Rebuilding America's Financial Liquidity

Remarks of Robert P. Mayo,
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In the present atmosphere of controversy on vital issues--foreign and domestic, social and economic--there is one area of all but universal agreement. It is that 1971 should see a continuous, quarter-by-quarter, rise in business activity. Substantial disagreement exists, however, as to the extent of the recovery, and the degree of success that will be achieved in moderating the twin evils of price inflation and unemployment.

It is my purpose today to outline the evidence that the financial foundations have already been laid for a sustained recovery. Easier monetary policy pursued during the past year has not yet accomplished its purpose. As long as there is substantial unused capacity in the form of manpower and facilities, Federal Reserve policy actions will continue to encourage the growth of bank deposits, other liquid assets, and the availability of credit. Acceptance of this view, however, does not imply that monetary ease can be pushed to any length without serious consequences.

Throughout the past quarter century, Federal Reserve policy has never lacked vigorous critics. These critics can be divided broadly into two groups--those who desire a more stimulative policy and those who prefer a more restrictive policy. The former tend to emphasize the problem of full employment, the latter the problem of inflation. It certainly is no secret, now that the proceedings of the Federal Open Market Committee are published, that both points of view are always present <u>within</u> the councils of the System. Clearly, grave dangers exist in following one objective to the exclusion of the other. Like the yang and yin of oriental philosophy, the joint objectives of moderating unemployment and restraining inflation are opposed, but also complementary. As we have seen several times since World War II, excessive price increases inevitably cause imbalances, reduced productivity, and added unemployment. It is the responsibility of the monetary authorities to find the most appropriate path to stable growth and prosperity. I should add, insofar as it is in their power. Monetary policy is not omnipotent. There are no precise relationships between monetary developments, however measured, and the course of economic activity. Our markets and institutions are far too complicated to be finely tuned by one or more controlling levers.

When the Federal Open Market Committee, of which I am now a member, met in January 1970 it was apparent that the economy as a whole had leveled off. Declines were occurring in some sectors, particularly housing and defense, but "prices were continuing to rise at a rapid pace." In accord with this understanding, the FOMC communicated to the "desk" at the Federal Reserve Bank of New York, which conducts open market operations in government securities for the entire System, its "desire to see a modest growth in money and bank credit . . ." as its paramount objective. In February 1970, this directive was strengthened to read "moderate growth of money and bank credit . . .."

I will not take time here to review all of the steps taken by the System to encourage growth of money and credit in 1970. Aside from open market operations, these included reductions in the discount rate, cuts in margin requirements on stock purchases, adjustments of reserve requirements, and liberalization of the rates commercial banks can pay on time deposits. Rather, I shall emphasize the quantitative evidence of the year-long trend to easier monetary and credit conditions.

In the week ending January 27, 1971, Federal Reserve credit outstanding averaged $66.6 billion, up almost $5 billion from a year earlier--an increase of 8 percent. System holdings of government securities, which account for the lion's share of Reserve Bank credit, were up $6.3 billion, or 11 percent. Member bank borrowings, also included in Reserve Bank credit, were less than $400 million, only one-third as large as a year earlier. The lower level of borrowings, of course, reflects reduced reserve pressures on banks. On the other side of the System's balance sheet, Federal Reserve notes (which now account for virtually all of the nation's paper currency) were up 7 percent. Member bank reserves rose 6 percent. These reserves, "high powered dollars," provide the base for expansion, not only of commercial bank credit, but the entire financial structure of the nation.

Increasingly, the rate of change in the money stock (defined narrowly as currency and demand deposits in the hands of the public) is used as a symbol for the overall thrust of monetary policy, sometimes termed "the Friedman effect." In December, the money supply was $215 billion (seasonally adjusted, daily average basis), up 5.4 percent from a year earlier. This increase compares with a 3.1 percent rise in 1969 (with practically no increase in the second half of that year). The rise in the money stock in 1970 was less than in 1967 or 1968, but it was larger than in any previous post-World War II year, except 1951.

Useful as the money stock concept may be as an analytical tool, it must be remembered that it is not only overly simplified--but it is also a heterogeneous quantity. For example, the past decade has witnessed a substantially greater proportional rise in currency outstanding than in demand deposits, for reasons that are not completely clear. In individual years, however, demand deposits have increased faster than currency. Within the currency component, for example, the rise in $100 bills in the past decade has been twice the rise for the total money stock. At present, almost $12 billion worth of $100 bills are outstanding. Note, I do not say "in circulation" because some of these bills apparently are held as a store of value. There are almost 120 million hundred dollar bills outstanding, but there probably are none at all in the wallets of this audience!

You might also be interested in the fact that about $6 billion of coin is now outstanding--about $30 in change for each of us. Again, I doubt if anyone in the audience is that "loaded." Coins outstanding increased four times as fast as the total money stock in the past decade. The Kennedy half dollars are one factor. From 1964 through 1969, almost 1.3 billion Kennedy halves were coined and issued, about as many half dollars as had been issued in the entire period of U. S. coinage from 1792 through 1963. About 10 percent of the Kennedy halves were issued through the Federal Reserve Bank of Chicago. Unlike the earlier Franklin halves, they seldom come back to us for recirculation. Simple arithmetic tells us that six Kennedy halves have been issued for every man, woman, and child in the United States. (I know many have gone abroad.) Very soon the public's appetite for Eisenhower dollars is to be tested.

Demand deposits account for more than three-fourths of the money stock. It is often said that 90 percent of all transactions are made by check. But that is only a wild guess. Probably by far the largest share of purchases, certainly business purchases, are made on credit, and are settled later by check. But qualification is impossible on the basis of present knowledge.

A substantial share of all demand deposits is represented by compensating balances in banks, held to reimburse these banks for services rendered. We do not know the total amount of compensating balances, how strictly requirements are enforced, or the extent to which these arrangements vary with changes in credit conditions. But compensating balances are part of the money stock, as defined, often referred to as the "active money supply." At the other end of the spectrum are the overdraft arrangements now offered by many banks. Individuals are encouraged by those banks to keep their demand balances in the red. The money stock of people using such arrangements is negative.

Sometimes commercial bank time accounts are included in a broader concept of the money stock, commonly referred to as "M2." The usefulness of this concept has been undermined by the rapid development and recent sharp fluctuations in the negotiable certificates of deposits (CDs) issued by large banks. From an investor's standpoint, CDs are closely akin to other liquid assets such as Treasury bills or commercial paper. In 1969, total time and savings deposits of commercial banks declined 5 percent, mainly because banks were prevented by Regulation Q ceilings from paying competitive market rates for CD money. Because restrictions were eased in 1970, and because short-term market rates declined sharply, the rebound in time and savings accounts was dramatic. For the year as a whole, commercial bank time and savings accounts were up more than 18 percent, a record increase. The recovery in outstanding CDs was augmented by an upsurge in other time and savings accounts.

Deposits at savings and loan associations rose 8 percent in

1970, compared to 3 percent in the previous year. The $11 billion rise in S&L deposits set a new record. Deposits of mututal savings banks, important in the East, rose 7 percent in 1970, compared to 4 percent in the previous year. At most banks and other savings institutions inflows of time and savings funds were especially strong in the final months of 1970. Apparently, this trend continued in January 1971.

The more rapid increase in deposits of financial institutions in 1970 was accompanied by comparable increases in their earning assets. In the case of commercial banks, total loans and investments (adjusted for sales of loans to affiliates) increased 7.4 percent last year, almost twice as much as in 1969. Loan demand was very weak in the final quarter of the year partly because of the slower pace of the economy, and the auto strike, but primarily because of refundings of loans through sales of securities. For the year as a whole, bank loans rose less than 4 percent, compared to a 10 percent rise in 1969. But bank holdings of governments and municipals rose 12 and 20 percent, respectively. In 1969, banks liquidated 16 percent of their governments, and merely maintained holdings of municipals, to help them to accommodate heavy loan demand.

Most of the increase in deposits at S&Ls, and half of the increase in deposits at mutual savings banks, was reflected in larger holdings of mortgage loans. Resources of S&Ls in 1970 were supplemented by a rise in borrowings from the Federal Home Loan Banks. (Under similar circumstances in 1967 borrowings from the Home Loan Banks declined.) The improvement in the lending power of thrift institutions contributed to the sharp uptrend in housing starts in the second half of 1970.

As you all know, the securities markets absorbed an enormous volume of new issues in 1970. Despite especially heavy flotations in the fourth quarter, long-term interest rates declined significantly late in the year.

New corporate capital issues, more than 70 percent nonconvertible bonds, totaled almost $39 billion last year, up 45 percent from the record total of 1969. New issues of long-term municipals rose 50 percent to $18 billion, a total that exceeds the 1968 record. Thus far in 1971, offerings of both corporate and municipal securities have substantially exceeded the levels of early 1970. The large volume of corporate securities sold in 1970 helped to improve the balance sheet liquidity ratios of many firms. It now appears that the long-term decline in the ratio of corporate liquid assets to short-term liabilities was halted and reversed last year. Unfortunately, the available data on corporate holdings of liquid assets leave much to be desired. A recent survey of business holdings of liquid assets is currently being evaluated by statisticians at the SEC. Hopefully, the information developed will shed needed light on this sector.

Attempts to analyze the various aspects of the financial markets often lead one to wander through the trees looking for the forest. Fortunately, the staff of the Board of Governors of the Federal Reserve System, constructs a body of data under the heading, the "Flow of Funds," that relates the national income accounts to developments in the financial sectors of the economy. Estimates of financial flows--funds raised and funds invested--are not yet available for the fourth quarter of 1970. Nevertheless, data for the first three quarters of the year provide an instructive overview of financial developments in the crucial period under review.

Total funds raised by the nonfinancial sectors of the economy (i. e., excluding intermediaries), both public and private, totaled $88 billion in 1969, down from $97 billion in 1968. The peak quarterly rate for this aggregate in 1969, $93 billion, was reached in the third quarter, coincident with the peak of business activity.

Total funds raised by the nonfinancial sectors declined to an annual rate of $80 billion in the first quarter of 1970. In the second quarter, however, the rate jumped to more than $100 billion, and it reached $103 billion in the third quarter. Except for the effects of the GM strike, this extremely high rate of financing probably continued in the fourth quarter.

The most pronounced shift in the 1969-70 period in the Flow of Funds reflected the shift in the federal sector. From a surplus in the first half of 1969 the federal government moved to a deficit position, mainly because of reduced revenues that required raising funds at a $19 billion annual rate in the third quarter of 1970. One does not have to be identified either as a "monetarist" or as a "fiscalist" to foresee an expansion in business activity in 1971.

A review of the course of interest rates in the past year suggests, once again, the need for caution concerning generalization in this area. Short-term rates declined through most of 1970, but long-term rates reached peaks about midyear. The rate on three-month Treasury bills, the nearest market approximation to a "pure" interest rate, was at an all-time high of 8 percent at the start of 1970. By late January 1971, the bill rate had declined to 4.2 percent--the lowest since mid-1967. The drop in the rate banks pay to borrow each other's excess reserves--the federal funds rate--was even sharper, from 9 percent to less than 4 percent.

Commercial paper rates, at 8 percent as recently as last summer, are now below 5 percent. Commercial banks have cut their prime rate from 8.5 percent in February 1970 to 6 percent currently, with an unprecedented flurry of reductions since last September. Rates on new issues of high-grade corporate bonds dropped from 9.2 percent last June to about 7.5 percent recently.

Interest rates are the price of credit, and reflect, like other prices, the interaction of supply and demand. In recent months, most of the downward pressure apparently has come from the supply side, because the total volume of funds raised has been large. But one should not assume that the monetary authorities can determine the course of interest rates through long periods of time. Unlike prices of goods, the price of credit cannot be forced down indefinitely by increasing the supply. Because of price inflation, lenders demand, and borrowers are willing to pay, a premium to compensate for erosion of the purchasing power of the dollar.

You may have noted that in this discussion of liquidity I have made only passing reference to ratios that purport to measure liquidity in an objective sense. This is because I regard liquidity more as a state of mind than a concept subject to quantification. Liquidity is ample when an individual, business, or institution is confident that funds will be available to pay bills when they come due. Current and prospective income, the collection rate on receivables, and the extent of unused lines of credit are all important considerations. A man with a substantial bank account who thinks his job is in jeopardy is less willing to spend and to assume new commitments (feels less liquid) than a man with a negative bank balance who has just been promoted.

The shock to the confidence of many individuals administered by the recession (mild perhaps, but recession nonetheless) of 1969-70 has had far more to do with the erosion of liquidity than changes in any financial aggregates. The psychological impact of the recent business decline, I believe, was more severe than in any of the previous postwar recessions, which featured much larger declines in activity and employment. Partly, this is because the balloon of endless expansion inflated in the 1965-68 period has burst. Partly, it is the drop in the stock market, the Penn Central failure, and the problems of the brokerage industry--problems which many of you are all too aware of. Partly, it is the persistence of inflation in the face of lower profits and slower growth in incomes.

Confidence will be rejuvenated only when it becomes evident that a pronounced recovery in business activity is underway. There are encouraging signs that such evidence is near at hand. Residential construction activity is extremely vigorous. Retail sales improved in December and January. The end of the auto strike has revived affected sectors of that industry. Total employment ceased to decline in late 1970, and probably is rising in early 1971. Personal income continued to rise quarter-to-quarter through the slowdown in activity. Consumers have been saving at historically high rates. The growth of liquid assets, and the availability of consumer credit, indicates that the potential to spend is very large. The consumer is the real key to sound economic revival in 1971.

Earlier in my talk I described the financial developments that have laid the foundations for a return to prosperity. Most of us are disappointed that clearer signs of an improvement in economic conditions have not already appeared. The fact that there are lags between monetary policy actions and their effects is well known. But the timing of the lags is still somewhat unpredictable. The lags apparently are longer this time--certainly longer than in 1967 when the slowdown in activity was reversed within a six-month period.

Disappointment with the results of monetary policy thus far must not lead to incautious excesses that may be harmful rather than beneficial to economic recovery. An even sharper increase in the growth of money and credit at this time will not quickly revive the nation's depressed psychology which is already on the mend. That will take time. The available funds are there today. And if credit unavailability is threatening to hamper recovery, you can be sure that the monetary authorities will act swiftly and surely.

Each of us could draw up a list of episodes of the 1969-70 period that might have been recalled as harbingers of disaster if the economic adjustment had snowballed into a deeper recession. The fact that such a prospect was not realized bears testimony to the basic strength of our business and financial structure. With a proper balance of fiscal and monetary policies, plus responsible union and management policies in industry, I firmly believe that the Seventies will go down as the greatest decade in American history.