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BANKS AND RISING INTEREST RATES

Talk by Darryl R. Francis, President,
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The commercial banks of the United States are currently subject to exceptional dynamic change. The central force in this rapid development is a tremendous demand for loan funds.

I propose in this discussion (1) to outline some of the basic facts relative to recent trends in banking, (2) to consider the causes of our present situation, and (3) to examine effects and some necessary policies.

Basic Facts

By way of background, commercial banking has had three phases in the past 20 years. First, up to 1960 the banks were not our most dynamic financial institutions. The decline in the relative role of commercial banks had been going on since the beginning of the century. In 1900 commercial banks had 55 per cent of the assets of all financial institutions; by the 1950's this had fallen to about one-third. The fact that commercial bank deposits were 78 per cent of all deposit-type funds in 1950 and by 1960 had fallen to 65 per cent is evidence that the trend continued for another decade.

Beginning about 1961 and extending until last year commercial banks began to play a more vital role in the nation's financial picture. From 1960 to 1965 total time and savings deposits increased 15 per cent per year, or twice as fast as in the previous decade. Demand deposits

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also increased much faster in 1960-65 than in the previous five years. As a result of these faster growth rates, commercial banks regained a part of the ground lost in prior years.

During the past year the course of commercial banking was again in some respects reversed in response to changing economic circumstances. The changed circumstances are: (1) Excess total demand for production has developed, primarily in response to a highly stimulative Federal budget. (2) A great demand for loan funds by business has followed from the excess demand for goods and services. (3) These great loan fund demands in the private sector, plus the direct effects of the Federal budget on borrowing and saving, have pushed the demand for funds ahead faster than the growth in fund supplies. (4) This demand and supply situation has pushed market interest rates steadily upward.

Since a year ago yields on long-term bonds have risen 50 basis points and on 90-day Treasury bills 150 basis points. Rates paid on large negotiable certificates of deposit have risen a full percentage point, and rates on commercial paper, one-and-a-half percentage points. (5) Under these circumstances of rapidly rising interest rates, the rates paid by financial intermediaries such as commercial banks and savings and loan associations have lagged behind other rates. Intermediaries have thus found it increasingly difficult to maintain their role in the flow of saving into investment. Savers have tended more to invest their saving directly, and funds have tended more to flow through the open market at the expense of financial intermediaries.

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Underlying Causes

I turn now to some of the underlying causes of these changed conditions. In response to the market demand for investment and loan funds, interest rates in general have been pushed up rapidly during the past year. The rates paid by commercial banks have not led in this movement and, indeed, may have lagged the general trend. As open market rates increased in response to supply and demand forces, loanable funds tended to bypass commercial banks. It became necessary for commercial banks to increase the rates they paid to avoid further deterioration of their relative role in the financial process. Bankers strive to be able to meet the financial needs of their customers. It is in response to these general market forces that interest rates have risen on large negotiable CD's, as well as on other certificates of deposit, and on savings accounts. If banks had not raised these rates, funds would have flowed to a much greater extent through other avenues and much less through the commercial banks.

At this point let me give you my views as to why interest rates have gone up so greatly in the past year. Interest rates generally trend upward in periods of economic expansion. This usual behavior of rising rates occurred from 1961 to 1965. During the past year, however, rates spurted upward much more rapidly. Why have we had this great rate increase during the past year? As I see it, the increase came from a jump in demand for loan funds, not from a restriction on supply. At least it did not come from any Federal

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Reserve restriction before this past summer. In the year ended in May, Federal Reserve credit grew 8 per cent, bank reserves 5 per cent, bank credit 9 per cent, and the money supply 6 per cent. These do not appear to be restrictive rates of growth.

It was said that the Federal Reserve was a major factor causing higher interest rates when the discount rate and the Regulation Q ceiling were raised in early December 1965. However, interest rates had already been moving up strongly for several months prior to these actions. In the last half of 1965 Treasury bill yields had moved above the discount rate. Also, practically every other interest rate had trended strongly upward. The discount rate and the Regulation Q ceiling were adjusted upward only after market rates had moved.

We find then that interest rates moved up because of the great demand for loan funds. This, in turn, was due to the very easy Federal budget beginning a year ago. An easy budget led to excessive total demand for loan funds.

Treasury actions have also exerted upward pressure on some interest rates. Interest yields on long-term U. S. Treasury bonds have recently been about 4.80 per cent, 55 basis points above the 4.25 per cent maximum the Treasury is allowed to pay on new issues. The market rate on these securities rose above the 4.25 per cent limit about September 1965. Since then, the Treasury has been forced to do all its financing with securities

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bearing five years' maturity or less. As a result, the average maturing on Treasury securities has declined from 64 months a year ago to 59 months. This trend may be interpreted as a progressively stimulative or inflationary factor. With the Treasury estopped from issuing securities with more than five years' maturity, the yield on 3-to-5-year U.S. issues has moved upward from 4.25 a year ago to 5 per cent in June, and to the neighborhood of 5-3/4 per cent in recent weeks.

Another remarkable aspect of Federal government debt management has been with respect to agency issues. Here the yields have risen more than yields on comparable direct obligations of the government. The sale to the public by various agencies of participations in their portfolios has placed upward pressure on their interest rates.

The main key to lower interest rates without further upward pressure on prices would be a less expansive budget. This could be achieved through either an increase in tax rates to pay for Federal expenditures or a reduction of expenditures. Attention is beginning to be given to this possibility.

Market Interest Rates Affect Bank Deposits

In response to rising market rates in late 1965 and relatively inflexible rates paid by banks, commercial banks began to find it difficult to hold deposits. The maximum interest rate on certificates of deposit was raised at the end of 1965. Subsequently, in early 1966, the rates on 4-to-6-month prime commercial paper and on prime bankers' acceptances were about 5.0 per cent. Rates on both

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were well below the new 5-1/2 per cent Regulation Q limit. Under these circumstances, banks were permitted to meet competitive market rates. However, these market rates moved steadily upward and in June reached about the upper limit that commercial banks are permitted to pay on time deposits. In July rates on such paper moved above the maximum level permitted by Regulation Q. Recently commercial paper rates have been 38 basis points and bankers' acceptances 25 basis points above the maximum that can be paid on bank certificates of deposit. Consequently, banks are facing very great difficulties in attracting and holding funds. The volume of time deposits has recently been under great downward pressure due to the higher rates being paid on open market funds.

Bankers experienced their first difficulties in attracting and holding funds almost exactly a year ago. Through August 1965 CD's were increasing at a rate of about 33 per cent a year. In September, however, the rapid rate of increase of CD's fell markedly. Since then their rate of increase has declined until in the last three months they rose at a rate of only 3 per cent a year. With regard to total time and savings deposits banks were able to continue to increase these accounts through October 1965 at about the 15 per cent rate of the past five years. This was due to rapid increases in savings-type CD's and in savings accounts. But since last October the rate of increase in total time and savings deposits has declined from the 15 per cent rate to a 9 per cent rate in the last three months. This experience has, in general, been common to all the financial intermediaries. Commercial banks, however, have fared better than some others.

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Recent Decline of Demand Deposits

While banks have been able to attract time and savings deposits somewhat less rapidly since last fall than previously, demand deposits continued to grow at a relatively high rate until quite recently. Private demand deposits grew 5-1/2 per cent during the year ending in May 1966. This was the fastest growth in demand deposits for any year since the Korean War. Thus, monetary expansion or restraint, up to three months ago, was not a factor in the tightness of credit markets and the rising interest rate. Such pressures appear to have come from the demand side and not from monetary actions.

This picture may have changed somewhat in the past few months. Private demand deposits have declined in the past three months. The money supply, of which these deposits are the main component, has accordingly declined. This is the first such decline in several years. In this connection I want to emphasize two points: First, the reduction of money supply was not responsible for the rise in interest rates and the tight situation of the banks during the past year as a whole. Up until May or June of this year bank reserves and the money supply were rising rapidly. Second, in view of the general inflationary situation and the stimulative Federal budget, monetary restriction may be necessary if we are to avoid progressive inflation.

So long as the basic supply and demand situation with respect to loan and investment funds produces high general interest rates, it is necessary for the commercial banks to go along with these trends. Banks must both pay high rates and charge high rates if they are to

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perform their function in the economy. In many ways the high and increasing general level of interest rates is disruptive and undesirable. But if the general level of rates needs to be kept down, total demand for loanable funds must be reduced. Public policy can accomplish this only by influencing the supply and demand situation with respect to the total product of the economy. The only way we know to accomplish this is by a more restrictive Federal budget which may be shaping up and possibly also by a somewhat less rapid monetary expansion. It is to be noted that the rapid upward movement of interest rates in the past year started just when we reached a very high level of resource utilization. Simultaneously, the stance of the Federal budget became the most stimulative in many years. More rapid monetary expansion would tend to drive up total demand. Demand for investment funds would rise further, and after these increments to the credit supply are absorbed, interest rates will continue up.

So long as the basic influence of supply and demand conditions upon interest rates is stimulative, attempts to restrict rates paid by various types of borrowers will only interfere with the most efficient operation of the economic system. Limitations upon the interest rates paid or charged by financial institutions, including the commercial banks, mean that funds will flow through other avenues, notably the open market. When funds flow through the open market, a special advantage is given to those who can most effectively use that market. Both users of funds and suppliers of funds in that market are benefited. Generally speaking, more use of the open market

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means that the big borrowers get special access to funds and big savers get special benefits of the higher interest rates paid. On the other hand, when interest rates paid by the banks are limited, small borrowers who cannot get use of the open market tend to be deprived of their customary share of funds. Furthermore, small savers who cannot get use of the open market tend to receive relatively low interest rates. In other words, such restrictions tend to be most damaging to one group for which help is intended, namely, the small borrowers.

Effects and Necessary Policies

As demands for loan funds have continued unabated or even increased, and as the flow of funds to the banks has declined in recent months, banks have had a hard problem allocating available funds. Because of the great investment plans of business, and the increasing needs for funds to finance payrolls, inventories and sales credit, bank loans to business have expanded with exceptional rapidity. In some respects this may have been a reasonable rise of credit from the standpoint of the banks and of the economy in general. At a time, however, when total demand is excessive and planned investment exceeds planned saving, it is necessary that some plans get cut out. At such a time it may be reasonable that the plans cut will be those for long-term investment, that is, those for capital goods which will yield their services only over a long period of time.

It is reasonable that investment for the time being be concentrated in capital goods which will produce most in the near future.

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Longer-term investment may be postponed until total demand has been brought into line with productive capacity and planned investment in line with planned saving. This is what has happened. Bank credit has been flowing in greater measure to meet the short and intermediate needs of business. It has been flowing in less measure to meet the very long-term uses of housing and public construction. The demand for housing credit, and in a sense the needs, may have been somewhat less intense than for short- and intermediate term production credit. During the past year, while the interest rate on corporate bonds has increased about 30 per cent, that on conventional first mortgages has increased 13 per cent.

Commercial banks have done a tremendous job of adapting their operations to the stresses and strains of the past year. You have had to adjust to the excessive demand for loan funds. In the face of rapidly rising market interest rates you have attempted to retain deposits and attract new funds. You have had some success; your total time and savings deposits have continued to increase, though at a declining rate.

In conclusion, if we are to avoid the disruptive effects of continuing increasing high interest rates, we must have proper limitations on total demand for goods and services. These could be provided primarily by an adequately restrictive Federal budget and by accompanying limitation on monetary expansion. The President has asked Congress to suspend for 16 months the 7 per cent tax credit for new business investment in equipment and the accelerated depreciation

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of buildings and structures. In addition, the Secretary of Treasury has announced a freeze on new borrowings by Federal agencies until the end of the year. These actions should, to some extent, serve to moderate over-all demand in the economy and strains on credit and financial resources.

The steps which are necessary to restrict total demand in general and price inflation are the same as those necessary to limit the demand for investment funds. These steps will also keep in bounds the upward surge of interest rates. A tighter Federal budget and monetary restriction can do the two necessary jobs. They can keep down total dollar spending and stop inflation. They can keep down credit demand and keep interest rates in bounds. If these steps can be taken, the current problems of banks, savings and loan associations, and other financial institutions can be solved.

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