advertising are limited for agriculture as a whole.

The supply side of the market might seem the more likely area of manipulation for farmers, but the highly competitive structure of agriculture tends to deter any lasting group effort to restrict supply. As individuals, farmers face a completely “elastic” demand for their production. Market conditions generally allow them to sell any amount they can produce at the price being paid at the time with each farmer’s output too small to have any appreciable influence on the price. The price is influenced primarily by total supply. If producers increase the supply, prices must decline to induce consumers to buy more and speculators to hold larger inventories. While it may be to the individual farmer’s advantage to restrict supply in concert with other farmers, not knowing what others may do, he tends to produce at a fairly steady pace taking into consideration his costs and expected selling prices.

Only by government intervention have large numbers of farmers been persuaded to limit production, and reliance has been primarily on payments to farmers to obtain their cooperation. Yet, even with government controls, most farmers have been able, at least partially, to neutralize the restraints by using more fertilizer and other resources to boost acreage yields.

Control of supply

Programs to control supply can be directed toward the control of either production or utilization. Production control has the greatest potential for raising prices, but it is also

the most objectionable to farmers because it impinges directly on their freedom as managers. While farmers may agree generally that the production of a commodity should be curtailed to raise its price, the means of devising and enforcing individual quotas or allotments have not been adequate.

Efforts to boost prices by controlling utilization rely on the diversion of part of the supply to other than usual uses. Where this form of control is applicable, it allows farmers freer rein to produce as they choose. This form of control is limited, however, to products with more than one use and different demand characteristics in different markets. Milk, for example, is consumed as fluid milk and as manufactured products, such as butter, cheese, ice cream, and dried and condensed milk. Dairymen can raise their incomes by splitting the market for fluid milk from the market for processed milk and limiting the amount of milk going into the fluid milk market. Because the demand for fluid milk is not as responsive to price changes as the demand for other dairy products, the supply diverted to the market for processed milk depresses prices less there than it would in the fluid milk market.

Another form of disposal control is "export dumping." The amount of a product sold on the domestic market is restricted to increase the price, and the excess is then sold on the export market at a lower price. The ability to export surpluses is often limited, however, by "antidumping" laws enacted by other countries to protect their producers.

Either form of disposal control tends to increase the supply in response to the increase in average price. As the supply increases, more of the total must be diverted into a secondary market. Prices then decline in that market, partly offsetting effects of the higher prices in the primary market.

Production control, if effective, allows producers to raise prices and maximize income. But for a price to be raised significantly for long, the commodity must have no close substitutes and consumers must have a strong preference for it. Also, acceptable procedures must be provided for sharing the market between producers, and the total output must be effectively controlled.

Production quotas would appear to be the most effective means of control, but they are the least attractive to farmers. Farmers prefer acreage allotments for crops and number-of-head allotments for livestock because these types of controls allow them to exercise their ingenuity as producers and seek to increase their share of the total supply by more intensive cultivation of crops and heavier feeding of livestock. It is also necessary to control the entrance of new producers attracted by the higher prices.

Neither form of supply control is easy to achieve for agricultural products, even—*as experience has shown*—with the intervention of federal and state governments. Even the associations of fruit growers in California and other groups dealing in specialized commodities grown in fairly small areas owe much of their success to state and federal marketing orders.

It does not appear that farmers can make significant price gains without control of supply, and because of the structure of agriculture, voluntary supply controls do not seem likely to develop.

Another alternative is government control of supply. This approach is repugnant to many farmers, however, and may not be politically feasible in the years ahead. In the final analysis, consumers—and increasingly urban consumers—have to pay the cost of higher agricultural prices. Though farmers have had the support of Congress in the past,

with the rise in urban population and the growing interest in the problems of poverty, hunger, and inflation, programs to boost farm prices may attract less and less support.

Community of interests

If farmers cannot gain effective control of supply, voluntarily or through government intervention, agriculture may be able to increase its bargaining power only through greater use of the community-of-interest principle. Most successful bargaining cooperatives have been operated under this principle—that all parties to a bargain give something in return for a gain. In negotiating hog contracts with packers, for example, bargaining associations have agreed to deliver a specified number of hogs to the packing plant at specified times, to provide animals of specified quality and weight, and to absorb some of the losses incurred as a result of damaged

carcasses. In return, packers have agreed to pay a base price for hogs plus a premium for quality carcasses. Such agreements reduce the packer's procurement and labor costs, allow better scheduling of operations, and ensure a steady flow of high-quality hogs. The farmer receives a premium for producing better hogs and is assured of a known market for a specified number and quality of hogs.

The bargaining power of farmers may become increasingly important as changes are made in agricultural production, marketing, and legislation. But bargaining power alone will not solve the condition commonly known as "the farm problem." This problem springs essentially from an overcommitment of resources—primarily human resources—as is evidenced by the continued decline in the agricultural labor force and the chronic tendency to produce more than can be sold at prices "generally acceptable" to farmers.

Personal certificates—a stabilizer?

Many banks have expanded their time-deposit services in recent years to include—in addition to regular savings accounts—time certificates or open-account deposits. Even in certificates, many banks offer various sizes and maturities or forms that emphasize growth, income, or some other feature. By offering an assortment of accounts, even though the interest earnings are about the same, banks can appeal to a variety of customers according to their preferences and needs.

Instruments differ from bank to bank—in the method and frequency of computation and payment of interest, in the minimum balance required for interest, in the time

period for which funds must be committed, in the amount that can be deposited or withdrawn at any one time and in a variety of other ways as well. One bank may offer, for example, 3-, 6- and 12-month 5-percent certificates for a minimum of \$1,000, compounding the interest quarterly, while another offers 5-year certificates at the same rate, but with interest compounded daily and requiring a minimum investment of only \$100.

Despite such differences, however, users of time deposit services are grouped the same at all banks in at least one important respect. The regulation authorized by the Banking Act of 1935 defines three types of time de-

deposit—savings accounts, certificates of deposit, and open accounts. Savings deposits are usually held by people interested mainly in the availability of their funds for immediate withdrawal on request. Holders of certificates and open accounts must be willing to wait at least 30, and often 90, days or more for instruments to mature or for the expiration of notices to withdraw. While holders of both certificates and open accounts must be willing to commit their funds for specified periods, open accounts are more flexible than certificates and, therefore, sometimes preferred by depositors. Open accounts, which include the so-called “golden passbook” accounts, allow interim additions and withdrawals during the term of the instrument thereby making them closely resemble savings accounts.

Why certificates?

Banks pay more for certificate and open-account funds than for savings accounts partly because, with interest costs a large part of total operating costs, the squeeze on earnings can be reduced by limiting the higher interest rate to only part of the accounts they hold. This consideration becomes less important, however, as more deposits drift into higher yielding accounts.

Certificate promotion may also lower handling costs by discouraging deposit transactions. Unlike a saving account, a certificate does not allow “activity” before the funds are withdrawn. In addition, a range of accounts differing more in their particular terms than in their yield can discourage “comparison shopping” by savers and investors, and, in turn, abate rivalry between competitors over market shares.

For many banks, however, the clear advantage of certificate promotion is in portfolio spacing. Because of the specified maturities of certificates, banks can better

predict when their liabilities will come due. Such predictions are, in turn, helpful in forecasting liquidity requirements and in scheduling asset maturities.

Role of rate ceilings

The vigor with which banks have pursued the advantages of diversification in time instruments has depended, however, on the intensity of the pressures they faced to find loanable funds and the differentiations they were allowed to make in interest rates. Until 1965, essentially the same ceiling applied to all three types of time deposits.¹ Consequently, although use of rate differentials was adopted sporadically by banks in Detroit and a few other financial centers, differentials were confined largely to banks serving smaller communities, where competition for funds was less intense and savings inflow sufficient to take care of loan demand.

Faced with rising demand for credit and growing need for funds, banks that had been promoting alternative time instruments, especially the biggest banks in larger centers, pushed their rates on savings accounts to the limit in such years as 1961 and 1964—just before new rate ceilings were set. Having thereby eliminated a rate premium for certificate funds, they stopped promoting certificates. The result was a massive transfer of funds into the more liquid savings accounts within the banks.²

¹A slight differential was introduced in late 1964 when the ceiling rate on certificates and open-account deposits of 90 days or more was increased. It was moved up only a half-point, however, over the 4-percent ceiling on savings deposits.

²Smaller banks may give greater consideration to the advantage gained from knowing the maturity of time liabilities than large city banks, since they have fewer alternatives for coping with deposit drains.

Likewise, the most important reason many banks, especially larger ones, give for using a variety of instruments and rates now is the 4-percent limit on

In December 1965, The Federal Reserve and the Federal Deposit Insurance Corporation raised to 5.5 percent the ceiling on interest rates commercial banks could pay on certificates and open accounts. The hike, from 4.5 percent on certificates and open accounts with maturities of 90 days or more and 4 percent on those for shorter periods, widened the possible differential on various types of instruments at a time when the highest rate banks were allowed to pay on savings accounts was the same, as, or less than, the dividend rates nonbank competitors paid on similar accounts.

Returns on market securities were rising, as were bank demands for loanable funds. The new rate ceilings combined with market pressures, therefore, encouraged banks to innovate with new types of accounts paying more than 4 percent designed to attract and hold personal savings.

In September 1966, to restrict “unsound” competition for personal savings and help increase the availability of home mortgage funds, regulatory agencies lowered to 5 percent the top rate that could be paid by banks on certificate and open-account deposits in denominations of less than \$100,000, mainly held by individuals. The only exception was the ceiling on single-maturity time deposits of \$100,000 or more, which was left at 5.5 percent. Since then, the difference in rate ceilings between regular savings accounts and other time deposits under \$100,000 has remained fixed at 1 percent.

Effect on withdrawal activity

An increase in time-account options to include higher rate certificates can increase deposit totals but it also raises the trouble-savings-account interest, the need to avoid sizable deposit declines, and the possibility of attracting additional deposit inflow by offering accounts at higher rates.

some question of the effect of aggressive bidding for funds on deposit withdrawal activity overall. Because of fairly low and generally predictable withdrawal rates, time deposits (mostly savings deposits) have traditionally been thought of as funds available for investment in mortgages and other long-term assets. An increase in interest-sensitive funds held in time accounts is thought to expose banks to the risk of sizable withdrawals if their interest rates fall behind those offered by competitors or available from security markets. If shifts can be expected, then, growth in the proportion of time deposits in certificate form would imply the need for greater liquidity and more short-term marketable securities in bank portfolios.

Savings-account withdrawal activity in the district increased sharply in early 1966 and has remained high ever since. Amounts withdrawn at banks in 51 urban areas in the first six months of 1968, for example averaged \$5.90 a month for every \$100 of average balances. That is against \$4.88 per \$100 in the first half of 1965—an increase of 20 percent.

Practices banks adopted to make savings accounts more attractive—such as payment of interest from day of deposit to the day of withdrawal and the disbursement of funds directly through money order and bank drafts—may have induced shifts from checking accounts to savings accounts, thereby increasing the withdrawal activity. But at the same time, by making savings accounts more attractive, these practices also held more savings deposits, helping moderate withdrawal volume.

The chief factor responsible for the increase in savings-account withdrawals was undoubtedly the diversion of funds to accounts at savings and loan associations, credit unions, and other investment media yielding

higher returns. In June 1968, the prevailing rate on savings deposits in 42 of the 51 urban areas of the district was 4 percent—the ceiling rate. Against this, many savings and loan associations paid 4.5 and 4.75 percent on accounts that could be withdrawn on demand. Over one-quarter of the district's credit unions paid 5 percent or more and another one-quarter paid between 4.5 and 5.0 percent on regular share accounts. The return on Series E savings bonds was 4.15 percent when held seven years, and Freedom Shares were yielding 4.74 percent with four and a half-year maturities.³

Competitive pressures on personal certificates were less. As with savings accounts, rates on time certificates were at the ceiling. Banks in all 51 areas paid 5 percent in June, compared with a rate of 5 or 5.25 percent paid by savings and loan associations. Then too, bank certificates and open-account deposits offer some advantages over savings and loan certificates. Some bank certificates mature in less than the six months required by savings and loan associations, and some are offered in denominations of \$100 or less.⁴ The “golden passbook” time accounts offered by banks usually require only a 90-day period before savings can be withdrawn.

Also, the yield spread of, say, 9- to 12-month U. S. government issues over 1-year, 5-percent time certificates, after reaching a high of 80 basis points in September 1966, narrowed through mid-1967, and though rising, did not exceed the 1966 record until May 1968, when the threat of “disintermediation” was again posed by deposit outflows to the security market. The certificate withdrawal rate for May was, nevertheless, only \$3.41 per \$100, and \$3.48 for the full first

³Effective June 1, 1968 the rate on Series E bonds was raised to 4.25 percent and on Freedom Shares to 5 percent.

six months of this year. Even in some of the district's largest centers where depositor sensitivity to yield might be greatest, certificate withdrawal rates were little higher than in smaller places. Thus, in the district's four major areas (Chicago, Detroit, Milwaukee, and Indianapolis), the certificate withdrawal rate averaged \$4.17 per \$100 for the first half of 1968—only 69 cents more per \$100 than the average for the district.

Associated with higher savings-account withdrawals in 1968 than in 1965 was a lower level of certificate withdrawals. As a result, the rise in withdrawals from all per-

⁴The Federal Home Loan Bank System has discouraged large shifts of funds to certificates at savings and loan associations by establishing a 50-percent limit on the proportion of an association's share capital that can be in the form of certificates with a maturity of less than three years. The minimum amount on certificates is \$1,000. Associations' efforts to stay within the 50-percent limit have frequently contributed to savings and loan certificates being issued in denominations of \$5,000 or more. Also, because most associations can pay no more than 4.75 percent on regular savings and 5.25 percent on certificates, the differential is only a half percent, compared with a full 1 percent for commercial banks. Another regulation working against savings and loan certificates is the requirement that certificates must be held at least six months to earn a dividend rate above the associations' rate on regular share accounts.

To assist associations close to the 50-percent limit, the Federal Home Loan Bank relaxed its rules, effective October 1, to permit an association to issue certificates as long as the weighted average of dividends on all its accounts does not exceed 5 percent.

Few mutual savings banks issue certificates. The largest ones did not do so until April 1, 1968, when the New York law was revised to enable banking authorities to limit the ratio of certificates to total deposits to within a 15- to 40-percent range. Moreover, the flat 5-percent maximum that mutual savings banks can pay on any account under Federal Deposit Insurance Corporation regulations restrains offerings of certificates.

These regulatory restraints stem from public supervisors' concern over institutions' vulnerability to deposit and share decline from too much dependence on interest-sensitive funds.

sonal savings deposits was only about half the rise in the savings-account component.

Further evidence that certificates have helped hold down withdrawal activity so far this year comes from a comparison of areas in the district. By 1968, the larger an area's proportion of total personal savings deposits represented by certificates, the lower the rate of withdrawals.

Effect on variability

Withdrawals as a percent of average balances has varied much more from month to month for personal certificates than for savings accounts, undoubtedly reflecting the larger amounts involved per certificate and the greater sensitivity of these balances to yields. The variability in the monthly certificate withdrawal rates over the period January 1966 to June 1968 were about 2.5 times as great as in savings account withdrawals.

Nevertheless, there have been no system-

Level and variability in withdrawal activity related to proportion of personal accounts held as certificates

Monthly withdrawal rates (per \$100 of average balances) ¹	Certificates as percent of total personal balances, June 30, 1968				
	0-29	30-39	40-49	50 and over	All areas
January 1966 to June 1968					
Savings accounts					
Average	\$5.11	\$5.26	\$5.46	\$5.57	\$5.36
Deviation around average	1.20	1.85	1.58	1.82	1.62
Relative deviation (percent)	24	38	30	33	31
Personal certificates					
Average	\$3.80	\$3.86	\$2.74	\$1.72	\$2.99
Deviation around average	2.90	3.40	2.10	1.02	2.32
Relative deviation (percent)	74	93	72	60	75
Total					
Average	\$4.85	\$4.61	\$4.37	\$3.47	\$4.32
Deviation around average	1.17	1.68	1.37	1.16	1.34
Relative deviation (percent)	24	43	32	33	33
July 1963 to December 1965					
Total					
Average	\$3.99	\$4.15	\$3.81	\$3.41	\$3.84
Deviation around average	.86	1.27	1.15	1.27	1.14
Relative deviation (percent)	22	31	30	36	30
Number of areas	11	12	16	12	51

¹ Average, deviation around average, and relative deviation computed for each area and averaged for all areas within specified group. Deviation of withdrawal rates, alternately referred to as the standard deviation, divided by the average gives the relative deviation.

Note: Commercial banks in the following areas are included in the tabulation:

Certificates as proportion of total personal balances, June 30, 1968

Illinois		Iowa		Grand Rapids	35
Bloomington	16	Burlington	67	Jackson	26
Champaign	33	Cedar Rapids	42	Kalamazoo	46
Chicago	22	Clinton	34	Lansing	33
Danville	34	Council Bluffs	71	Muskegon	29
Decatur	44	Des Moines	59	Port Huron	38
Peoria	28	Dubuque	46	Saginaw	22
Quad Cities	53	Marshalltown	47	Wisconsin	
Rockford	20	Mason City	62	Appleton	49
Springfield	40	Muscatine	57	Green Bay	55
		Ottumwa	77	Kenosha	40
Indiana		Sioux City	37	Madison	57
Anderson	42	Waterloo	60	Manitowac	38
Fort Wayne	42	Michigan		Milwaukee	29
Gary-Hammond	40	Adrian	31	Oshkosh	45
Indianapolis	48	Ann Arbor	22	Racine	49
Lafayette	69	Battle Creek	33	Sheboygan	46
Muncie	53	Bay City	18		
South Bend	38	Detroit	35	Seventh District,	
Terre Haute	47	Flint	20	51 areas	30

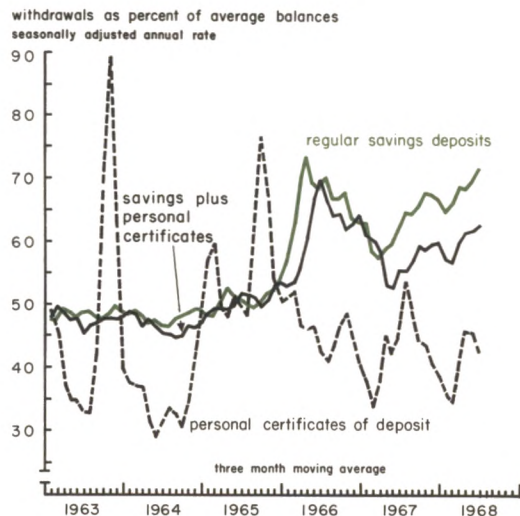
atic differences in the district in the size of fluctuations in withdrawals rising out of larger proportions of certificates. The average variation in the 12 areas where certificates accounted for at least half the deposits was the same as the average for the district. This similarity arises in part from offsetting changes in the extent of variation in savings and certificates accompanying the growth in certificates.

Furthermore, a comparison of withdrawal rates in the deposit total before and after the 1965 change in regulation—that is, for the two periods, the 30 months from July 1963 to December 1965 and the 30 months from January 1966 to June 1968, shows that, while variability in withdrawal activity has increased with more of personal savings in the form of certificates, the increase was small.

While the growth of balances in the form of certificates worked towards the lower overall withdrawal rate, the use of certificates appears to have influenced variability very little. This, no doubt, has been because the rate ceiling on certificates of small denominations has generally been high enough for banks to attract and hold individuals' savings.

A fairly wide differential in the maximum rates at a time when the demand for loanable funds was increasing encouraged banks to establish savings and investment programs appealing to different types of customers.

Withdrawals from savings accounts in upward trend since early 1967



Segmentation of depositors, however, did not greatly change the basic nature of the funds attracted and held by banks. Banks were merely tapping a familiar source of funds in a different way.

From experience in the Seventh District, it appears that the risk of unanticipated withdrawals large enough to disrupt the liquidity provisions banks have made may well be less, and certainly no greater, than when banks confined their time offerings to conventional savings accounts.

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