

AN ALTERNATIVE ROUTE TO ECONOMIC STABILIZATION

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The route taken to economic stabilization in the past year is a subject of great concern to all of us. It is of particular concern to bank lending officers who have taken some severe lumps. It is my belief that there is a more equitable route to stabilization objectives than the one which we have taken.

I shall begin this discussion with a brief review of the excesses created in the second half of the 1960's which led to the need for restrictive monetary actions last year. The nation experienced excess demand for goods and services as a result of highly expansive monetary policies from 1965 to early 1969. Money grew at the annual rate of 5.5 per cent from May 1965 to January 1969. The stock of money grew in excess of 7 per cent per year during 1967 and 1968. In response to excessive monetary growth, the general price index, which had been increasing one to two per cent per year in the early 1960's, accelerated to 5.1 per cent in 1969. Consumer prices rose in excess of 6 per cent per year during 1969 and are expected to continue up this year, since prices tend to lag most other indicators of economic activity. Reflecting expectations of further price increases, interest rates have risen to record levels in recent months.

Public policies were adopted in early 1969 to brake the pace of an overly expansive economy. Growth of the money stock declined in the first half of the year to a 4 per cent rate. At midyear monetary actions became quite restrictive when the growth rate of money declined to less than 1 per cent. Restrictive monetary actions were necessary and their overall impact on economic activity has been desirable.

Several sensitive indicators suggest the impact of the slower rate of monetary growth on economic activity. Industrial production has declined for five consecutive months. The rate of personal income growth in recent months was only about half the rate of such growth in 1968. Payroll employment has declined slightly, whereas such employment rose more than 3 per cent in 1968. Corporate profits turned down in the third quarter of last year and retail sales have shown little growth since last spring. By the fourth quarter, growth of total spending had declined to an annual rate of 4 per cent, well below spending rates earlier in the year. There are few who question the fact that the more restrictive monetary actions have been effective in reducing the rate of growth in total demand for goods and services. Despite the continued persistence of price increases, I am sure that the restrictive actions will soon have a significant impact on prices and interest rates.

Impact of Restrictive Actions Uneven

My remarks, however, shall not be addressed to the need for restrictive monetary actions or to their overall impact. Instead they are concerned with the particular monetary actions that have been maintained over this period. These actions were of two distinct types. One type of action was taken to restrict the growth of such monetary aggregates as total bank reserves, the monetary base, and the stock of money - actions that limit total credit in the economy. A second type of action involved restrictions on rates that banks and savings and loan associations could offer for savings. The impact of interest rate restrictions is primarily on financial intermediaries with little or no influence on total credit flows. Attraction of savings was unduly limited by these actions. Since January 1969 borrowers who were limited to banks and other financial intermediaries for funds were thus more restricted by monetary actions than large corporate business which had access to capital markets.

Financial Intermediaries Overly Restricted

Total bank deposits have declined at a 3 per cent rate and time deposits at a 6 per cent rate since January 1969. In contrast to this abrupt decline, total deposits rose at the rate of 8.5 per cent and time deposits at an 11 per cent rate from 1960 to 1968. Demand deposits continued to grow last year,

but at a slower rate than heretofore. The sharp turnabout of time deposits coupled with the slower rate of growth of demand deposits last year suggests that something other than general monetary actions was the primary restrictive force on bank and savings and loan association lending. Overall lending capacity of banks, however, was not diminished quite as much in 1969 as indicated by the deposit loss. They resorted as never before to capital markets by selling debentures, capital notes, etc. Through this route banks were able to increase total bank credit by 1 per cent during the year, all of which occurred early in the year. Bank credit has declined in recent months as a result of the more restrictive monetary actions since June.

Savings and loan associations were likewise subject to the same forces as commercial banks. After having risen at the annual rate of 10 per cent from 1960 to 1968, shares in savings and loan associations rose only 3.6 per cent in 1969, and in recent months there has been no gain in such share holdings.

#### Residential Construction and Small Business Investment Slacken

Reflecting the slower rate of growth of funds available to financial intermediaries and thus less mortgage credit, residential building declined during 1969. Such construction declined from an annual rate of \$25 billion in the first quarter of 1969 to an annual

rate of \$22.6 billion in October. Lending officers recognize that some credit remains available for home purchases, but at rates and terms which have greatly reduced the market demand for homes.

A slower rate of capital expenditure also developed in the noncorporate nonfinancial business. Capital expenditures by such firms, which account for about 50 per cent of total nonfinancial business investment, rose only 3.7 per cent in the year ending with the third quarter of 1969 from a year earlier. In contrast, capital outlays by these firms rose 5.5 per cent per year in the four years 1964-68. Furthermore, the growth of such investment declined sharply in the third quarter 1969 as a result of the more restrictive monetary policies at midyear. Like the housing industry, these firms are largely dependent on financial intermediaries for credit.

#### Large Corporate Business Expands

In contrast to the severe pinch on the financial intermediaries, credit to corporate business apparently continued unabated. Credit market liabilities by such firms rose 42 per cent in the first three quarters of 1969 from a year earlier. Such liabilities rose only 23 per cent per year from 1964 to 1968. Bank loans to corporate business did decline as monetary actions became more restrictive after mid-1969; however, such declines

were more than offset by sales of commercial paper and reductions in corporate holdings of government securities and time deposits. As a result, capital expenditures by corporations continued up in the first three quarters of 1969, averaging 16 per cent more than a year earlier. Furthermore, capital investment of such firms continued to rise in each succeeding quarter through the third quarter 1969 despite the restrictive monetary actions. Such expenditures grew only 10 per cent per year from 1964 to 1968.<sup>1/</sup>

Interest Rate Restrictions Cause of Disparity

I believe that these data are sufficient to point up the uneven impacts by sector of the combination of public policies used in the 1969 restraint program. I am biased neither for nor against big business per se. It is evident to me, however, that the particular set of monetary actions taken in 1969 was heavily weighted in favor of big corporate business and against small business and residential construction and consumers.

Regulation Q restrictions in the face of the restrictive monetary actions were responsible for intensifying the stabilization problem. These restrictions on interest rates caused turmoil in financial markets and interrupted the ongoing process of credit operations at commercial banks and savings and loan associations.

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1/ Board of Governors of the Federal Reserve System, Flow of Funds, Seasonally Adjusted Third Quarter, 1969.

Just as any other price, interest rates are subject to the forces of supply and demand. Similar to controls on other prices, controls on interest rates lead to other problems of allocation and use.<sup>2/</sup> When the ceiling rates for savings are set at levels lower than the market warrants, savers withhold their funds from these financial agencies, and the flow of credit to these agencies declines. It then becomes necessary either to ration the credit or charge higher rates to borrowers in order to distribute the shortage. In a free market the rates would be bid up to a point where the quantity offered and the quantity taken are equal. Interest rate controls are not consistent with this principle of equating supply and demand.

#### Ceilings Set Too Low

To demonstrate the impact of interest rate ceilings, let's discuss for a moment your reaction as lending officers to usury laws. When permissible rates which you can charge on a given type of loan are less than rates on other types of loans or investments, you reduce your loans in the controlled areas. You place your funds in other areas where higher earnings are permissible. You try to maximize your returns, given the usual risk constraints.

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<sup>2/</sup> For a discussion of interest rate controls, see Clifton B. Luttrell "Interest Rate Controls -- Perspective, Purpose, and Problems" in the September 1968 issue of the Federal Reserve Bank of St. Louis Review.

Evidence indicates that many of your time and savings depositors invest their savings in the same manner that you invest your bank funds. They attempt to maximize returns on such savings, given their individual liquidity and safety constraints. When competitive market rates rise above the maximum rates that banks and savings and loan firms are permitted to pay, many savers withdraw their funds and invest them at the higher rates. This is what has happened during the past year.

Although the latest change in the maximum permissible rates on savings deposits was in 1964 and on time deposits in April 1968, the relationship between these ceiling rates and market rates has greatly changed. For example, in November 1964 ceiling rates were last set on all savings accounts at 4 per cent, slightly above the rate on 90 day Treasury bills and about equal to the rate on prime commercial paper. By last December, however, the rates on Treasury bills and commercial paper had increased more than 400 basis points. Since April 1968, when rates were last increased on time deposits, average rates on Treasury bills and prime commercial paper have risen more than 250 basis points.

As a result of the widening disparity in permissible rates on savings and market rates on other debt instruments, many savers shifted their savings from the financial intermediaries where rates are

controlled to other debt instruments with the higher yields. The gap between permissible and market rates widened with the more restrictive monetary policies after mid-1969, and the shifting of savings from intermediaries to other credit instruments picked up momentum. Total time and savings deposits at weekly reporting banks declined from \$112 billion in December 1968 to \$96 billion in December 1969.<sup>3/</sup> The shift would have taken place at these rate differences without the restrictive monetary policies. The fact that the shift picked up momentum simultaneously with the more restrictive monetary policies, however, is not coincidental. The more restrictive policies caused a temporary rise in the market rates, thus contributing to the rate disparity and to the disintermediation.

#### Disintermediation Unnecessary

Disintermediation is unnecessary for economic stabilization. The total flow of savings into debt instruments is not greatly retarded by rate ceilings for bank deposits and savings and loan shares. The larger savers simply shift from one means of investment to another. I doubt whether such shifts have a measurable impact on the velocity of money and on total demand created by a given money stock.

As indicated earlier, the major result of these rate restrictions is that some sectors of the

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<sup>3/</sup> These banks account for over half of all commercial bank time and savings deposits.

economy are favored at the expense of other sectors. The fact that banks and savings and loan associations are prohibited from bidding up the market price on funds means that larger supplies of credit are available to those who are not restricted by ceiling rates. Larger corporate business has this freedom. It can issue relatively safe debt instruments to the public, and, with the restrictions on banks and a shortage of bank credit, corporations took advantage of this opportunity last year by selling more credit market instruments.

In the absence of rate restrictions the banks and savings and loan associations would have purchased some portion of the funds which ultimately went to larger corporations and Government agencies. With higher rates on time and savings deposits and savings and loan shares, these funds would have continued to grow. Some additional credit would have been fed out to all sectors of the economy and the disparity in activity among the various sectors would have been less than it actually was.

In my view, the restrictive monetary policies cannot be blamed for the sharp cutback in residential construction and relatively low rate of growth in unincorporated business. This was caused by the strangling of our efficient financial intermediaries through restrictions on rates that they were permitted to pay savers. In the absence of such controls residential construction would probably have continued up. Unincorporated business

investment would have continued up at a slower rate than in prior years, but at a somewhat faster rate than actually occurred. Larger corporate business investment would have slowed along with other sectors of the economy since part of the funds obtained from savers through sales of credit market instruments and other assets would not have been available. It is impossible to quantify these amounts because we do not know the demand elasticities for credit by the various sectors.

The restrictions on interest rates not only affect banks and savings and loan associations, but also create major equity problems. For example, it seems to me that the potential home buyer should have the same basic right to the credit market as a large corporate business. I see no reason why the demand of noncorporate business for credit should not be reflected through financial agencies to savers just as the demand by large business can be reflected directly through sales of commercial paper. I furthermore see no reason why small savers should be denied a market rate on savings. This proliferation of rate ceilings according to volume of savings results in market returns to those savers with higher incomes and below-market returns to others. It further widens income distribution caused by differences in inherited wealth or ability. To me this type of regulation is symbolic of an earlier age when most people were denied basic market rights, and has no place in a free democratic society.

Summary

In conclusion, the restrictive monetary actions in the past year have been effective in reducing aggregate demand for goods and services. Lower interest rates and a slower rate of growth in prices will follow after a reasonable time lag.

The reduction in total spending growth was much greater in some sectors than in others. Sectors which require large quantities of credit in relation to total costs and which are limited to banks or savings and loan companies for their credit were restricted more than other sectors. Examples of the more restricted activities include residential construction and small business investment. Borrowers in these sectors were too small to enter the capital markets directly and were, therefore, cut off from all possibility for growth when the restrictions began to cause a reduction in bank and savings and loan balances. Larger corporations, however, were able to offset losses in bank credit with gains in commercial paper sales and a reduction in their inventory of Government bonds.

Without the rate restrictions, I believe that the impact of the restrictive policies would have been distributed equally among all credit users. Banks and savings and loan associations would have obtained more funds if permitted to pay higher rates to savers. Some larger corporations would have reduced their borrowings at the higher rates and the change in the rate of economic

activity would have been more nearly uniform among all major sectors.

In addition to the greater impact of the interest rate restrictions in some sectors, the equity considerations of such regulations are important. They arbitrarily deny small users of credit the opportunity to compete with big business for funds and small savers the opportunity of receiving a market rate for their savings.