Federal Reserve Bank of San Francisco

July 13, 1973

Raising Ceilings

Federal authorities increased rate ceilings on consumer deposits last week, thus enabling the regulated financial institutions to bid more effectively against market securities for the funds of individual savers. These actions were taken to help individuals earn higher returns on their deposits, but also to help the institutions guard against the repetition of 1966- or '69- style heavy savings outflows.

The Federal Reserve Board of Governors, in amending Regulation Q, permitted member banks to raise from 4½ to 5 percent the maximum rate payable on passbook savings, and the Federal Home Loan Bank Board meanwhile allowed a smaller increase, from 5 to 5¼ percent, on maximum passbook rates payable by federally-supervised savings-and-loan associations. These authorities raised rate ceilings by varying amounts—by one-half percentage point or more—on various types of certificate accounts, depending on maturity and minimum amount of deposit. In fact, ceilings were lifted completely for deposits maturing in four years or more with a minimum denomination of $1,000.

Some banks and S&L's immediately hiked their rates to the new ceilings, but others appeared reluctant to follow suit—not suprisingly, in view of the substantial costs involved in such a move. These costs can be especially large in the case of passbook savings, since all existing passbook accounts benefit from a rate boost, whereas existing certificate accounts do not. Banks alone could be faced with an additional interest cost of $607 million annually if rates were boosted one-half percentage point for the entire $121 billion held in passbook accounts.

Less reliance on Q

The latest policy actions, when viewed with other policy measures of the past several months, suggest that the monetary authorities are relying much more heavily on general rather than specific weapons in their current fight against inflation. In other words, they are utilizing open-market operations, discount-rate increases and reserve-requirement changes almost exclusively, with much less reliance on Regulation Q interest-rate ceilings as a means of curbing the over-rapid credit expansion. This can be deduced not only from last week's action, but even more from the mid-May decision to suspend rate ceilings entirely on large negotiable CD's with maturities of 90 days or more. (Ceilings on short-term CD's were suspended in 1970.)

In 1966 and 1969, by way of contrast, the maintenance of low Reg-Q ceilings drained funds out of the institutions and into money-market instruments—the dreaded process of disintermediation. (Several economists once offered a prize for the coining of a better word, but unfortunately there were no takers.) As Reg Q merely diverted funds from controlled institutions to uncontrolled markets, it tended to disrupt

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the financial system without increasing the total restrictiveness of monetary policy.

Some disintermediation has already occurred this year; net savings inflows into the S&L's during the January-May period were 26 percent below the year-ago pace, and the situation has worsened as the year has progressed. The recent policy measures, however, suggest that this situation could improve, with considerably less reliance on Regulation Q as an instrument of policy in the future.

Disintermediation

On several different occasions since the mid-1960's, deposit-rate ceilings have fallen below market interest rates, so that depositors have received a lower return on their funds than they would have obtained through direct investment of their funds in the money market. Disintermediation thus occurred, as funds that ordinarily would have been channeled to depository institutions were instead withdrawn (or withheld) because of the availability of higher-yielding direct investments.

The result in both 1966 and 1969 was a severe loss of deposits, which limited the institutions' ability to serve their customers' needs. The liquidity squeeze was most evident at the large banks, which suffered from exceptionally heavy deposit withdrawals as their customers—especially their large depositors—became increasingly conscious of the higher returns available elsewhere. Moreover, as thrift institutions became increasingly unable to attract funds, the private mortgage market shrank, necessitating direct Federal intervention on a massive scale to support the mortgage market.

Ceilings and savings

Ceilings first came into use under the Banking Act of 1933. This legislation was designed to reduce interest-rate competition among banks, since it was felt that such competition tended to increase bank costs and to encourage the purchase of risky high-yield assets. When Federal ceilings were applied to S&L's in 1966, the objectives were somewhat different—first, to hold down deposit rates and insulate depository institutions from the money-market forces that might drain funds from them, and secondly, to prevent the shift of funds among intermediaries by maintaining a differential between bank and thrift-institution rates.

The Reg-Q ceiling on commercial-bank passbook savings was set at 2½ percent in 1936, and thereafter raised at infrequent intervals—to 3 percent in 1957, to 3½ percent in 1962, and to 4 percent in 1964. The passbook rate was then left unchanged until the January-1970 hike to 4½ percent, but in the meantime,

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rate ceilings were raised several times on the various types of certificate accounts that go under the heading of consumer-type time deposits. The higher rates paid on certificates attracted an increasingly larger share of savings funds into this category over the years.

However, with the sharp rise in market rates during the tight-money periods, financial-institution rates fell far behind. Between 1968 and 1969, for instance, the average rate paid on commercial-bank savings accounts rose from 4.48 to 4.87 percent, and the average for S&L accounts rose from 4.71 to 4.81 percent—but over the same period, the 90-day Treasury bill rate jumped from 5.34 to 6.68 percent, and finally reached almost 8 percent at the early-1970 peak.

During 1969, on the average, Treasury bills thus offered savers almost two percentage points higher return than they were likely to obtain from deposit accounts. The margin narrowed considerably as monetary conditions eased, but it has since widened again. In mid-1973, Treasury bills once again paid close to 8 percent, far above the new ceilings on savings accounts.

Consequently, major fluctuations in savings accounts have occurred in response to rapid changes in money rates. The net increase in household savings dropped from $27.0 to $19.4 billion between 1965 and 1966, and more dramatically, from $29.0 to $4.6 billion between 1968 and 1969. Despite the easing of rate ceilings in 1973, this year should witness a substantial decline from 1972's unprecedented savings inflow of $77.5 billion.

Phasing out Q?

The usefulness of interest-rate ceilings has been heavily debated during past inflationary periods, but the discussion has been given greater focus in recent years by the Commission on Financial Structure and Regulation—the Hunt Commission. (The Commission submitted its report in December 1971, and the Administration has since been mulling over its recommendations.) One of its major proposals was for the elimination of interest-rate ceilings, largely because of the danger of disintermediation.

The Commission argued, however, for a gradual phasing-out of such ceilings on consumer deposits. The group reasoned that many banks and thrift institutions are locked into substantial long-term investments at relatively low returns, so that they are sensitive to the interest-rate risks of a fully deregulated market. The latest policy measures apparently support this reasoning, since rate ceilings on all but the longest-maturity consumer deposits have only been increased —and not suspended completely.

William Burke

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/27/73	Change from 6/20/73	Change from year ago Dollar	Change from year ago Percent
Loans adjusted and investments *	73,424	+ 509	+ 9,898	+ 15.58
Loans adjusted—total*	56,185	+ 318	+ 10,181	+ 22.13
Commercial and industrial	20,119	+ 6	+ 3,278	+ 19.46
Real estate	16,460	+ 88	+ 2,787	+ 20.38
Consumer instalment	8,354	+ 43	+ 1,343	+ 19.16
U.S. Treasury securities	5,775	+ 124	− 549	− 8.68
Other securities	11,464	+ 67	+ 266	+ 2.38
Deposits (less cash items)—total*	71,044	+ 327	+ 8,790	+ 14.12
Demand deposits adjusted	21,083	+ 64	+ 1,898	+ 9.89
U.S. Government deposits	878	+ 58	− 76	− 6.74
Time deposits—total*	47,864	+ 213	+ 7,005	+ 17.14
Savings	18,040	+ 75	− 159	− 0.87
Other time I.P.C.	20,311	+ 166	+ 4,917	+ 31.94
State and political subdivisions	6,825	− 57	+ 1,368	+ 25.07
(Large negotiable CD's)	9,744	+ 179	+ 4,560	+ 87.96

Weekly Averages of Daily Figures	Week ended 6/27/73	Week ended 6/20/73	Comparable year-ago period
Member Bank Reserve Position			
Excess reserves	86	− 20	26
Borrowings	186	235	5
Net free (+) / Net borrowed (−)	− 100	− 255	+ 21
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions			
Net purchases (+) / Net sales (−)	+ 808	+ 509	−1,347
Transactions: U.S. securities dealers			
Net loans (+) / Net borrowings (−)	+ 168	+ 608	− 189

*Includes items not shown separately.

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